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The Evolving Global Business Landscape: Implications for the International Investment Policy Regime

Michael Gestrin and Ana Novik

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Think Piece

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This paper presents a summary of the OECD's recent and ongoing work on the evolving global business landscape. It has been prepared for the E15 investment discussions at the World Economic Forum. The paper was prepared by Ana NOVIK, Head of the Investment Division and Michael GESTRIN, Senior Economist both at the OECD Directorate for Financial Affairs.

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ABSTRACT

This paper presents a summary of the OECD's recent and ongoing work on the evolving global business landscape. It begins with a brief survey of global investment trends and then examines three factors that could have implications for the international investment policy regime: changes in the ways companies organise their international operations; increases in government involvement in some segments of the global economy; and gaps in the governance of international investment flows.

The paper argues that the international investment landscape is undergoing major changes and is being shaped by new factors outside of the boundaries of traditional investment policies and international investment agreements.

CONTENTS

LIST OF ABBREVIATIONS AND ACRONYMS

EU	European Union
FDI	Foreign direct investment
ICN	International Competition Network
IIAs	International investment agreements (IIAs)
M&A	Mergers and acquisitions
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
POEs	Privately-owned enterprises
SOE	State-owned enterprise
SPEs	Special purpose entities

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INTRODUCTION

This paper begins with a short survey of global investment trends. It then identifies three factors that could hold implications for the international investment policy regime. Briefly, these are:

- Changes in the ways in which companies organise their international operations, which could hold implications for the coverage of the current international investment regime;
- The growing involvement of governments in some segments of the global economy, with possible unintended consequences for international investment flows; and
- Governance gaps in the current international investment regime in areas that are becoming increasingly important for international investment flows.

GLOBAL TRENDS IN CROSS-BORDER INVESTMENT

The rapid integration of the world economy in recent decades has resulted in a powerful upward trend in the stock of global cross-border investment (Figure 1). This trend displayed little evidence of being affected by global recessions in the early 1990s and during the technology bust of 2001-02. After stopping briefly at the beginning of the recent financial crisis, it has resumed its steady rise, if somewhat less rapidly. Since 1990, the value of global foreign direct investment (FDI) stocks has risen from less than US$2 trillion to about US$26 trillion. FDI has greatly outstripped the growth of the world economy, inflation, or global trade.

In the short term, however, flows of such investment have been volatile, displaying a marked cyclical pattern. Figure 2 shows the evolution of two measures of cross-border investment activity: global FDI outflows from 1997 to 2013 and global cross-border mergers and acquisitions (M&A) flows from 1997 to 2014.[1] The two recent boom and bust cycles, the first associated with the "dot.com" bubble and the second linked to the 2008 financial crisis, are clearly evident. Currently, global FDI flows remain about 40 percent below the record level set in 2007, and the value of cross-border M&A is down almost 50 percent.

The industry composition of cross-border M&A remains evenly balanced at the global level. The top eight broad sectors accounted for 66 percent of total cross-border M&A in 2014, with no sector accounting for more than 11 percent. Previous M&A cycles have tended to be driven by activity in one or two leading sectors. In the lead-up to the 2000 peak in international investment activity, telecommunications, propelled by a global wave of privatisations, was the driver. In the lead-up to the international investment boom of 2007, the financial sector and real estate were the drivers (Figure 3). At the global level, there is no clear indication of a sector breaking away as happened in previous M&A booms, although the signs of a new M&A cycle have been clearly in evidence in the first half of 2015, fuelled in large measure by quantitative easing programmes.

One sector that has been booming in the post-financial crisis era is the state-owned enterprise (SOE) sector. Cross-border M&A by SOEs increased sharply starting in 2008 and accounted for more than 20 percent of total cross-border M&A in 2009 (Figure 4). SOE activity has decreased since but remains well above its historical levels at just under 10 percent of the total. Cross-border M&A by SOEs has played an important counter-cyclical role in the aftermath of the financial crisis, but has also given rise to concerns, which are considered below in the discussion of factors affecting the outlook.

