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World investment prospects to 2010
Boom or backlash?

Special edition

The Economist Intelligence Unit

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Columbia Program on International Investment

The Columbia Program on International Investment (CPII), headed by Karl P. Sauvant, is a joint undertaking of the Columbia Law School, under Dean David M. Schizer, and The Earth Institute at Columbia University, directed by Jeffrey D. Sachs. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. The CPII focuses on the analysis and teaching of the implications of FDI for public policy and international investment law. Its objectives are to analyze important topical policy-oriented issues related to FDI, develop and disseminate practical approaches and solutions, and provide students with a challenging learning environment.

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A backlash against foreign direct investment?

By Karl P Sauvant[1], Executive Director, Columbia Program on International Investment

Following decades of liberalisation and openness to foreign direct investment (FDI), there are signs of a possible backlash. How serious are these developments: could they intensify and ultimately have a serious negative impact on global FDI flows? This article argues that in their current manifestation, various reactions to FDI do not yet add up to a serious backlash or presage a marked slowdown in FDI flows. But there is no reason for complacency. Approaches to FDI have changed in the past, and they can change again in the future. The assessment of the benefits and costs of FDI will continue to involve not only economic factors, but also considerations such as security and other political and social factors.

Introduction

Global FDI has had a good run. From US$40bn in the early 1980s, world FDI inflows reached US$955bn in 2005 and are expected to surpass US$1trn in 2006. Global FDI inflows are projected to rise further, to US$1.4trn, by the end of this decade.[2]

Furthermore, the cumulative world stock of inward FDI surpassed US$10trn in 2005 and is forecast by the Economist Intelligence Unit to exceed US$16trn by 2010. This has already made FDI the most important mechanism to deliver goods and services to foreign markets: the global sales of foreign affiliates were worth some US$19trn last year, compared with world exports of goods amounting to US$11trn. At the same time, some one-third of world trade is now intra-firm trade—the lifeblood of the growing integrated international production system.[3]

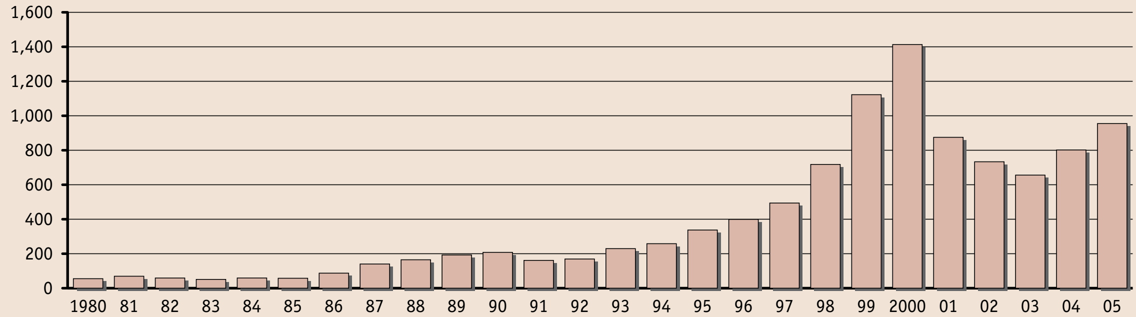
The principal driving force behind the rapid growth in FDI has been a combination of three factors:

- the liberalisation of FDI regimes, creating new opportunities for companies to expand, especially when industries are opened up for FDI;
- technological developments that make it possible to manage international business systems in an integrated manner and hence make it easier to locate parts of the value-added chain abroad (including through the offshoring of services); and
- competition among firms that drives them to take advantage of the new opportunities and technological possibilities.

Global FDI has had a formidable run, indeed—but is it coming to an end? Will the driving forces of FDI weaken because of a possible backlash?

