Foreign Investment: Is the Policy Pendulum Swinging Back?

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In the last five decades, there have been dramatic swings in the policy pendulum governing foreign investments at various levels in response to changing global political context. In the 1960s and 70s, the dominant thinking was foreign investments should be restricted as it interferes in the domestic economic policy making besides posing a threat to national sovereignty. The 1980s and 90s witnessed major swings in the investment policy pendulum towards greater liberalization of the regulatory framework at the national level. The swing was more pronounced in developing countries, particularly in Asia, Latin America, and Central and Eastern Europe . Countries unilaterally (sometimes voluntarily) undertook liberalization measures such as lifting their controls on foreign ownership, removing performance requirements, and liberalizing their capital account. An increasing trend towards privatizing public sector companies in developing and transition countries added momentum to investment liberalization processes. Several countries also offered various guarantees and subsidies to foreign investors.

The extent of these swings in policy can be measured in several ways. For instance, expropriations had increased in the 1960s and early 1970s, but almost disappeared in the 1990s. According to UNCTAD, a total of 1,393 regulatory changes were introduced in national investment regimes during 1991-2001, out of which 1,315 (almost 95 per cent) were meant to create a favorable investment environment. In 2001 alone, as many as 208 regulatory changes were made by 71 countries, of which only 16 changes were less favorable for foreign investors.

The 1990s witnessed a surge in the number of bilateral investment treaties (BITs) as more and more countries started adopting liberalized investment policies. The highest number of BITs were negotiated and concluded during this decade. Regional initiatives on investment liberalization also emerged in the 1990s. In 1991, negotiations took place between the US , Canada , and Mexico to launch the North American Free Trade Agreement (NAFTA) in 1994. In many aspects, NAFTA was simply an extension to Mexico of the existing Canada-US Free Trade Agreement.

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Despite the dominant trend towards greater liberalization of investment flows, nowadays certain kinds of investments have come under closer scrutiny by policy makers. In several countries (both developed and developing), there are moves to tighten existing investment rules or to enact new rules to regulate foreign investments and protect “strategic sectors” from foreign investors.

Unlike the 1990s, nowadays the costs and benefits of foreign investments are being evaluated in a much more balanced manner, keeping in mind not only economic factors but also social, political, and strategic factors. It is increasingly becoming clear that the benefits of foreign investment have been fewer than anticipated while the costs have been much bigger. In some host countries (such as Bolivia and Malaysia), there is a greater realization of costs involved with foreign investment. The initial euphoria associated with the benefits of foreign investments seems to be subsided. To a large extent, disappointment with certain kinds of foreign investment has put a big question mark on the benefits of investment liberalization.

The growing unease with foreign investments could be grasped from several recent developments, some of which are summarized below:

* Several Latin American countries (such as Bolivia , Ecuador , Argentina , Ecuador , and Venezuela) are renegotiating contracts with TNCs to bring economic equilibrium between the foreign company and the host country. In Bolivia , for instance, the government successfully renegotiated contracts with ten foreign energy companies (mostly from the region) in October 2006. Under the new contracts, majority ownership of gas fields has been transferred to the state and government's energy tax revenues are expected to increase by four times. The renegotiation of contracts was the outcome of the nationalization policy announced by President, Mr. Evo Morales, on May 1, 2006, under which foreign companies were asked to sign new contracts giving the government majority control or leave the country. In March 2006, Ecuador passed a new law that gives the government 60 per cent tax on oil profit of foreign companies if the oil prices exceed certain benchmarks.

* Cross-border M&As deals have become the bone of contention in recent years. As discussed elsewhere, several important M&As deals have been blocked by policy makers in both the developing and the developed world. In many countries, attempts are being made to screen foreign investments from a security perspective.

* In 2006, India 's National Security Council suggested a new law, National Security Exception Act, which would empower the government "to suspend or prohibit any foreign acquisition, merger or takeover of an Indian company that is considered prejudicial to national interest."

* Russia is considering new rules to protect its strategic resources, particularly oil and gas. Despite strong pressure from the EU (the main consumer of Russian energy resources), Russia has refused to ratify the Energy Charter Treaty which covers the key areas of trade, investment protection, environmental issues, and dispute resolution. Though Russia signed the charter in the early 1990s, it has refused to ratify it. Russia has refused to provide non-discriminating access to foreign companies to the country's pipelines, primarily the gas transportation network controlled by state-owned gas company, Gazprom.