INDICATIONS THAT MNES ARE CHANGING THEIR BUSINESS MODELS

One of the ways MNEs have been changing their business models concerns the growing importance of financial flows (as opposed to flows of FDI) that these companies channel across borders using their international networks. These flows play numerous functions, including for tax planning purposes, the management of income flows associated with licencing and other services, as well as the financing of M&A and greenfield investments.

Among the more common vehicles for channelling such financial flows are special purpose entities (SPEs), firms under

1 FDI statistics and data on international M&A constitute two of the best sources of information on direct investments by MNEs. Although not strictly comparable, these two series follow each other closely, only moving in different directions twice between 1997 and 2013. FDI statistics are provided by governments and are reported in every country's balance of payments statistics. Data on M&A is obtained from Dealogic's M&A Analytics database, a privately run database. An advantage of international M&A data over FDI data is timeliness.

the control of the multinational enterprise (MNE) whose main function is the management of financial flows. These firms typically do not engage in the core business of the MNE, e.g., an SPE set up by an automotive assembler will not build cars. Given the way FDI is defined, SPEs have come to represent a major component of global FDI flows. For example, in the European Union (EU), SPEs accounted for 75 percent of inflows in 2013. Although OECD countries have all started reporting their FDI statistics with breakdowns for FDI flows to and from SPEs, most countries in the world do not. Consequently, although it is recognised that these types of flows have become much more significant over time, we do not know by exactly how much or where these flows are coming from or going to.

Another important emerging change in the way MNEs are organising themselves internationally relates to international divestment. Just as MNEs acquire international assets through M&A, they also regularly divest themselves of international assets as market conditions and strategic corporate priorities change. In aggregate terms, the difference between cross-border M&A and international divestment can provide an indicator of how much MNEs are adding to the stock of international investment in the form of net cross-border M&A. This is useful, because it shows by how much and in which sectors cross-border M&A is creating new economic linkages between countries. It also shows by how much and in which sectors MNE investment linkages between countries are weakening or even disappearing altogether as when international disinvestment exceeds cross-border M&A.

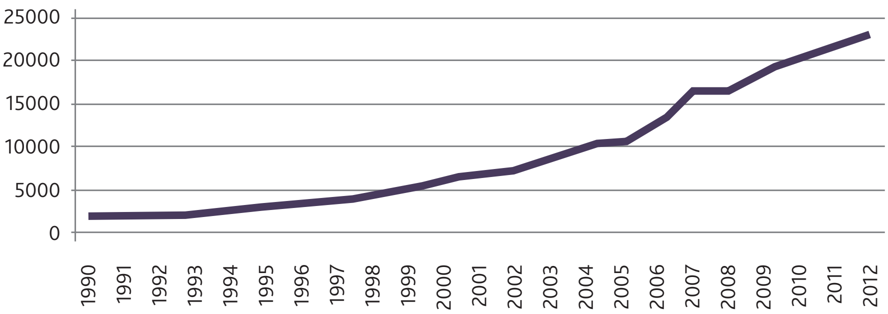

FIGURE 1:

Global FDI stocks (US$ billions)

Source: OECD International Investment Statistics database and International Monetary Fund.

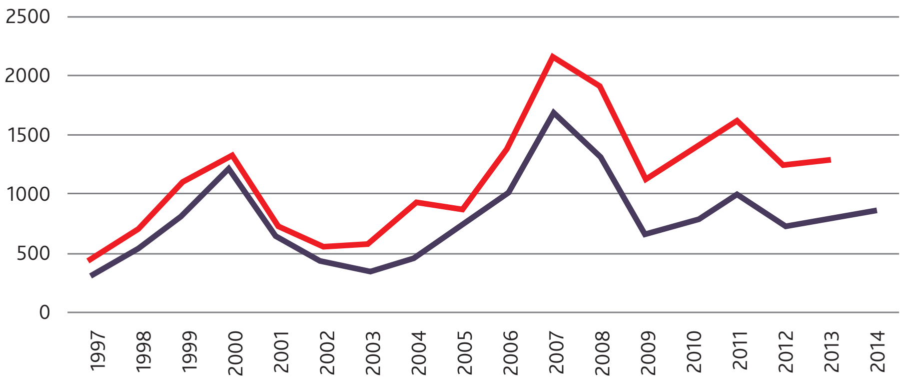

FIGURE 2:

Global cross-border investment since 1997 (US$ billions)

LEGEND:

International mergers and acquisitions

Foreign direct investment outflows

Source: OECD International Investment Statistics database, International Monetary Fund, Dealogic M&A Analytics database OECD

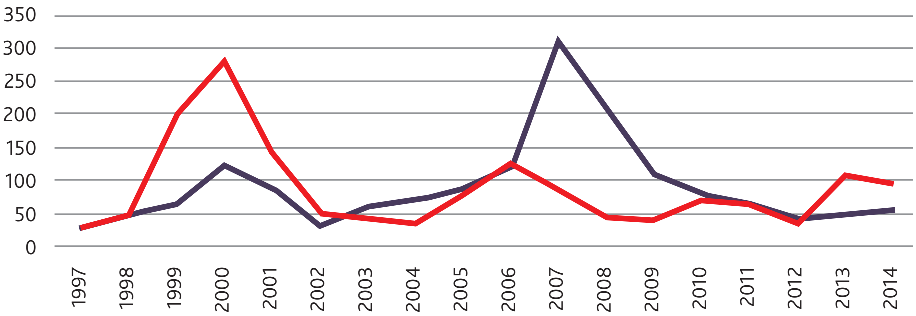

FIGURE 3:

Cross-border M&A in finance and communications (US$ billions)

LEGEND:

Finance

Telecommunications

Source: Dealogic, M&A Analytics database, OECD calculations.

At the global level, net cross-border M&A declined by 9 percent in 2014, in contrast with gross cross-border M&A which increased by 8 percent (Figure 5). This was due to a 25 percent increase in international divestment. In addition, the ratio of international divestment to cross-border M&A reached 57 percent, its highest level since 2004 (which itself was an exceptional year, owing to a number of major international divestments coinciding with record low M&A levels). This suggests that a growth trajectory for MNE investment, characterised by high levels of net cross-border M&A and a low international divestment-to-cross-border M&A ratio, has transitioned to a post-crisis restructuring trajectory with the opposite characteristics. In other words, the increase in cross-border M&A now occurring is more focused on international corporate restructuring than on creating new economic linkages between countries.

2007 relates to the shift of world economic activity toward the emerging market economies and the resulting need for MNEs to reshape, significantly, the way they organise their international operations. The growing share of de-globalising deals in international divestment could be attributed to the tendency toward more reliance on contractual and other non-equity forms of international business relationships within the context of global value chains. It could be that firms are becoming relatively less reliant on FDI as a vehicle for building international businesses.

The trends toward increased use of SPEs as well as the growing importance of cross-border divestments by MNEs could hold important implications for the coverage of the current international investment regime. If these trends persist and MNEs become more focused on financial functions related to the management of brands and technologies and make more use of non-equity modes of managing global value chains, this would imply that the extent to which international investment agreements (IIAs) cover cross-border economic activity, based as they are on cross-border ownership, could decline.

TOO MUCH GOVERNMENT INVOLVEMENT IN SOME MARKETS MAY BE DISCOURAGING INTERNATIONAL INVESTMENT

Investment policymakers have traditionally focused on explicit impediments to international investment, such as limits on foreign ownership, trade-related investment measures, and screening requirements. In recent years, the general trend has been toward more open investment regimes. Even during the financial crisis, regular G20 monitoring has not found any clear evidence of a general trend toward rising investment protectionism.

However, governments play an important role in the governance of the global economy, both directly and indirectly, and in some instances heightened government involvement is generating distortions and inefficiencies that could act as a brake on investment. This section considers two examples.