FDI can bring with it a range of benefits, including capital, technology, skills, higher wages, access

Global FDI inflows
(US$ bn)

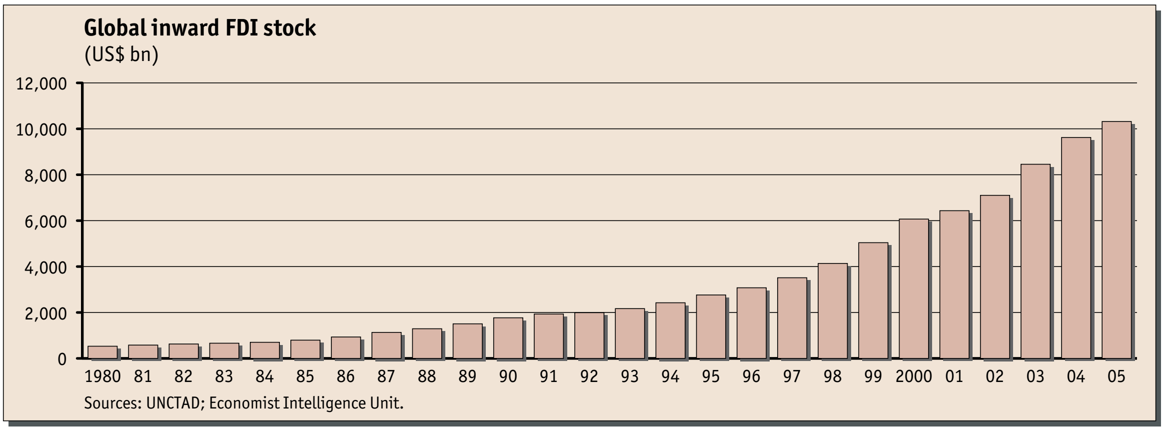


Sources: UNCTAD; Economist Intelligence Unit.

[1] I wish to acknowledge helpful comments from Laza Kekic, Persa Economou, Padma Mallampally and Chris Wilkie.

[2] See the article in this volume by Laza Kekic, "Global foreign direct investment: recent trends and forecasts to 2010".

[3] See also Samuel J Palmisano, "The globally integrated enterprise", *Foreign Affairs*, vol. 85 (May/June 2006), pp. 127-36.



to markets, more competition and cheaper goods and services for consumers. However, it can also have costs, including the crowding out of domestic firms, predatory transfer pricing, restrictive business practices, and the loss of control over what many governments see as strategic sectors.

Tensions affecting FDI

FDI is thus characterised by a series of tensions. The relationship between governments and multinational corporations (MNCs)—the firms undertaking FDI—can be marked by strains arising from MNCs' pursuit of their global corporate interests and governments' pursuit of national interests. From the point of view of FDI-recipient governments, there can sometimes be a dissonance between policies designed to attract FDI and policies to maximise its benefits. For countries that are not only recipients of FDI, but are also significant outward investors, tensions are possible between the country's interest as a host country and its interests as an investor country. Finally, there are the constraints that the growing integrated international production system (and its intra-firm international division of labour) and international investment laws place on the national policy space of countries. The key is how these various tensions are balanced, how the costs and benefits of FDI are being evaluated. As a result, attitudes and approaches to FDI are often ambivalent, with supportive and sceptical attitudes struggling for supremacy in policymaking.

During the 1970s, the decade when MNCs caught the public eye, many governments felt that the costs of FDI outweighed its benefits. This was when MNCs were often seen as "new imperialists" that hindered development. Foreign affiliates were often nationalised and the entry and operations of MNCs were subject to considerable control. "Permanent sovereignty over natural resources" was the watchword of the decade, and the quest for control over "strategic industries" often informed policy. Developing countries were the leaders of restrictive actions, but developed countries were not immune, as the success of Jean-Jacques Servan-Schreiber's *Le defit americain* showed.[4]

