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"A 'BIT' Therapy for Foreign Investment Schizophrenia?"

It's a great pleasure for me to be with you today to discuss what has become a very hot topic worldwide – investment. While I will begin, as most speakers do, by boring you with some data, my real message is going to be more psychological than economic. Today we'll be talking about schizophrenia, reflecting the conflicted views many governments have about both inward and outward investment.

I can summarize that debate very simply. With respect to outward investment the debate is between those who regard it as win-win for both parties and those who see it as a zero sum game – a dollar sent abroad is one less dollar invested at home.

With respect to inward investment the debate is between those who see it as job creating and those who see it as a national security or economic security threat.

This debate is sharpening, but it is not clear which side is winning. Investment protectionism has been increasing in many countries, while the same countries are simultaneously trying to attract new investment to stimulate economic growth.

<u>FDI flows have not regained their pre-crisis levels</u>. Global FDI fell from its high of $2 trillion in 2007 to $1.2 trillion in 2009. FDI growth stalled in 2012, falling 18% from its 2011 level, and estimates are that it will remain flat in 2013 at about $1.45 trillion. Although U.S. outward investment declined between 2008 and 2012, the U.S. share of global FDI increased to 15% from 11%, largely as a result of the larger decline by others.

Outbound FDI declined in 22 of 38 developed countries in 2012, due to policy uncertainty in recipient countries as well as the uncertain macro-economic outlook. Continuing macroeconomic uncertainties, particularly in Europe, will likely continue to discourage increases in outbound investment.

Given the obvious economic benefits of investment, the financial crisis has had a perverse effect on it. On the one hand, many countries have stepped up their efforts to attract foreign investment via tax incentives, special economic zones and liberalized regulation. Programs such as the U.S.' "Select USA" promote inward investment through publicizing opportunities and streamlining federal business facilitation programs without offering financial incentives.

On the other hand, many of these same countries, concerned about protecting their existing industries, have simultaneously adopted policies that discourage foreign investors. This schizophrenia most often shows itself in national industrial policies, especially as they are used by governments to evaluate the economic benefit of foreign investments. In many countries industrial policies have broadened from protecting infant industries to favoring national champions, strategic enterprises and critical infrastructure.

In fact the long-term global trend in investment policy is toward increased regulation and restriction. This is a significant shift since the beginning of this century. One index of this shift is that only 20 new Bilateral Investment Treaties were signed in 2012, the lowest annual number in a quarter century. 2012 also saw a record number of investor-state claims filed, reflecting growing private sector frustration with host country discrimination. UNCTAD's *2013 World Investment Report* indicates that 25% of all investment-related policy measures adopted in 2012 increased restrictions --- up from 6% in 2001.

In the past, countries applied restrictions on FDI to industries deemed to be strategic, which often meant extractive industries and those related to defense. Increasingly, however, the definition of "strategic" has been expanding so it now includes critical infrastructure, designated strategic enterprises, financial institutions and national champions. Examples include Argentina's insurance regulations, Indonesia's limits on private bank ownership, the Philippines' limitations on new mining contracts, and Kazakhstan's new law requiring 51% government ownership of any new trunk pipeline construction.

In addition, investment screening processes have become increasingly difficult and complex, which has resulted in the withdrawal of a significant number of proposals around the world since 2009. According to the UNCTAD 2013 World Investment Report, the majority of withdrawals were for business reasons, including the global recession, but 15% resulted from regulatory barriers and political opposition. Of this 15%, economic benefit tests accounted for 9%, competition policies for 44% and other regulatory approval issues for 35%, 6% for "general political opposition and national security concerns for only 3%.

There are many good examples of foreign investment schizophrenia. Let me discuss two briefly.

<u>China:</u> Two-way FDI between the US and China continues to grow rapidly in spite of governmental constraints in both countries. U.S. FDI into China grew by 6.4% to $80 billion in the first 8 months of this year while Chinese FDI into the U.S. rose by an estimated $5 billion in the first 6 months.