State ownership and government support for outward FDI

As highlighted in the general trends section above, SOEs have become important players in the global marketplace (Figure 4), in particular during the global financial crisis that started in 2008, when SOEs played an important countercyclical role. However, concerns have also been raised about possibly unfair advantages that SOEs enjoy in global markets, in addition to in their home markets, by virtue of their links to governments. Among the most commonly cited is access to preferential financing for their international investments. Although it is difficult to prove empirically that SOEs do enjoy such advantages, a comparison of how SOEs and privately owned enterprises (POEs) structure their cross-border M&A deals does point in this direction. For example, the average international deal size of SOEs is more than double that of POEs (Figure 6). This finding is not affected when controlled for industry or firm size and is consistent over time.[2]

Another important difference between the cross-border M&A deals of SOEs and POEs concerns the size of the equity stakes preferred by each type of firm. SOEs show a strong preference for taking partial stakes in their international targets, while for POEs 100 percent ownership is often preferred (Figure 7). This finding is counterintuitive, given that average SOE deal sizes are significantly larger than POE deal sizes; SOEs pay more for smaller stakes. What this shows is that SOEs ascribe higher valuations to their targets than POEs. While factors other than preferential access to finance, and therefore a lower cost of capital, might partially explain this finding, it is, nonetheless, what one would expect to find if indeed SOEs did enjoy preferential access to financing for their M&A deals.

The extraordinary increase in international investment from the emerging market economies beginning around 2004-5 has often been lauded as a sign that investment globalisation is becoming more balanced. It has also created an expectation that an erosion of the parallel home-host/north-south distinction would bring about greater convergence on policy issues (since countries would no longer be seeing their interests uniquely from either a narrow host-country or home-country perspective).

However, the rapid rise of emerging market economies as sources of international investment (however measured) also gives rise to a question that has important implications for the outlook: is outward investment from emerging markets and China, in particular, based on various forms of policy support (rather than competitive advantage) and therefore only sustainable as long as this support is maintained?

2 Figures 6.9 and 6.10 are based on a comparison of all SOE and POE deals worth more than US$5 million during the period 1996-2013.

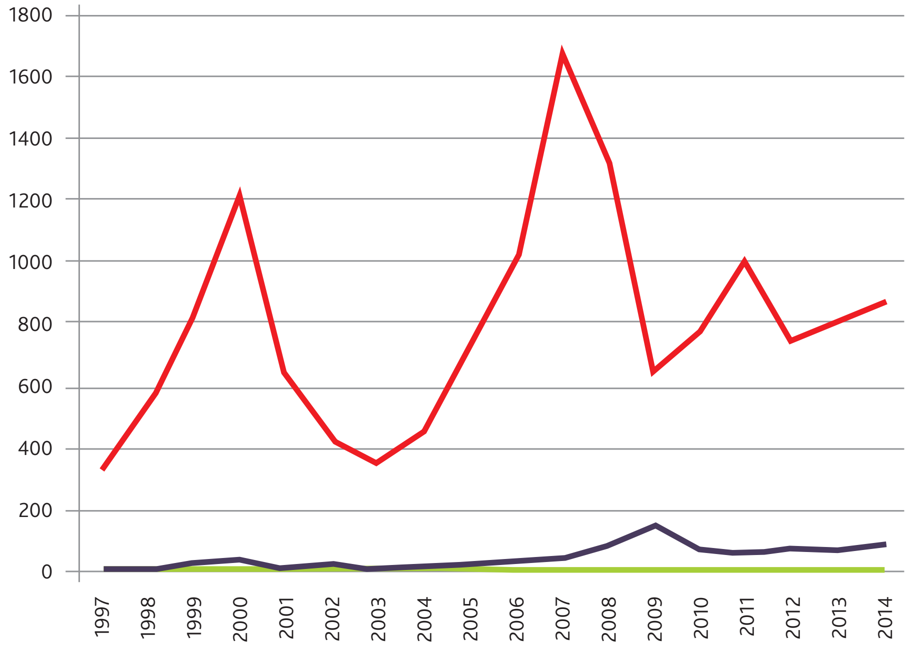

FIGURE 4:

Cross-border M&A by SOEs (US$ billions and percent, right axis)

LEGEND:

- State-owned enterprise-led international M&A
- Total international mergers and acquisitions
- State-owned enterprise-led international M&A/ total international M&A (%, right axis)

Source: Dealogic, M&A Analytics database, OECD calculations.