The pendulum swings towards FDI openness

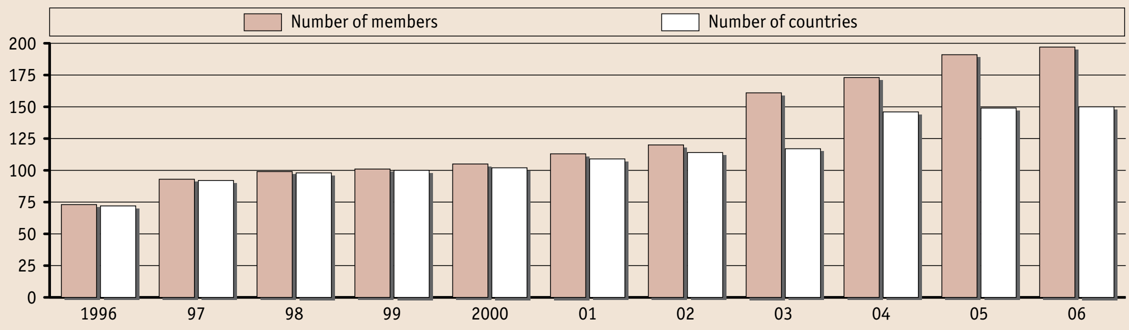
With the impetus coming from developed countries, the pendulum began to swing towards liberalisation and openness to FDI in the 1980s. From being often perceived as a problem, FDI came increasingly to be seen as a major part of the solution of how to boost economic growth and development. Nothing exemplifies this more than changes in national FDI regimes and the proliferation of investment promotion agencies (IPAs): of the 2,156 regulatory changes that took place worldwide between 1991 and 2004, 93% were in the direction of creating a more hospitable environment for MNCs.[5]

At the same time, membership of the World Association of Investment Promotion Agencies (WAIPA)—the premier association of IPAs—grew from zero in 1995 (the year of its establishment) to 200 (from 150 countries) in July 2006. By now, practically every country has one (or more) investment promotion

[4] Jean-Jacques Servan-Schreiber, *The American Challenge*, Penguin, Melbourne, 1968.

[5] UN Conference on Trade and Development (UNCTAD), *World Investment Report 2005*, p. 26.

Membership of World Association of Investment Promotion Agencies



Source: World Association of Investment Promotion Agencies.

agency whose task it is to attract FDI. These often rely on an extensive range of incentives that, at times, lead to bidding wars among or even within countries. At the international level, the improvement of the national investment climate was complemented by an increase in the number of bilateral investment treaties (meant primarily to protect FDI), from fewer than 400 at the end of the 1980s to 2,400 at the end of 2004. Moreover, today, virtually every free-trade agreement also contains provisions on liberalising investment.

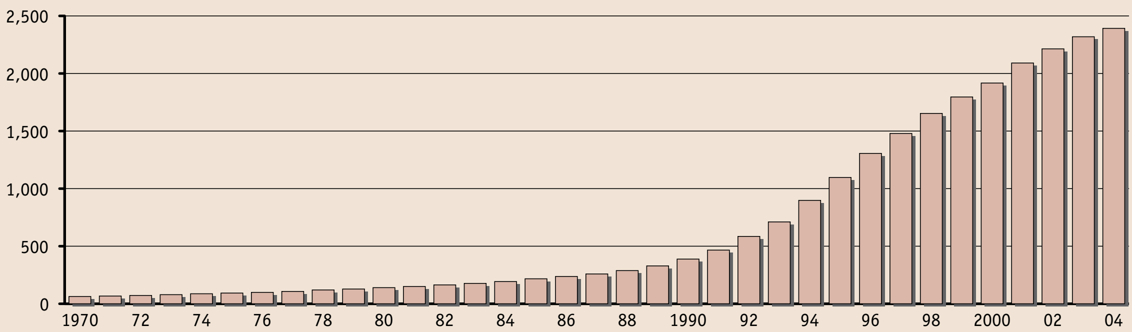
Is the pendulum beginning to swing back?

This liberalisation trend is still continuing. However, there are also several indications that the perception of the balance of costs and benefits of FDI may be changing again. Is a backlash in the making? Are we entering a phase of retrenchment in policies and attitudes towards FDI, with a possible serious negative impact on global FDI flows?

