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Economic Nationalism on the Rise

Foreign Direct Investment in the USA after the Dubai Fiasco

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The failed takeover of the terminal port operations at six American sea ports by a Dubai company has cast a spotlight on growing economic nationalism in the United States. This could turn into a serious domestic problem for President Bush and the Republican Party by the midterm elections in November 2006. For several reasons, however, the newly rekindled American debate on how to deal with foreign direct investment is also a cause for concern on an international level. First, it reflects a growing tendency in the U.S. to implement restrictions on trade and capital flows under the banner of "national security;" even Europe-based companies cannot count on remaining unaffected. Second, such restrictions on FDI in the United States as currently considered in the Congress, curtail the usability of the immense dollar holdings that have accrued in states running trade surpluses with the U.S. That, in turn, can accelerate a flight out of dollar assets, thereby initiating the global adjustment crisis which has so far been avoided in spite of the US current account deficit's continual rise. And, third, the Dubai Ports debate is putting the relationship between America and its most valued Arab allies under heavy strain by discrediting their heretofore close political and economic ties with the U.S.

On March 8, the port service company Dubai Ports World (DP World) formally acquired ownership of British-based Peninsula & Oriental Steam Navigation Co. (P&O), giving it control of the port operation enterprises of New York, Newark, Philadelphia, Baltimore, Miami, and New Orleans. The very next day, DP World reacted to an urgent request from the White House by pledging to sell these holdings to an American entity as soon as possible. This request came on the heels of a resolution by the House of Representatives' Appropriations Committee, marking, for the time being, the climax of a heated three-week debate. On the day of DP World's formal takeover of P&O, the Committee had resolved with a 62-to-2-vote bipartisan consensus to insert an amendment prohibiting the execution of the port transaction into the 91.1 billion dollar Emergency Supplemental Appropriations Act for military actions in Iraq and Afghanistan and for the reconstruction after hurricane Katrina.

The Dubai ports affair appears to have

revived the kind of economic nationalism not seen in the USA since the late 1980s, when a similar wave of protectionist sentiment swept the country in the face of a growing number of acquisitions of American companies and institutions by Japanese investors. It is becoming evident once again—in the USA as well as in Europe—that direct investments, and especially acquisitions of firms by foreigners, provoke far stronger nationalist reflexes against the "sellout of national resources" than do foreign trade issues.

A Routine Transaction Turns into an Instrument of National Politics

Like all other direct investment in areas not relevant to national security by companies based in friendly states, the acquisition planned by DP World and P&O was initially treated as a routine transaction. The Committee on Foreign Investments in the United States (CFIUS), responsible for the review of foreign acquisitions of US firms, was first informed of the two companies' plan on October 17, 2005. On December 16, DP World and P&O officially filed a notice of the intended takeover. At the end of the 30-day review period, the CFIUS stated that it had no objections, and the two companies proceeded with their negotiations. Finally, P&O shareholders approved the transaction on February 13, 2006. The planned deal, valued at 6.8 billion dollars, appeared unobjectionable to the CFIUS for one because the transaction in question was not an acquisition of an American-owned firm by a foreign company, but a transaction between two foreign enterprises involving American subsidiaries. Furthermore, CFIUS evidently did not consider the affected US branch of business—port management—to be of strategic importance. Accordingly, neither the departments and agencies involved in the CFIUS process nor the media initially classified the acquisition as politically explosive. The business press reported it only as back page news—until on 13 February, the day of the P&O shareholders' final decision, some journalists recognized the case's potential to stir up domestic politics. Subsequently, the CFIUS found itself the subject of massive public criticism which was quickly directed at the entire Presidential Administration. The CFIUS' commitment to confidentiality and the fact that the committee does not publish the results of its reviews quite probably gave an additional boost to the public's distrust.

The public campaign was initially motivated by political expedience. For the Democrats the subject provided a welcome opportunity to attack the President and his party on their home turf, national security. But even conservative Republicans, alarmed by the impression that national security had been subordinated to economic interests, pitted themselves against the President. Should the Democrats succeed in using economic nationalism to gain ground against seemingly lax protectors of national security in the congressional elections on November 7, then this will determine a central theme for President's Bush remaining two years in office. That, however, would drastically narrow the Administration's political range of action in its efforts to oppose such campaigns of trade and financial protectionism.

