13. FDI Protectionism is on the Rise

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Foreign direct investment (FDI) is the most important vehicle to bring goods and services to foreign markets. The rise of FDI was made possible, to a large extent, by an enabling regulatory environment, and there is no doubt that countries continue to improve the regulatory framework for FDI. At the same time, however, there are strong and visible signs that a re-evaluation of the open framework for FDI is under way, and this is reflected in the national and international regulatory rules governing this investment.[1]

So far, this change is most distinct at the national level. UNCTAD[2] reports that, of a total of 1,550 regulatory changes made during the period 1992-2002, only 6% were unfavorable to MNEs. The share of unfavorable changes doubled to 12% during 2003-2004, and again almost doubled to 21% during 2005-2007. Overall, countries that had implemented at least one regulatory change that made the investment framework less welcoming during 2006-2007 accounted for some 40% of world FDI flows-an impressive figure that demonstrates quite convincingly that a change is underway.[3] Moreover, no data are available on the extent to which unchanged laws and regulations are implemented in a more restrictive manner, increasing informal barriers to the entry and operations of foreign investors in a discriminatory manner.

Not every measure that makes the investment climate less welcoming for foreign direct investors is protectionist. Basically, there are two situations that qualify as FDI protectionism: In the context of inward FDI, FDI protectionism involves new measures by public authorities that are taken to prevent or discourage foreign direct investors from coming to, or staying in, a host country. In the context of outward FDI, FDI protectionism involves measures directed at domestic companies that require them to repatriate assets or operations to the home country or discourage certain types of new investments abroad. In fact, the definition is more complicated because, for instance, measures taken in the interest of legitimate public policy objectives – e.g., protecting national security, seeking to increase the contribution of FDI

1 For a full discussion, see. Karl P. Sauvant, "Driving and countervailing forces: a rebalancing of national FDI policies," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2008-2009* (New York : Oxford University Press, 2009), pp. 259-260.

2 UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008).

3 This was also recognized by the G20 in their meetings of November 2008 and April 2009, when they called for a moratorium on new investment protectionist measures.

to the host or home economy – are not necessarily instances of FDI protectionism, even if they make the investment climate less hospitable for foreign investors.

Even with this caveat, there has been a rise of FDI protectionism. It predates the current financial crisis and recession, suggesting that a reevaluation of the costs and benefits of FDI had already been underway.[4] Interestingly enough, developed countries have led this change in approach, i.e. countries that, in the past, had been the champions of the liberalization of entry and operational conditions for foreign investors and the protection of these investors under international investment law. The principal approach that has been taken is to evoke 'essential security interests' or similar concepts, such as 'national interests', to screen foreign investments at the national level.

The measures taken by the US are illustrative. On the one hand, the US remains one of the most open countries for FDI, as underlined, for example, in the May 2007 statement on 'Open economies' by President George W. Bush. At the same time, though, and especially in the aftermath of 9/11, national security concerns have risen in prominence. For the US, this concept involves primarily (but not only) military security (not defined), and therefore focuses on the protection of sectors that are important from that perspective, including 'critical infrastructure' (also undefined). To ensure that cross-border M&As do not infringe on national security, the authority of the Committee on Foreign Investment in the United States (CFIUS) to screen such transactions was strengthened in 2007 through the Foreign Investment and National Security Act (FINSA). There is a presumption that any M&A by a foreign sovereign investor (be it a state-owned enterprise or a sovereign wealth fund) reviewed by CFIUS needs to be investigated, unless it is determined at the stage of the review that no national security concerns remain. Not surprisingly, the number of notifications to CFIUS and the number of investigations rose from, respectively, 55 and 1 in 2001 to 165 and 22 in 2008. It is not known how many cross-border M&As that were intended or initiated did not go forward because of the new US regulatory framework.