* Although China 's foreign investment regime is significantly open but acquisitions of Chinese firms by foreign investors are increasingly being questioned amidst a growing mood of "economic patriotism." The National Development and Reform Commission of China has emphasized the need to shift to a "quality, not quantity" approach towards attracting foreign investments. The Commission asked the government to encourage foreign investments in higher-value-added sectors and discourage low-value export-processing and assembly-type manufacturing. In its policy document for the 11th Five-Year Plan released in

November 2006, the Commission suggested closer scrutiny of future mergers in sensitive sectors and called for new legislations on foreign takeovers. Since 2005, the rapid entry of foreign banks in the Chinese financial sector has raised serious concerns in the policy circles about the benefits of a liberalized financial regime.

* There has been a phenomenal increase in the disputes between TNCs and host governments in recent years. More than 200 international arbitration cases concerning investment projects have been initiated in the past few years. The disputes are expected to increase further given the rethinking on the benefits of foreign investments by some host governments.

* Of late, the growing engagement of private equity funds (such as Kohlberg Kravis Roberts & Company, Blackstone, and Carlyle Group) in the cross-border mergers and acquisitions has generated considerable public criticism in some developed countries. In 2005, Mr. Franz Müntefering, the then chairman of the Social Democratic Party (SPD), described private equity funds and hedge funds as “swarms of locusts that fall on companies, stripping them bare before moving on.” In the case of South Korea , the activities of private equity funds came under scrutiny following reports of non-payment of taxes. Private equity funds earned billions of dollars by taking over sick banks in the post-crisis period and later re-floated them in the Korean financial markets. After the strong public outcry, the regulatory authorities in Korea undertook stern actions against such funds. In the US, there are growing calls for strict regulation of private equity funds following the failed $50 billion takeover bid of Vivendi Universal of France by Kohlberg Kravis Roberts & Company in 2006. In the UK , the Financial Services Authority (FSA) reviewed the operations of private equity funds and found several areas of potential risk to the financial system because of their market abuse and anti-trust practices. The FSA called for closer regulation and supervision of private equity funds.

Similarly, the phenomenal rise of hedge funds, known for their short-term investment strategies and lack of transparency and accountability, has come under considerable criticism in many developed countries. The UK ’s FSA has taken a tough stand against hedge fund industry. In a discussion paper, the FSA warned that “some hedge funds are testing the boundaries of acceptable practice concerning insider trading and market manipulation.” The FSA also announced the establishment of a dedicated new unit which would monitor and supervise the trading behavior of hedge fund industry. This is a significant development given the fact that the bulk of European hedge funds are located in the UK and they account for at least 30 per cent of trading at the London Stock Exchange, which is the biggest stock market within the Europe . Even in the US , the Securities and Exchange Commission is examining new measures to increase its surveillance on hedge funds.

* The corporate scandals (from Enron to Worldcom to Parmalat) have further dented the benign image of TNCs worldwide. The scandals have exposed systemic flaws in the corporate governance model based on self-regulation. Despite much-touted claims of corporate transparency and disclosures, the basic norms of governance were completely flouted by these corporations. Regulations related to accounting and reporting were either circumvented or followed in letter rather than in spirit. What is even more disturbing is the fact that most of these corporations had their own codes of conduct, illustrating that voluntary codes of conduct are clearly insufficient to ensure that TNCs conduct their business operations responsibly. Such codes therefore should not be considered as a substitute for state regulations.

* Outsourcing has become a contentious political issue in many developed countries (for instance, US) because of the fear of white-collar job losses in the service sector.

How far these developments could lead to a major backlash against foreign investment remain to be seen. Nevertheless, there is an increased onus on the foreign investors and their advocates to prove (both theoretically and empirically) that foreign investments are always beneficial to the host country. Nowadays there are now very few supporters of the earlier market-friendly approaches that focused exclusively on investors' rights and nations' obligations. Even within the corporate world, questions related to investors' obligations in both home and host countries are being raised. Thus, any attempt to launch multilateral investment agreement that intends to serve the interests of foreign investors exclusively at the expense of weakening the regulatory framework is unlikely to succeed in the present geo-political context. No wonder, the policy focus has shifted away from multilateral to bilateral and regional investment agreements.

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