The "Committee on Foreign Investments in the United States" (CFIUS)

The reform of the CFIUS-process is likely to be at the core of US domestic political discourse in the coming months.

The CFIUS is a permanent working committee of the American government in which twelve cabinet departments and other government agencies are represented: the Department of the Treasury, which serves as the chair of the Committee and coordinates CFIUS logistics, and the Departments of State, Defense, Homeland Security, Justice, and Commerce, as well as six agencies reporting to the White House—the Council of Economic Advisors, the US Trade Representative, the Office of Manage-

ment and Budget, the Office of Science and Technology Policy, the National Security Council, and the National Economic Council. The intelligence agencies participate in an advisory function. The CFIUS was established in 1975 as a monitoring institution with the objective to prevent the uncontrolled sale into foreign ownership of companies forming the core of the American defense industry. The creation of the CFIUS was at least partly due to the fact that with the devaluation of the US dollar after the end of the Bretton-Woods regime, the amount of foreign direct investment in the United States had increased notably for the first time after World War II, at first primarily from European sources. The 1988 Exon-Florio amendment—named after its main sponsors in Congress—to the 1950 US Defense Production Act expanded the authority of the CFIUS to include all takeovers with potential negative repercussions for national security. The term "national security" remained deliberately vague. At that time, the law was above all a result of the increasing domestic irritation about soaring Japanese direct investment in the United States. The amendment lists five criteria for the assessment of foreign acquisitions, two of which can be regarded as relevant to national security in a narrow sense: whether the takeover affects the national defense industrial base and whether it could contribute to the proliferation of military goods or technology. The three other criteria—effects on the capacity of domestic industries to respond to a possible future military demand, foreign control over enterprises that might be necessary to meet the requirements of national security, possible repercussions of the transaction for US technological leadership in areas that could affect national security—are formulated in a remarkably indefinite manner.

Companies are not legally required to notify the CFIUS of ongoing negotiations with foreign parties, nor are transactions subject to authorization. However, every agency represented in the CFIUS can demand a review up to three years after a transaction has been completed. Should the reviewers conclude that the takeover does violate national security interests, it has to be unwound. Hence it is usually in the company's interest to engage the CFIUS in due time.

The review process begins with a 30-day period in which the Committee debates the planned transaction. If during this time the participating agencies raise objections, a second, 45-day investigation will be initiated. A stricter version of the Exon-Florio Amendment, initiated by Senator Robert Byrd in 1993, makes this in-depth investigation mandatory for all transactions in which the foreign purchaser is "controlled by or acting on behalf of a foreign government" and which "could result in control of a person engaged in interstate commerce in the U.S. that could affect the national security of the United States."

Over the course of the investigation, the CFIUS remains in continual negotiation with the parties to the contract. Besides a statement of no objection, the review might also result in a conditional approval which would, for example, preclude non-Americans from accessing important data or from influencing the US company's management decisions.

Congress and the CFIUS Reform

In 2005, the CFIUS operations to date were subjected to a congressionally mandated investigation by the Government Accountability Office (GAO). The September 28 GAO report formulated three main points of criticism on which the public rejection of the Dubai transaction later drew—to the extent that the opponents of the deal used substantive arguments at all. It can be assumed that these three points will be revisited in the likely reform of the CFIUS and its proceedings.

First, the report detects the lack of a consistent definition of the term "national security threat" among the CFIUS member

agencies. While the Department of the Treasury, in particular, uses a narrow concept of security that pertains solely to cases involving industries of direct military significance and to cases featuring negative intelligence on the foreign acquirer, other agencies, notably the Department of Defense, plead in favor of a much broader concept of national security that even takes into account possible long-term repercussions on the position of the U.S. as a global leader in the technology sector. The Department of the Treasury, for its part characteristically interested in as unobstructed a capital flow into the US as possible, deems such a broad concept of national security to be a pretext for covert industrial politics.

As a result of this lack of agreement, the GAO criticizes, the Committee does not conduct enough in-depth (45-day) investigations (between 1997 and 2004 only 8 of 470 cases received a second-stage review).