In other developed countries, concerns regarding national interests are more of a political and economic nature. In Europe, they involve particularly sovereign FDI from Russia (and, perhaps in the near future, from China) and, more broadly, the protection of national champions. Thus, Germany strengthened its screening mechanisms for non-EU investment early 2009 and France issued a decree in December 2005 regarding the authorization procedure for M&As in certain sectors. In Japan, legislation was strengthened in 2007 through a requirement for foreign investors to notify the Government 30 days in advance if they planned to acquire 10 percent or more of listed companies with technology that can be used in weapons systems. Australia and Canada modified their own screening mechanisms, with the former strengthening in 2008 the examination of investment projects by sovereign investors and the latter introducing a national security test in 2009.

Among emerging markets, China strengthened its review system in 2006, focusing

4 The financial crisis and recession may dampen the rise of FDI protectionism as countries seek capital to shore up local firms and to increase investment to help them emerge from the recession. But the crisis may also accentuate protectionism, especially if nationalistic impulses gain the upper hand, perhaps stimulated by fire-sales of domestic assets (as we saw during the Asian financial crisis).

on approval for transactions that, among other things, involve critical industries or may have an impact of the country's national economic security. And Russia has, since 2008, a law that requires that transactions between foreign investors and Russian companies be subject to government approval if certain conditions are met.

These national actions are supplemented by supranational efforts, although these are voluntary in nature. Thus, the EU Commission sought to complement the national approaches of members of the Community by elaborating guiding principles concerning SWFs. The OECD produced guidelines for host country investment policies relating to national security. And the International Working Group of Sovereign Wealth Funds agreed in 2008 on ‘Generally Accepted Principles and Practices’ and submitted them to the IMF's International Monetary and Financial Committee.

Several features characterize these actions. For one, they seek to balance support for an open investment regime with a desire to have sufficient flexibility to stop undesired foreign direct investments, typically involving cross-border mergers and acquisitions (M&As). The criterion most often used is ‘national security’ or related concept – but, and this is crucial, these concepts are not defined precisely but rather left open for definition by national governments. Screening mechanisms have the task to do that, but their decisions are typically the result of ‘black box’ deliberations and cannot be appealed. Such screening mechanisms, deciding on a case-by-case basis, make the investment climate less predictable and less transparent. However, it is clear that sovereign investors receive special attention, i.e., they are treated differently from domestic investors, especially when they are headquartered in emerging markets. Among other things, this reflects the fear that such investors pursue not only commercial interests but also political interests of the governments involved. While governments need of course the flexibility to pursue legitimate public policy objectives – be it national security or economic development – the boundary line between protecting legitimate national interests and protectionism is a fine one. This makes it all the more important to watch these new regulatory developments closely, especially also since the rules that are being put in place leave considerable discretion to national policy makers, and their decisions cannot be appealed.

The changes at the national level are also leading to changes in the nature of the international investment regime, giving governments more freedom to protect what they consider is important for them in the investment area. But this greater respect for national policy priorities is also logical from another perspective: the international investment regime as it has evolved over time has focused almost exclusively on the protection of international investors by conferring on them broad rights and few responsibilities, while host country governments assume broad responsibilities and have few rights.[5]

The critical challenge is to find the right balance between the rights and responsibilities of MNEs on the one hand and those of governments on the other. It needs to be a balance that combines the stability, predictability and transparency that firms need to make investment decisions with the policy space that governments need to pursue legitimate domestic policy objectives – and it must be a balance that does not

5 The underlying logic for this approach is, among other things, that MNEs are, in any event, subject to the laws and regulations of host countries that can be enforced through national courts and that such a regime helps countries to attract FDI.

open the door for measures that are primarily protectionist in nature. Finding regulatory solutions to this challenge is not easy. It will require international cooperation to establish rules, especially as regards the contents of such concepts as 'national interest', a very difficult task indeed, and one – if pursued at all in the foreseeable future – that will take considerable time. In the meantime, the best that can be done is to establish an FDI Protectionism Observatory to monitor new FDI protectionist measures and 'name and shame' the countries that take them.

About the author

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