FDI is the productive core of the global economy, precisely because it reflects the establishment of an integrated international production system. Not surprisingly, to the extent that there is a backlash against globalisation and the economic uncertainty it entails, the free flow of inward and outward FDI (like the free flow of trade), and the global supply chains with which it is associated, become suspect and vulnerable, especially when political and social concerns supplement or temper economic motives.

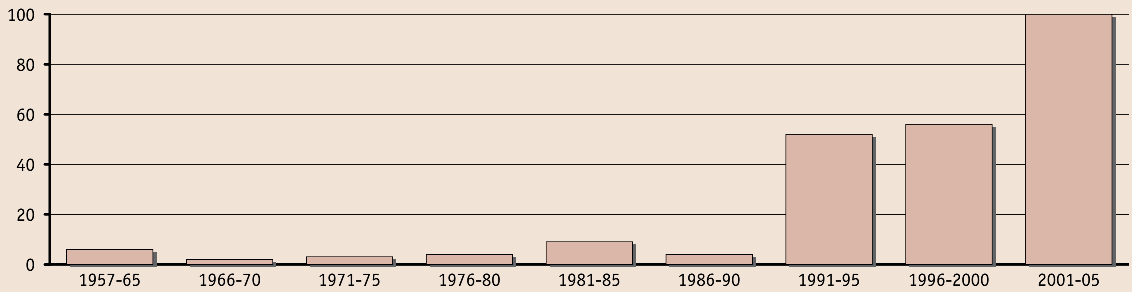
However, there are also FDI-specific issues that may affect investment flows—mostly these concern inward FDI, but some also relate to outward FDI. Inward investment in developed countries (and increasingly also in emerging markets) often takes the form of crossborder mergers and acquisitions (M&As), sometimes in the framework of privatisation programmes. In fact, since 2005 there has been a resurgence in crossborder M&As following several lean years. However, when crossborder M&As involve domestic firms that are regarded by politicians as "national champions"—perceived to be important for national security, cultural identity or economic

Cumulative number of bilateral investment treaties



Source: UNCTAD.

International investment treaties
(no. signed)



Note. Excluding bilateral investment treaties and treaties on double taxation.
Source: UNCTAD.

development (especially when reaching into what used to be called the "commanding heights" of an economy)—host-country resistance to such investment is becoming more frequent. The resistance is further fuelled in many countries by the fear of job losses.

Recent protectionist reactions in Europe and the US towards some M&As suggest that this favoured mode of entry for MNCs into other markets may become more difficult. Examples have included attempts to block acquisitions that were ultimately successful—the bid of Lenovo (China) to acquire the personal computer (PC) division of IBM (US), and the ultimately also successful bid by the Netherlands-based Mittal Steel for Arcelor (Luxembourg). However, other deals have been scuppered because of opposition, including the failed effort by CNOOC (China) to take over Unocal (US); Dubai Ports World's attempt to acquire P&O Steam Navigation Company (UK), which controlled five ports in the US; and a rumoured attempt by Pepsi (US) to take over Danone (France). A potential bid by Gazprom (Russia) for Centrica (UK) is facing difficulties, as are the bid by Germany's E.ON for Endesa (Spain) and the effort by UniCredit (Italy) to consolidate its affiliates in Poland. Such actions seem to be in tune with popular attitudes, at least in some European countries: a 2006 Harris poll showed that some 50% of respondents in Italy, France and Spain, about 60% in Germany and close to 70% in the UK[6] think that it is too easy for foreign companies to take over businesses in their own countries.[7] This may be fertile ground, potentially, for further restrictive action.

The growing involvement of foreign private equity groups in M&As adds an edge to this mode of entry into foreign markets, as such transactions are typically not seen to be long-term investments, but rather as seeking only quick profits. In Germany, this led a prominent politician to liken such investors to the "biblical plague of locusts".