Second, the GAO report points out that the investigation periods are too short. In addition, the report expresses concerns about the fact that companies involved in a transaction with a foreign buyer can, and are even actively encouraged by the Treasury's CFIUS managing office to retract their notification while the review is ongoing, thus stopping the process before possible security-based objections have been cleared. In most of these cases the transaction is then, upon completion, filed again. But, as mentioned above, it is not ever required that the CFIUS be notified.

Third, the GAO criticizes the lack of transparency of CFIUS operations. Once the CFIUS has approved a transaction, there is currently no institutionalized way for Congress or other governmental agencies to raise objections. Only very rarely does the CFIUS actually submit its recommendation on a case to the President's office in which case the Congress also has to be notified (this only happened in two of the 470 cases registered between 1997 and 2004).

The GAO concludes that on its tightrope walk between national security and economic or capital market interests the CFIUS overall leans too strongly towards the latter.

In Congress, the GAO's recommendations have already found their way into a few draft bills that, in the wake of the Dubai ports controversy, are likely to be addressed speedily. Legislative initiatives on the CFIUS reform are due to be introduced in both the House of Representatives and the Senate before the end of March. In the House, Republican House majority leader Roy Blunt is supporting such a move. In the Senate, a group headed by Republican Senator Richard Shelby will submit a bill to enhance scrutiny of foreign acquisitions in the US. Changes in legislation can still be expected in the legislative term of the 109th Congress which ends in January 2007. These changes would make the regulatory procedure for foreign acquisitions in the US longer, more political and, above all, more strongly aligned with a broader definition of national security.

A transfer of the CFIUS chair from the Treasury to the Department of Defense, encouraged by the Republican Senator James Inhofe and others, could be the institutional guarantor for such a transformation. Inhofe motivates his suggestion by arguing that it is the Treasury's main concern to back the dollar and to sustain the stability of capital markets while the priority should be national security.

A transfer of this kind would be another indicator of the Treasury's political weakness and lack of influence in George W. Bush's Administration.

Most significantly, the CFIUS review process will continue to be discretionary, bound by very few rules, and hence hardly predictable even after a reform. However, it is likely that the principle "when in doubt, favor the investor," thus far employed by the Treasury taking advantage of its discretionary powers, will be reversed.

Foreign Investment as a Threat to Security?

Was the Dubai ports deal a singular case? Despite the political particularities and sensitivities of each individual case, a general pattern can be discerned in the handful of acquisitions by foreign firms in the USA that were actually contested.

In the ports deal, several issues considered critical by the American public came together against the backdrop of the "War on Terror": The combination of *Arab* and *state-owned* enterprise fuels the already widespread political distrust of Arab states and of their long-term political reliability and stability in particular, and at the same time feeds into general worries over foreign states exerting an influence over the USA. This distrust has been further intensified by fears that terrorist attacks could be perpetrated using the ports, for example employing containers, and by irritation over the insufficient port security precautions taken so far.

In the meantime, another transaction involving a Dubai company has come to the attention of the public: the acquisition of a British electronics firm with subsidiaries in the USA which are supposedly suppliers to the defense sector.

It is especially ironic, or even tragic, that the Emirate at the center of the controversy is a shining example of modernization in the Arab world; not a significant producer of oil, Dubai has become the business and financial hub of the United Arab Emirates (UAE). To the United States, the UAE are consequently a "beachhead of modernization;" the US-UAE Trade and Investment Framework Agreement (TIFA) was signed in March of 2004, and a Free Trade Agreement is being negotiated though the latest round of negotiations has had to be adjourned in the wake of the failed ports deal.

Beyond the particularities of the Dubai case, purchases of American firms by foreign companies have increasingly aroused political discomfiture in recent years, which cannot be sufficiently explained by the particular American sensitivity to security questions since September 11, 2001. Instead, the feeling of economic vulnerability in the face of the uncontrolled rise of the twin budget and current account deficits, which has been gaining ground in the American political public sphere, is also contributing to this unease regarding foreign investment. Above all, however, China's economic rise and its immense dollar holdings are felt to be a threat—similar to the perception of Japan in the late 1980s, but in China's case far more pronounced due to the lack of a formal security alliance.

