

Capitalism, Patriotism and Economic War

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Introduction

During the last 25 years world economies have exhibited significant increases in foreign direct investment (FDI), significant increases in cross-border mergers, significant increases in deregulation of prices and entry in transportation, communications, energy, and financial services sectors, significant reductions in tariff and non-tariff barriers to international trade, and increased harmonization of antitrust laws and policies as they affect mergers in particular and (to a lesser extent) exclusionary behavior by dominant firms. The U.S. has formal antitrust cooperative agreements with the EU, Canada, Australia, Brazil, Germany, Japan, Israel, and Mexico. These are the trends. There have been bumps in the road in the past and there will be bumps in the road in the future. The question is --- are these bumps the first signals of significant changes in government policies that will reverse these trends?

I believe that the answer is “no” as long as the major developed countries (e.g. the U.S. France, Germany, Italy, Japan) retain a commitment to competition and free trade, take a leadership position in supporting policies promoting competition and free trade, and work with developing countries to support mutual market opening policies that are sensitive to the challenges faced by developing countries. By “leadership” in developed countries I also mean avoiding pandering to domestic special interest groups who may oppose global competition to feather their own nests and scaring the population about the dangers of globalization in order to achieve unrelated political ends. While the leadership could be stronger, especially in some European countries, I am optimistic that we will stay on current course without fundamental changes in capitalism or economic warfare.

Some Facts

Let me first outline some key facts and then discuss some of the bumps in the road. Bumps in the road in the area of global trade, investment and competition need special attention, both to understand what they actually mean and because they can lead to tit-for-tat behavior that can potentially undermine the trends of the last few decades.

Direct foreign investment flows into both developed and developing countries have increased significantly and continuously in the last few years, after recovering from the effects of the telecom and dot.com booms and busts after 2000. The share of FDI in world GDP in 2005 was on the order of 10 times that in 1980. Developed countries continue to be large net exporters of FDI to developing countries.

The number of cross border mergers has continued to grow over time though the comparative deal values are distorted by the telecom boom after 2000. The number of cross border deals grew from about 150 in 1990 to about 900 in 2005.

The developed countries with the largest net outflows of capital in 2005 were the UK, France, Japan, Switzerland and the Netherlands. The U.S. was 9th, well behind Canada. The majority of EU country outward FDI is with other EU countries as is the case for cross-border merger activity.

The U.S. continues to grow as a destination for FDI from both developed and developing countries.

The world's top 10 non-financial transnational companies were headquartered in the U.S. (4), the UK (3), France (2), Japan (1).

Mainland China's inflows of FDI far exceed its outflows of FDI, though outflows of FDI have been growing rapidly in the last few years (These data are difficult to interpret because Hong Kong is treated separately in all public data series and is a major source of inflows into Mainland China and perhaps outflows from Mainland China. China's outward FDI is probably much higher than the official numbers suggest.)

- Increasing outward FDI flows became a declared policy of China in early 2000. This reflected a desire to recycle growing trade surpluses and to reduce pressure on the overheating domestic economy. Perhaps of more significance for this discussion, it also reflected a desire to acquire ownership interests in global natural resources, to buy access and expertise in more advanced technology, and to acquire modern organizational management skills. The top destinations for China's FDI outflows are the U.S., Russia, Hong Kong, Thailand, Australia, Canada and Japan. The Chinese are certainly not invading Europe.

- Russia has become and will become an increasingly important investor in other countries as long as oil and natural gas prices remain high, though it has plenty of investment opportunities at home. The UK is the largest recent recipient of Russian FDI.

Overall, I would conclude that this is hardly a picture that suggests despair about a crisis of capitalism, protectionism or economic warfare.

The Bumps

It is dangerous to infer trends from a few high profile cases that receive a lot of media attention. The U.S. places few restrictions on foreign investments or acquisitions and a small number of recent high profile cases are not representative of any long term trends to make foreign acquisitions of U.S. companies more difficult or the beginning of an economic war with China, Russia or the Middle East. Some recent developments in cross-border mergers involving energy companies within Europe are more troubling because they may represent trouble for market liberalization in Europe.

a) The U.S.: There are essentially no special restrictions placed on foreign investment in "greenfield" business ventures, except for long-standing restrictions on foreign ownership in a few specific sectors (e.g. airlines and nuclear power plants). Foreign companies seeking to acquire an existing U.S. company must pass through the same antitrust scrutiny under U.S. merger law as would a U.S. company seeking to make the same acquisition. The one exception are foreign acquisitions that fall under the provision of the Exon-Florio Amendment of 1988 (as amended by the Byrd amendment in 1993) because they may raise national security concerns. Such mergers can be reviewed by the Committee on Foreign Investment in the United States (CFIUS which was established for this purpose administratively in 1975. Notification by an acquirer is technically voluntary, but CFIUS can later come back and review an acquisition after the fact if they are not notified). CFIUS is authorized to review a proposed acquisition by a foreign owner (only) to determine whether it represents a threat to national security. If CFIUS chooses to investigate the acquisition it may provide a report to the President and it is ultimately up to the President to decide whether to block an acquisition. The entire process must be completed in 90 days.

