Trade Protection

I. It's Not Investment "Protectionism"

Why all blocks on foreign investment are not created equal.

BY ALAN BEATTIE

A new specter is stalking the world—that of investment protectionism. Not the practice, but the concept. Traditional protectionism—blocking cross-border flows of goods and services—is being conflated with restrictions on international flows of capital and corporate ownership. This confuses rather than illuminates the debate on international economic governance. Here's why.

The arguments against trade protection are well rehearsed. By preventing trade in goods and services with other countries, tariffs and other restrictions stop countries specializing in what they do best, those specialisms having arisen as a result of having particular endowments (cheap labor or abundant land) or having built up a cluster of expertise (information technology from India, movies from Hollywood).

Economies are—or they ought to be—run primarily for the benefit of consumers, not one particular gang of shareholders relative to another.

But as economists from Jagdish Bhagwati on down have shown, and even International Monetary Fund research has accepted, the arguments for liberalizing capital flows are conceptually and empirically weaker. Financial markets, as we have painfully discovered, are subject to bubbles, panics and crashes. For smaller and poorer economies in particular, the efficiency benefits of deeper capital markets can easily be outweighed by their higher volatility. Chile and Malaysia have become clichéd examples of highly

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Faceoff

II. The Rules of Foreign Investment

BY NICOLAS VÉRON

It's time to flesh out the ground rules.

National attitudes to foreign investment have differed for a long time. The United Kingdom [has] remained undisturbed when iconic companies have been acquired by foreigners, including most of its merchant banks, auto makers, steel and chemical industries, ports, airports, and electricity facilities. The French and Japanese, by contrast, tend to see "national champions" as heritage that requires public protection. The United States and Germany lie somewhere in between.

But attitudes also depend on the identity of the investor. In the United States, investors from across the Atlantic have been able to acquire companies as "strategic" as Westinghouse (the nuclear plant maker, bought by British Nuclear Fuels Ltd in 1998), Lockheed Martin Aerospace Electronic Systems (bought by BAE Systems in 2000), oil companies Amoco and Arco (bought by BP respectively in 1998 and 2000), cell phone operators AirTouch and VoiceStream (bought respectively by Vodafone and T-Mobile in 1999 and 2001), Lucent (merged with France's Alcatel in 2006), Chrysler (bought by Daimler-Benz in 1998), or Bankers Trust (bought by Deutsche Bank in 1998).

From a political viewpoint, cross-border integration binds countries together.

By contrast, Japanese investments in the 1980s were greeted with concern, which eventually led to the Exon-Florio Amendment to the Trade and Competitiveness Act of 1988 establishing a formal review process. In spite of being a reliable Cold War ally, Japan was plainly less welcome than Western Europeans. Similar discrimination was observed in 2006 when Dubai Ports World (DPW) acquired Britain's P&O, which had developed a U.S. ports facility business without meeting much political opposition. Even though Dubai was considered a U.S. ally in the war on terror, the backlash in Congress forced DPW to

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successful trading nations that nonetheless kept capital controls on the books for long periods. Calling them protectionist is misleading and unfair.

The argument against "investment protectionism" as a concept can go yet further. It applies not just to portfolio flows of footloose capital but to cross-border takeovers, the international market in corporate control.

Take one of the most famous examples: the warning from the Elysee Palace against PepsiCo's abortive bid for the French food company Danone in 2005. The official intervention was widely and rightly mocked as France's "strategic yogurt policy." But would it have made any difference? What matters to most French people is whether there is a (forgive me) liquid and competitive market in yogurt, not the nationality of those who own the dairies and the brands.

National security considerations are not all simply excuses, particularly in sectors like energy.

Import tariffs are very likely to interfere in this, by restricting trade with countries where it is cheaper to produce. Weak antitrust policy might also interfere in it, if competitors to Danone are preventing from setting up *in situ* and producing better yogurt. But the only way in which cross-border investment restrictions would interfere is by stopping more efficient foreign managers coming in and taking over Danone's operations.

That would be a serious concern if hostile takeovers were a good way of disciplining underperforming firms. But, no matter what M&A lawyers and financiers tell potential clients, they are not. The targets of successful takeovers are not systematically more profitable after being taken over. The market for corporate control is not an efficient one. Natural selection does not work in the takeover process. (This remarkable result was first obtained by Ajit Singh at Cambridge in 1971 and, with a remarkable degree of empirical persistence, never satisfactorily challenged since.) Economies are—or they ought to be—run primarily for the benefit of consumers, not one particular gang of shareholders relative to another.

This does not mean it is a good idea for governments to block foreign investors with abandon. In emerging market countries with a shallow bench of corporate talent and weak institutions for raising capital, restricting international involvement might well be more akin to trade tariffs—keeping out a systematically more efficient class of competitor. Even in some rich countries, greenfield investment as opposed to mergers and acquisitions seem to have brought in a qualitatively better type of producer, such as the foreign car companies that shook up the U.K. car industry. (It has, though, become harder to make this argument in view of the extreme difficulties that the rich world's companies and their banks are having.)

And, of course, bad arguments can be made—usually involving national security—to prevent more efficient foreign operators taking over. This particularly applies when the market in question is what we once used to call a natural monopoly, where product market competition is limited by law or the nature of production. My personal favorite was the repulsion of a bid by the Canadian state pension fund for a stake in the operations of Auckland airport. I quite literally find it hard to imagine a less threatening entity than a Canadian state pension manager.

