Ways to stem the drift into protectionism

June 25, 2008
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After two decades in which most of the world embraced open investment policies, producing investment flows that grew at nearly twice the pace of global trade, some governments are putting up new barriers to foreign acquisitions.

In April, the Canadian government blocked the US group Alliant Techsystems from purchasing the space technology division of MacDonald Dettwiler – the first transaction ever blocked under the Investment Canada Act. That same month the Japanese government forbade The Children's Investment Fund of the UK from increasing its stake in the electricity wholesaler J-Power, the first time it has blocked a foreign investment in a public company. Controversy led to Dubai investors pulling out from acquiring the Auckland airport; months later, the government of New Zealand blocked a Canadian pension fund's proposed 40 per cent stake in the same airport.

In a Council on Foreign Relations report released today, we show that in the past two years at least 11 big countries, which together received more than 40 per cent of world inflows of foreign direct investment in 2006, have approved or are considering new rules to restrict and/or expand government scrutiny of FDI. In 2005 and 2006, the United Nations tracked record numbers of new FDI restrictions worldwide.

What accounts for this protectionist drift in FDI policy? One of the main reasons, as was shown by the congressional furore two years ago over Dubai Ports World's proposed acquisition of some US ports, is that emerging countries are becoming much bigger foreign investors. Non-traditional sources of FDI, such as China, India and the Middle East, have exploded owing to their rapid economic growth, high energy prices and global imbalances. Much of the anxiety has been focused on the rapid growth of sovereign wealth funds, even though they have been around and investing for 50 plus years without causing problems.

Foreign investment is flowing to more sensitive sectors of the economy, including "critical infrastructure" such as ports, airports, energy and telecommunications. While it is not unreasonable for governments to review FDI in such sectors, some governments are claiming that a wide range of sectors – from mining to gambling – are "critical" and must be safeguarded.

What might be the consequences of new FDI restrictions? To date they have not measurably contracted global flows, which are influenced by many economic factors beyond government regulation. But in certain countries and industries new FDI restrictions have led to proposed transactions being denied and have deterred other potential investors. Some countries are setting up new screening mechanisms that result in longer, more complex and more regulated transactions, raising the bar for investment. Such restrictions are discouraging some FDI transactions and may have even more deleterious effects with the general slowdown in the world economy.

Restrictions on FDI flows would harm host and source countries alike. Companies acquired or established by foreign multinationals subsequently tend to show faster growth in jobs, wages, investment and productivity. And countries that invest abroad gain as well, by allowing their companies better to serve foreign markets.

New FDI restrictions could also increase the cost for financing global current-account imbalances, including in the US. Beyond selling portfolio assets such as government securities, countries can finance current-account deficits via cross-border mergers and acquisitions. This increases the stability of the world economy, because FDI is a less volatile form of international capital flow than portfolio investment.

To halt this protectionist drift, we urge a series of specific actions for governments and multilateral organisations. While national security screening of foreign investments may improve public confidence, it is easy for such reviews to slide into economic protectionism. To avoid this, we propose a code of conduct to help countries make better decisions on whether to bar certain transactions.

Investment reviews should be narrowly tailored and focused on national security, not on broader economic factors which should be left to the market. This process should provide predictability by ensuring that reviews will be conducted within a definite, short time frame. Confidentiality must be ensured. Countries should avoid automatic screening of all proposed foreign investments in a particular sector, or should screen only in those sectors that are vital for national security.

International co-operation can also help. The Organisation for Economic Co-operation and Development should help provide a road map for countries to safeguard their legitimate security interests without distorting investment. The International Monetary Fund has called for greater transparency from sovereign wealth funds and could do the same for FDI involving state-owned enterprises. The meetings of the Group of Eight leading industrial nations can reinforce sound FDI policies at the highest level.

Such new efforts are needed to stem this protectionist drift and support global economic prosperity.

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