Resistance to crossborder M&As was also reflected in the European Commission's takeover directive, which was diluted compared with initial drafts because of opposition by several EU member countries to a more significant liberalisation.[8] In addition, several European countries have tightened their takeover rules. In North America, a bill had been tabled in Canada to give the government new powers to review security-related FDI, and a US Senate committee sought to block the planned liberalisation of takeover rules for airlines by foreigners. Furthermore, two bills are at present making their way through the US Congress that would subject potential foreign takeovers to more rigorous scrutiny—relatively limited changes are being considered in the House of Representatives and a far more restrictive bill is before the Senate.[9] All these developments demonstrate a potentially serious reservoir of resistance to crossborder M&As.

Emerging-market MNCs attract special attention

In some developed countries there has also been an especially negative reaction to high-profile attempted takeovers by firms from emerging markets. Compare, for example, the lack of reaction to the tie-up between Alcatel (France) and Lucent (US) with the response to the bids by CNOOC or the Indian-owned Mittal Steel mentioned earlier. Or compare the reaction to

[6] Interestingly, the UK policy has been by far and away the most open to crossborder M&As among the countries mentioned here.

[7] *Financial Times*, June 19th 2006.

[8] For a recent review, see OECD, "Trends and recent developments in foreign direct investment", 2006.

[9] This is not the first time the issue is in the limelight. See the refutation of investment protectionism by Edward M Graham and Paul R Krugman, *Foreign Direct Investment in the United States*, IIE, Washington, DC, 1995. The reference is to the third edition; the first edition had been influential in stemming the trend towards making foreign investment regulation and oversight stronger during the 1980s.

the acquisition of oil assets in Africa and elsewhere by Northern and Southern firms: whereas such acquisitions by established US or west European firms barely merit a mention in the financial press, the same action by Chinese or Indian companies can become front-page news—with, sometimes, almost a hint of "how dare they" in some of the reporting. As emerging-market MNCs expand further and on a larger scale, seeking to secure natural resources, taking over brand names and acquiring technology, defensive reactions may well turn into outright restrictions.

MNCs from emerging markets, the "new kids on the block", are becoming important players in world FDI; they already account for more than 10% of the world's FDI stocks and flows. Firms from emerging markets, like MNCs from developed countries, need to acquire a portfolio of international assets to be competitive. Emerging-market MNCs are sometimes (rightly or wrongly) seen as having an unfair advantage (explicit backing and support from their governments) or being more prone than their developed-country counterparts to undesirable behaviour (low standards of governance and less socially responsible behaviour).[10] Be that as it may, established MNCs, and their home countries, will need to adjust to this new constellation of forces and its implications for world FDI.

Reactions to outsourcing of services

Another type of reaction—this time to outward FDI—may well arise as the offshoring of services gathers more speed and touches more and more white-collar workers. Advances in information and communications technology (ICT) have made all information-intensive services more tradeable: they can now be produced in one place and consumed in another. Offshoring allows, for the first time, an international division of labour in the production of services (mirroring what is already occurring in manufacturing)—with all its advantages (and risks). The potential is high, as reflected not only in the share of services in GDP (more than two-thirds in developed countries), but also in the fact that, so far, only some 10% of services production enters international trade, compared with more than half of industrial production.

A rapidly increasing number of firms are likely to locate part of their services production abroad, and it is also likely that an increasing proportion of offshoring will take place through FDI.[11] Outward FDI related to the outsourcing of services functions may trigger an intensifying reaction to losses of white-collar jobs in investor countries—similar to the reaction in the developed world to the loss of blue-collar jobs linked to outward FDI in manufacturing. The potential for an adverse response may be especially acute in some west European countries, given prevailing high levels of unemployment.[12] The absence of adequate adjustment mechanisms to deal with the rapidly unfolding revolution in the international trade and investment in services may well lead to a serious backlash against this type of outward FDI.