On the other hand, national security considerations are not all simply excuses, particularly in sectors like energy where operators can have all sorts of ulterior nonprofit motives. To me it would be a legitimate source of concern if, say, a natural gas company that in effect acts as an arm of the Russian state wanted to take over a monopoly gas distribution network in a country involved in some foreign policy dispute with Moscow. The prevalence of bad arguments for a particular policy does not mean that good arguments cannot be made for them as well.

In order to have detailed policy discussions, it remains important to draw distinctions between restrictions on trade and those on investment. It is easy to see why they have been conflated, particularly by trade ministers. Traditional trade policy is driven by mercantilist lobbies seeking access to foreign markets: the function of institutions like the World Trade Organization is to knit together these producer interests to serve a consumer interest. Investment policy is likewise driven by domestic companies trying to get into foreign markets. From the perspective of the European Commission or the U.S. Trade Representative's office, these lobbies must all look much the same, not least because they will often involve the same people.

But their effects are distinct. International trade in goods and services is directly and intimately connected with what should be the ultimate aim of policy—to create effective and competitive markets and keep, as it were, the yogurt flowing. Cross-border movements of capital and investment are only intermittently and tangentially related to that end.

Blocks on foreign investment, and particularly on portfolio flows, can be called many things. But labelling them "protectionism" is unhelpful. For the sake of clarity in policy as well as language, we should resist it. ◆

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resell its newly acquired American ports assets to a division of AIG.

Political sensitivity about investment origin rises as the pattern of investing countries changes. In the past decade, the capacity to invest internationally has massively shifted from developed countries to Gulf States, China, Russia, and other countries with illiberal political regimes. Using Freedom House's rankings, the share of countries classified "free" in global aggregate current-account surpluses has plummeted from 77 percent in 1998 to 39 percent in 2008. Even assuming a renminbi revaluation and further oil price decline, such countries are likely to keep a lot of cash to invest internationally in the foreseeable future. The public agitation about sovereign wealth funds over the past two years mirrors this dominance of authoritarian regimes in new investment flows. If it had been only about the likes of Norway, sovereign wealth funds would barely have been noticed—even though political and diplomatic correctness has tended to blur the policy debate all along.

While the United States has reacted with occasional protectionist spikes, such as on Unocal (2005), P&O (2006) and 3Com (2007–08), on the other side of the Atlantic the reaction has been made more confused still by the interference with the European Union's unfinished efforts to build a single internal market. Consider France's public stance on sovereign wealth funds. Paris has advocated a "financially driven" investment profile for sovereign wealth funds willing to invest in the European Union, as embodied by the International Monetary Fund-sponsored Santiago principles for sovereign wealth fund investment, jointly adopted this fall by twenty-six investing countries. But simultaneously, Nicolas Sarkozy on October 23 announced the creation of a state "strategic investment fund" to "prevent national industrial groups from falling into foreign hands," hardly the most financially driven of investment mandates.

The result of this confusion: genuine national security concerns, raised by the prospect of investment flows from illiberal overseas governments, mixed with pig-headed protectionism to threaten the openness to investment from all foreign countries, including fellow EU member states or the United States. Thus we saw several governments' attempts to block Mittal Steel's hostile takeover bid on Luxembourg-based Arcelor in 2006 even as it posed no security threat, with arguments that sometimes verged on sheer xenophobia, or Italy's successful discouragement of the attempted takeover of Autostrade, a highway manager, by Spain's Abertis.

The rise of investment protectionism matters for economic and political reasons. In the services sectors that now make up the bulk of developed economies, companies often need a local presence to serve customers, and this presence often has to be built by acquisitions. Take banking: of Europe's twenty largest independent listed banks (as of September 2008), only the smallest one (Poland's PKO) was created after 1900. In such markets you cannot build a significant competitive position with only greenfield investment and internal growth. Thus, the economic benefits of international competition cannot be reaped if foreign acquisitions are forbidden. From a political viewpoint, cross-border integration binds countries together. The European Union may not have decided to extend a financial lifeline to Hungary in mid-October 2008, had it not been for Western European banks' extensive operations there, themselves mostly resulting from cross-border acquisitions. As called for in the Schuman declaration of May 9, 1950—the European Union's closest equivalent to the U.S. Declaration of Independence—economic integration in this case created a politically significant "de facto solidarity."

How should policymakers react to the new multipolar world of international investment? Most important is probably the quality of regulatory and competition policies. One reason that Congress grew so nervous about P&O's acquisition by DPW was the widespread doubts about the quality of security oversight, especially computer screening, carried out by U.S. customs. Similarly, if weak competition policy allows a company to build an unassailable position in a market which is important for national security, that company's acquisition by foreign interests may become a threat. Conversely, if regulatory and competition policy are effective, "corporate nationality" becomes in most cases irrelevant to security concerns.

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However, cases will always remain in which, as Lenin said, trust is good but control is better. The United States has a broadly adequate process in place for such control since the enactment of Exon-Florio twenty years ago. The European Union, by contrast, lacks a consistent framework and should build one with appropriate EU-level legislation, while individual security assessments can remain in the hands of its member states. Denial about the security risks that may arise from the new patterns of international investment would be a poor way to defend Europe's economic openness. ◆