China has a web of policies to develop and promote national champions that constitute pre-establishment barriers, and it also poses post-establishment challenges through policies like forced localization and technology transfer. Their effect is compounded by continued theft of foreign investors' intellectual property.

On the brighter side, in what appears to be a significant change of policy, China agreed at the recent Strategic & Economic Dialogue with the United States to negotiate a high-standard Bilateral Investment Treaty (BIT) in which all sectors would be covered except those designated on a list of negotiated exceptions – a negative list approach they had previously rejected. China may well present a much longer list of exceptions than would be acceptable to the U.S., and this will be one area of intense discussion. China also agreed to national treatment of investments at the pre-establishment phase. A high-standard BIT would also preclude performance requirements and nonconforming measures and thereby expand market access. BIT negotiations will be protracted, but their success would make the environment vastly more predictable and transparent for investors.

<u>India</u>: India began liberalizing its policy toward FDI in the early 1990s, but with major exceptions like atomic energy, agriculture and insurance. More recently India has been back pedaling rapidly, no doubt partly in anticipation of upcoming elections. In 2012 India announced a "Preferential Market Access" policy to boost local manufacturing in India's information technology sector. The U.S. IT sector and the U.S. government strenuously objected the program which the Indian government subsequently agreed

to review. Time will tell what shape it will ultimately take since Indian chip makers see it as vital to their growth.

The second trend is a series of discriminatory measures that have increasingly alarmed foreign investors. India has compulsorily licensed or revoked patents on more than 15 major drugs. IT companies face local content requirements. Foreign companies encounter inconsistent and arbitrary tax treatment, impediments in obtaining permits, and bureaucratically determined limits on foreign investment in various sectors. India's industrial policy promotes certain domestic sectors, such as IT, telecommunications and pharmaceuticals and uses an extensive array of caps on FDI in key sectors. These include 74% caps in mining and airport construction and management, a 49% cap on FDI in banking and telecommunications, and a 26% cap in FDI insurance and in defense-related industries. This, along with the recent disapproval of multi-brand retailing, contributed to a 21% decline in FDI in the year ending in March 2013. By no means are all U.S. companies deterred by India's back-sliding. Coca-Cola, GE and Google have recently announced ambitious direct investment plans.

As with China, much more two-way FDI would take place if the current BIT negotiations succeed. They began in 2009, held a third round last August, and reconfirmed their intent to continue at the September meeting between President Obama and Prime Minister Singh. There is a good bit of skepticism in the U.S. about the future of these talks. Unlike China, segments of Indian civil society are strongly opposed to all of India's BITs, and their government has talked the talk but not walked the walk so far. At this point I think a successful conclusion is less likely than the case of China.

Mixed signals about investment are not solely the province of emerging economies. A number of developed countries, including the United States, officially welcome all investment but have screening procedures allowing them to veto or limit specific cases.

As you know, the U.S. does not have a coordinated industrial policy and maintains an open investment policy except for reviews of inward FDI with potential national security impact. Because of some controversial proposed investments over the past decade, the US process for reviewing a proposed foreign investment's impact on national security has come under pressure to broaden both the scope and criteria for its reviews. The Committee on Foreign Investment in the United States (CFIUS) reviews foreign acquisitions of U.S. companies on national security criteria, and its underlying statute does not provide for different criteria for investments by different countries or for those by state-owned enterprises.

So far the number of reviews has been relatively small: 155 in 2008, 65 in 2009, 93 in 2010, and 111 in 2011. Manufacturing reviews are by far the largest category. These fell from 72 in 2008 to 36 in 2010 largely due to the recession, but increased to 49 in 2011. The second largest category, finance, information and services, fell from 42 in 2008 to 35 in 2010 and increased slightly to 38 in 2011. Computer and electronic products accounted for fully half the reviews in this category in 2011. All CFIUS cases were resolved without presidential decisions in 2010 and 2011, but in 2012 President Obama prohibited the Chinese company Ralls Corporation from owning wind farm projects near a naval facility in Oregon.

As a practical matter, a specific investment becomes controversial depending on:

- The investor's country;
- Whether the proposed investment occurs in an election year;

- Whether there is an unsuccessful, unhappy American buyer.