Already in late 2005 a similarly broad front had formed against the attempt of China's CNOOC to take over the US oil firm UNOCAL. The American oil major Chevron had submitted an offer for UNOCAL, an oil company with concessions mainly in Central Asia, but was significantly outbid by CNOOC. In view of strong Congressional opposition to this transaction, manifested in the form of a bipartisan resolution, CNOOC withdrew its bid even before the CFIUS had completed its review.

Earlier in 2005 a spectacular Chinese acquisition, Lenovo's purchase of IBM's personal computer business, was reviewed in depth by the CFIUS and finally received conditional approval despite widespread skepticism in domestic policy circles.

In 2003, conversely, the acquisition of the then-insolvent American telecommunications company Global Crossing by the telecom subsidiary of Hutchison Whampoa, one of Hong Kong's two oldest trading houses, had foundered against domestic political opposition in the USA. The allegedly close political relations of Hutchison's top management to Beijing's political leadership had been criticized in Congress. After Hutchison subsequently distanced itself from the transaction, Global Crossing went to the Singaporean telecommunications enterprise STT.

Were one to apply the standards of the most recent domestic political debates and the current legislative projects more generally, not very many attractive com-

panies would be left for foreign investors, especially not for acquisitions from the growing number of countries which Congress considers not to be sufficiently trustworthy. Not only would the defense and dual-use industries sector be excluded, with its great industrial weight within the American manufacturing industry, but so would the numerous subcontracting companies in this sector, and also all other enterprises relevant to national security in a broad sense: telecommunications, electronics/high technology, the raw materials and energy sector, transport and infrastructure, as well as financial services.

Finally, in this situation one also needs to anticipate that the economically nationalist mood mobilized by the Dubai case might advance the adoption of the so-called Schumer Amendment in Congress. The objective of the amendment is for China to revalue its currency to a "fair" level within a negotiation period of 180 days. Should the negotiations fail, a 27.5% duty would temporarily be levied on all imports from China; this duty would correspond to the magnitude of Renminbi appreciation deemed necessary.

It has thus far been expected that a congressional adoption of the Schumer Amendment will induce the President to exercise his veto—just as he had initially announced to veto a legal prohibition of the Dubai-Ports transaction. Should the amendment be passed, however, this is likely to put the WTO's multilateral trade regime to a severe test.

Transatlantic Ramifications

European onlookers may be observing the Dubai case and the escalating American economic nationalism in a relaxed manner, as European enterprises do not seem to be affected. This assumption could, however, turn out to be false. First, EU-based companies can by no means be safe from *direct* discrimination in planned takeovers. Second, they, too, will not be spared by the *indirect* effects.

It is for this reason that already in October 2005, upon publication of the GAO report on the Exon-Florio CFIUS process, the European-American Business Council (EABC) spoke out against a CFIUS reform which envisages

- Taking the CFIUS Chairmanship away from the Department of the Treasury
- Increasing discriminatory conditions for foreign investors in the USA
- Heightening the review process' transparency at the expense of the confidentiality of business information
- Widening the concept of national security and making it a protectionist instrument
- Prolonging the review time

One direct consequence of increased protectionist sentiments is the fate of the planned US-EU Open Sky agreement for the liberalization of transatlantic air traffic. In November 2005, after years of negotiations, the US and EU delegations had reached an agreement which included the liberalization of foreign direct investment in the aviation sector. In the past few weeks, this settlement has been met with disapproval in Congress. The argument: the Pentagon's any-time access to the American fleet of civil aircraft is no longer ensured if American airlines are majority foreign-owned.

Moreover, the jury is out on which issues will follow from Congress and the American public having discovered that almost all American port terminals have been operated by European-, Japanese-and other foreign-owned companies (e.g. Maersk and NYK) for a long time. The same is true for the fact that there are no longer any large American merchant marine companies. The draft bills which prescribe for the operating companies of "infrastructure relevant to national security"—such as ports—to have American owners remain in the legislative process even after DP World's withdrawal.

American reservations against European takeovers in the high-tech sector are likely to grow all the more so. One lobbyist of US economic nationalism, W. Hawkins of

"American Economic Alert," argued on the occasion of Congress' October 2005 consultations on the GAO report: "Europeans have been very aggressive in buying American technology firms to gain their secrets. Often, acquisitions are sought to improve the chances of landing Pentagon contracts that would move a larger share of military procurement overseas and out of reach of Defense Procurement Act."