More than 1500 acquisition notices have been filed with CFIUS since 1975 of which only 25 required an investigation. Of these 25 investigations, only 4 have been launched since 9/11/01. Of the 25 investigations, 12 were sent to the President for a decision and only one was prohibited (a China National Technology Import & Export Corporation acquisition of an aircraft component manufacturer). The other 13 notifications were withdrawn before CFIUS completed its investigation. Many acquisitions in "strategic areas" have been approved. For example, BAE Systems plc, a UK company and the fourth largest defense contractor in the world, has acquired several U.S. defense companies in the last few years without any fuss. Lenovo, the largest PC

company in China, acquired IBM's personal computer business in 2005. NTT of Japan acquired Verio (a U.S. internet company) in 2000. National Grid, a UK holding company, has made several acquisitions of U.S. electric utilities. Iberdrola (Spain) and EDP (Portugal) have made successful acquisitions of U.S. generation companies. Suez acquired the only LNG receipt terminal in the Eastern U.S. In the energy area it is easier for an EU company to acquire a U.S. company than for an EU energy company to acquire another EU energy company without government interference (other than as a result of antitrust issues).

Two recent U.S. acquisitions by foreign buyers have attracted a lot of media attention and political rhetoric, but they do not represent a change or trend in U.S. policy. In 2006, Dubai World Ports agreed to acquire P&O's global commercial ports operations. These operations included four ports along the east coast of the U.S. Although the acquisition was approved by CFIUS and President Bush, those decisions created a political firestorm, including proposals to tighten the statutory requirements under Exon-Florio. Dubai World Ports ultimately sold the U.S. operations to another company. At that time, few Americans (or Congressman) apparently even knew that most U.S. commercial port operations were privatized over the previous decade and conceptualized the nature of the acquisition differently from the reality. The proposed merger occurred in the midst of continuing media attention about lax port security and in the context of security concerns and distrust of Middle Eastern countries after 9/11. It also created an opportunity for the Democrats to embarrass the President. I consider the case to be an anomaly rather than the beginning of a long term trend and certainly not motivated by classical protectionism. Subsequent acquisitions by Middle Eastern firms, including an acquisition by a Dubai investment group of a firm that owns factories in the U.S. doing work for the U.S. military, have gone through without similar political opposition.

The second case that attracted a lot of media and political attention involved the proposed acquisition of UNOCAL, a medium-sized U.S. oil company, by State-owned China National Offshore Oil Corporation which was eventually abandoned. I note only two things here. First, this was a contested takeover bid, and China National Offshore's rival was Chevron a large U.S. oil company. The value of the competing bids was in dispute and Chevron had every incentive to stir up anti-China fears in an effort to win the bidding for UNOCAL. And they did so. Second, Chinese companies have made many successful U.S. acquisitions without any backlash.

b) Europe and National Champions: What appears to be more of a trend in Europe is increased state intervention in intra-EU cross-border mergers of EU energy companies, a growing emphasis on creating national champions in Europe (whatever that means), the disregard by some major EU countries of competition issues raised by EU competition authorities about European energy (electricity and gas) markets, and even disregard of the recommendations of individual country competition authorities (e.g. Germany). I have in mind here recent cases involving Endesa (Spain), Gaz de France, Ruhrgas, ENEL and others. Non-European companies (and even some UK companies) feel that they are or will be systematically discriminated against in these countries.

Some in Europe argue that they need big strong energy companies to support investment in new generating capacity in order to ensure supply security and to negotiate contracts with Gazprom for the same reason. Even if the investment argument is true, it does not required that the big strong companies have dominant positions in the competitive segments of electricity and gas markets in their individual countries. A company can be big and strong, own assets in many countries, and have a dominant position in none. Moreover, there is significant investment in new generating capacity in the UK which has both a fully liberalized electricity market and has eschewed the national champion fantasy; most UK generation and electric distribution companies are now owned by non-UK companies. With regard to Gazprom, efforts by national champion gas and electric generating companies to become increasingly tied to Gazprom through long-term gas supply contracts, stimulated in part by government pressures placed on

their national champions, is more likely to increase rather than reduce Gazprom's strategic bargaining power. Diversification of supplies and more investment in strategic storage would make more sense from a supply security perspective. Encouraging Gazprom to take financial interests in local gas transportation and distribution facilities creates significant potential vertical market power problems. Opposition to such acquisitions should not be seen as being motivated by the low standards of corporate governance in Russia.

From my perspective, recent developments in European energy markets represent an attack on market liberalization and basic goals for market integration upon which the EU is based. But the attack on market liberalization has little (directly) to do with globalization, the shift of manufacturing to developing countries or the increasing economic power of China and Russia. Rather it is motivated by more traditional political economy considerations: protect incumbents from competition, retain more government control of local electric and gas companies to placate their unions, to provide political levers for local politicians to pull more easily, to engage in taxation by regulation, and the misperception that pulling those levers will accrue to each country's long run benefit. It raises more fundamental questions about whether Europe will follow the rest of the world with continuing opening of markets and the promotion of global competition more generally.