The latter usually goes to his elected representatives seeking to change the outcome, thus inviting political demagoguery. (When the Chinese ask me for advice, I always tell them don't buy anything in an even-numbered year.)

Debates over the specific inevitably spark a debate over the general – whether US policy as a whole should change, and this debate will grow, fed by paranoia. I predict five arguments.

One is that CFIUS' exclusive focus on national security is too narrow and that the US should adopt some variation of the net economic benefit test imposed by Canada. Congress has considered this possibility twice -- in 1986 and 2007 -- and on both occasions chose not to do it. It is very likely this debate will occur again, possibly next year, and the outcome is uncertain. While it is an attractive argument for politicians at the federal level, local and state officials are far more interested in the jobs that will be preserved or created than they are in an abstract argument over national security.

Second is the argument that CFIUS should apply different criteria to investments by SOEs than by privately-owned companies on the grounds that they are essentially foreign government intrusions into the economy and not market-based investments. This argument is unlikely to succeed in a formal sense – there will be resistance to discriminatory criteria for one group as opposed to another. That does not mean, however, that when an actual SOE case is reviewed it would not be held to an implicit higher standard.

Third, there is growing concern about greenfield investments which at present are not subject to CFIUS review. For example, a Chinese SOE steel company could make a greenfield investment and thereby circumvent the trade rules against subsidies. The WTO allows countervailing duties against subsidized imports, which are endemic in the steel industry, but there is no relief provided for a domestic plant built with subsidized funds and which has access to essentially unlimited supplies of subsidized capital. We will certainly see efforts to bring greenfield investments under CFIUS purview, which would clearly have a chilling effect on them.

Fourth, we can expect to continue to see efforts to broaden the definition of national security, mission creep, if you will. The 2007 amendments added critical Infrastructure, and I expect efforts to broaden that further. Even in the recent Smithfield case, which gave new meaning to the term "bringing home the bacon," politicians were making a national security argument with a straight face.

Fifth, court decisions in the Ralls case -- the most recent last week -- make clear that our judicial system will not be a source of relief from CFIUS decisions, and that investors are well-advised to file rather than not and hoping no one is paying attention. Over time this will produce a significant increase in filings.

These proposals are cause for worry that the U.S. debate is beginning to reflect the same kind of paranoia that engulfed us in the late 1980s regarding Japanese investment. Only this time it is China. In 2012, a House Intelligence Committee report recommended that CFIUS block acquisitions by Huawei and ZTE as national security threats. The committee also recommended that Congress enact legislation expanding CFIUS' role in reviewing foreign acquisitions of telecommunications companies by SOEs or others that cannot be trusted to build critical infrastructure. No one would have thought twice about the Smithfield acquisition if the acquiring party had not been Chinese.

In the case of Japan, paranoia subsided both because of the lack of evidence there was a problem and because Japan's internal difficulties soon overtook their problems with us. It remains to be seen whether the same will happen with China. We do not have the same close relationship with them, so their investments will always be more controversial, but at the same time, frankly, we need the money and they've got most of it.

Conclusion

In the wake of the financial crisis, governments worldwide have faced conflicting pressures – the need for capital investment to stimulate growth and create jobs versus domestic political pressure to protect jobs. The result is the mixed messages I've discussed -- intense competition for FDI and equally strenuous efforts to block or channel it, thereby driving investors away.

One constructive step may be to use Bilateral Investment Treaties to create a level playing field and increase investor confidence. They will not obviate domestic reviews like those of CFIUS, but they can remove some of the common arguments used to oppose an investment, beginning with lack of reciprocity in the other country. At the same time, precisely because they promote investment, they are also objects of suspicion by the investment protectionists, and I have already been warned to expect U.S. opposition to a BIT with China.

Investment is a vital driver of global economic recovery and growth, and national policies that are designed to impose costs on foreign investors can and should be changed to encourage it instead. In the absence of multilateral rules governing treatment of investment -- and I don't see another try for an MIA coming along anytime soon -- bilateral and plurilateral investment treaties between and among major trading partners should be a key policy priority.