But the indirect effects of the American restrictions on acquisitions also need to be considered. If these limitations prevent prospective capital-rich buyers from "unwelcome countries" from purchasing European businesses with subsidiaries in the US, this drop-out of a group of bidders will reduce the market value of the concerned European companies.

This could especially turn into a problem for Great Britain. The most important European financial center, Great Britain is fostering a culture of openness for domestic takeovers by foreign firms at the same time as being by far the largest European source of direct investment in other countries. Especially touchily, Great Britain is also the biggest provider of direct foreign investments in the USA. And a substantial number of these Britain-based enterprises investing in the US are, in turn, held by or could be sold to investors from other countries, provided that restrictive American practices do not render them less attractive as takeover targets.

American economic nationalism presently appears to have a similarly virulent equivalent in Europe. France and Luxembourg are trying to prevent the takeover of the steel enterprise Arcelor by Mittal, an Indian steel company registered in the Netherlands and run from London; the Spanish government is working to block the German E.On AG's takeover of the electricity producer Endesa by way of a merger of Endesa with another Spanish company; the French government's list of "strategic sectors" which must under no circumstances be foreign-controlled is almost as long as a list of those sectors which, in the eyes of US economic nationalists, have to remain American. Nevertheless, as questionable as the economic nationalism currently surfacing in Europe may be for the European integration process, with its rejection of cross-border acquisitions, it is legally on a different plane than the kind practiced in the United States. Only excepting the narrowly defined defense sector, the provisions of European community law prevent overt state discrimination against offers from other EU countries to purchase domestic businesses. Individual member states or companies controlled by them can attempt to bypass these regulations, but their open violation will always have legal consequences.

In the US, on the other hand, there exists a *legal basis* for giving regulators wide scope to discriminate against acquisitions of firms by foreign actors.

Macroeconomic Dangers of Financial Protectionism

By running a current account deficit of more than 800 billion US dollar, the US is increasing other countries' cumulative dollar holdings by the same amount. By definition, these assets are ultimately claims on the American national economy. As such, they show up as capital imports in the American capital account—the balancing position of the current account. These assets can be invested in several ways: as interest-free or low-interest credits on accounts held with the US federal reserve system or with other American banks, as treasury bonds yielding only marginally higher interest rates, as company bonds or stocks, or as direct investments in enterprises—be it via the establishment of a new business or by way of acquiring existing firms.

Thanks to its sovereignty over its currency, the US has the option of laying down regulations for the use of foreign dollar assets accumulated by its trade partners. An official US prioritization of foreign policy and security considerations would

doubtlessly call for a strong preference for foreign investment in treasury bonds. This would ensure that the US government can continue to finance its budget deficit while avoiding interest rate hikes in the domestic capital market. Beyond government bonds, investment in real estate and financial investments—industrial bond issues or purchases of stocks below a blocking minority—might also be accepted. As demonstrated, direct investments by way of acquisitions of firms are increasingly greeted with reluctance. But are these restrictions on dollar usability tenable in the long run? And do they make economic sense? From an economic viewpoint, foreign direct investments are the most stable and least speculative form of long-term capital inflow. It is mainly for this reason that the high current account deficit of the late 1990s, which coincided with a budget surplus and was primarily driven by large inflows of foreign direct investment capital, did not present a cause for concern. In the current situation, in contrast, the factual restriction on the use of the dollar reserves held by the countries with some of the highest total dollar assets—China and Arab oil exporters—would send a fateful signal. This forced channeling of dollar reserves into the least profitable investments—treasury bonds and central bank accounts—will most likely induce the countries in question, most notably China, to increase their direct investments in emerging markets and resource-rich countries (for its investments in these markets, China is already being accused of mercantilism). Alternatively, countries with large dollar reserves will reallocate their reserves and reduce their dollar holdings in favor of other currencies, most importantly the Euro, as Arab states have already signaled after the Dubai fiasco.

The consequences of this development will not leave the USA unaffected. US capital market interest rates have already risen significantly in the past few weeks. Ramifications for the real estate market cannot be long coming. Were a heightened demand for capital from the growing Japanese and European economies to supervene at this point, an increasingly restrictive American stance towards foreign direct investment could quickly turn into a serious problem for the financing of the American current account deficit.

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