The growing unease with FDI has not been limited to developed countries. There are signs that it is spreading to emerging markets. This has in part been the result of the negative demonstration effect of controversies that surrounded the Lenovo and Dubai Ports World ventures in the US. Reactions in a country such as the US against FDI in certain lower-end technology industries (PCs) and infrastructure projects (harbours) send a clear message to other countries, including in emerging markets, that they also should (or can) show concern about their economic security.

For example, there is now a growing debate within China (by far the largest recipient of FDI among emerging markets) as to the merits of FDI, especially in the form of M&As (particularly in banking and insurance). There are reactions in South Korea, especially to private equity investors. Russia is considering rules to protect "strategic sectors" from foreign investors, especially—but not only—in the oil industry. In fact, concern in many countries about foreign control of natural resources (and the benefits that can be gained from them)—a dominant theme during the restrictive 1970s—is back on the agenda.

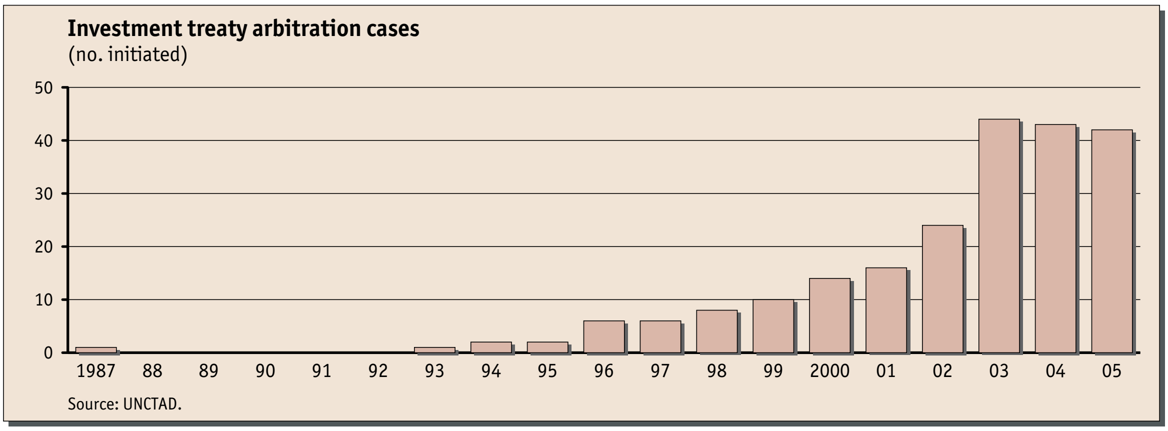
Contracts and conflicts

Contracts that define the relationship and distribution of benefits between MNCs and hosts in the case of large-scale projects in natural resources and

[10] It is interesting to note in this context that out of the over 3,000 firms that have subscribed to the United Nations Global Compact, roughly half are headquartered in emerging markets.

[11] For a detailed discussion, see UNCTAD, *World Investment Report 2004: The Shift Towards Services*.

[12] See in this context the broader discussions, involving also manufacturing, about *délocalisation* in France and "unpatriotic" outward investment in Germany.



infrastructure are being subjected to scrutiny in some countries. A number of governments (such as in Argentina, Bolivia, Ecuador, Liberia and Venezuela) are raising questions about existing contracts with MNCs because they believe (rightly or wrongly) that they did not get a fair deal. This is sometimes the result of the impression that MNCs hold all the cards when negotiating, whereas host countries are engaged in a "race to the bottom" in competing to attract investors. The concept of "twenty-first-century nationalisation", introduced by the Peruvian presidential candidate Ollanta Humala, mirrors in some respects perhaps the concept of "economic patriotism" of the French prime minister Dominique de Villepin.

The growing unease with FDI could contribute to more open conflicts between MNCs and the governments of host countries. In fact, we are witnessing a veritable explosion of disputes. Of the 219 known international arbitration cases concerning investment projects brought by November 2005, some two-thirds were initiated during the past three years—virtually all of them by MNCs against alleged misconduct by host country governments. They involve all groups of countries: 14 developed countries, ten countries from central and eastern Europe and 37 other emerging markets.[13] A number of factors are responsible for the increase in international disputes.[14] If the attitude of host countries towards FDI is indeed becoming more hostile, we can expect a further increase in the number of disputes between MNCs and host governments.

A shift may be under way in many countries in the approach to investment promotion. Liberalisation—simply opening up to FDI and creating a favourable investment climate—was for many countries the "first generation" of investment promotion strategies. In the second generation, countries established national IPAs and then sub-national IPAs. In the third generation of investment promotion strategies (and building on the first two), countries are attempting to target types of FDI that they consider to be most important for their economic development. For some, the maxim is no longer necessarily "the more FDI, the better"; rather the emphasis is shifting toward the quality of the FDI that is attracted. Such a shift towards a targeting approach could be combined with a slowdown of FDI liberalisation or even a partial reversal of non-discriminatory FDI liberalisation.

What could happen?

Although worldwide competition for FDI continues, there are some signs of a possible backlash against FDI in both developed countries and emerging markets. Assessments of the costs and benefits of FDI are often putting more emphasis than in the past on the costs. Although concrete actions against FDI are still relatively infrequent, we cannot take it for granted that dominant attitudes towards FDI will always remain welcoming.

Changing attitudes towards FDI may put even more of an onus on MNCs to demonstrate that they are bringing unequivocal net benefits to the host

[13] UNCTAD, "Latest developments in investor-state dispute settlement", *IIA Monitor*, no. 4, 2005.

[14] See Jeswald W Salacuse, "Explanations for the increased recourse to treaty-based investment dispute settlement: resolving the struggle of life against form?", in Karl P Sauvant, ed., *International Investment Law: Is the Regime Threatened by its Success?*, forthcoming.

country (above all in terms of the economic impact and in observing national laws, but also in the "softer areas" of good corporate citizenship, and socially and environmentally responsible behaviour). There may be increased pressure on MNCs to accept a "stakeholder" approach and create mechanisms through which not only shareholders are assured that their interests are taken into account, but also other groups directly affected by the operations of MNCs.

The national investment promotion strategies of host countries, too, can influence the balance of costs and benefits of FDI. Pride of place belongs here to the overall policy environment, and especially the FDI and business environment. Moreover, countries may increasingly put less relative emphasis on ways to attract FDI and more on measures that they see as crucial to maximising its benefits—IPAs may even be turned into IPDAs (investment promotion and development agencies), giving birth to a fourth generation of investment promotion strategies.[15] Home countries, for their part, may experience increased pressure to see to it that their MNCs live up to the best standards, especially in the areas of employment, the environment and human rights. And all countries may well pay more attention to the rule of law, including by developing a coherent and transparent international investment law system that respects the interests of all involved in the investment process.

Conclusion

Approaches to FDI have changed in the past, and they can change again in the future, depending on how governments assess the balance of its costs and benefits. This assessment will continue to involve not only economic factors, but also considerations such as security and other political and social factors. Reservations about FDI (and more generally against anything foreign) can be found in many countries. Appeals to "economic patriotism" can easily result in FDI protectionism.

In their current manifestation, the various developments discussed here do not yet add up to a backlash against FDI; they do not herald an end to FDI liberalisation or presage a marked slowdown in FDI flows. However, they do suggest that there is an increasing ambivalence in attitudes towards FDI and that it cannot be taken for granted that FDI openness will persist. It has also been argued in this article that the new climate may put an increasing onus on the need to demonstrate clearly that FDI contributes not only to corporate competitiveness, but also to the host country's development and welfare.

In the end, it would be ironic if developed countries—which led the FDI liberalisation wave of the past two decades or so and, like most other countries, benefited from it—now led a backlash against FDI and triggered a roll-back of liberalisation.

[15] Governments in emerging markets—typically capital importers—will face the additional challenge of explaining to their public the importance of *outward* FDI from their countries for the competitiveness of their firms and the performance of their economies.