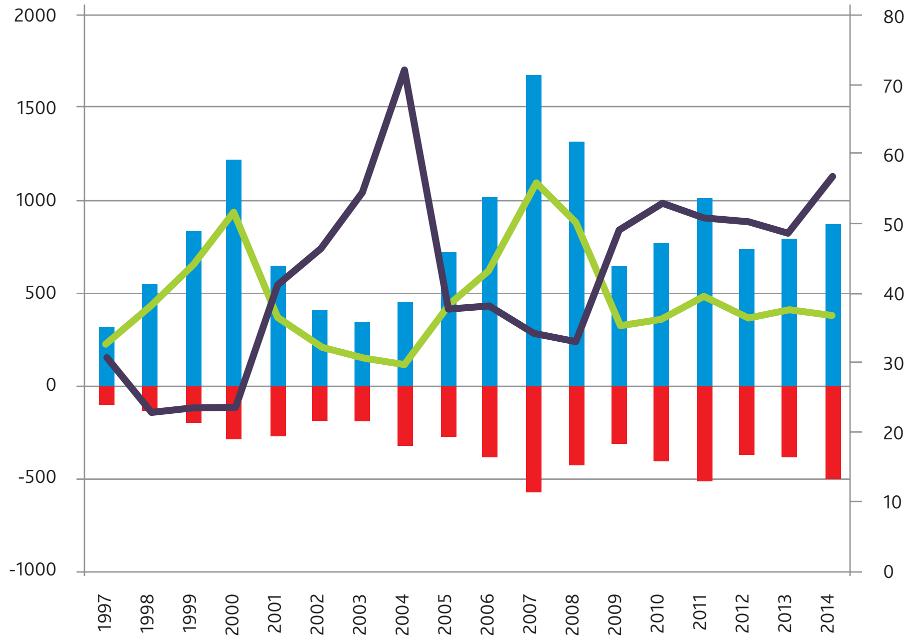

FIGURE 5:

Global cross-border mergers and acquisitions and international divestment (US$ billions and %, right axis)

LEGEND:

- International divestment
- Gross international M&A
- New international M&A
- International divestment/international M&A (%, right axis)

Source: Dealogic, M&A Analytics database, OECD calculations.

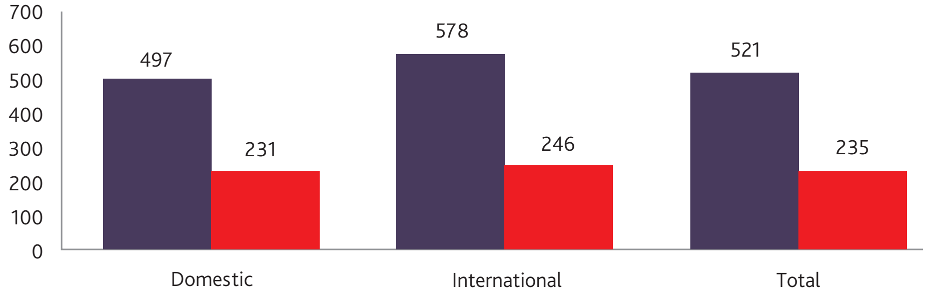

FIGURE 6:

Average deal sizes of state-owned and privately owned enterprises, 1996-2013 (US$ millions)

LEGEND:

- State-owned enterprises
- Privately-owned enterprises

Source: Dealogic, M&A Analytics database, OECD calculations.

One of the indications that points in this direction concerns the size of cross-border M&A deals. Just as previous booms have been led by surges in M&A activity in particular sectors, they have also been accompanied by sharp increases in average deal value (Figure 8). During each of the previous boom and bust cycles, the average value of cross-border M&A peaked at just under US$150 million. Emerging markets (excluding China) have performed very much like the advanced economies in this respect since about 2004, reflecting the fact that they had not yet become important sources of outward investment at the time of the first international investment boom in 2000.

China is represented separately in Figure 8. Up until 2004, China's average deal size wasn't much different than that of cross-border M&A from other emerging market economies and was generally lower than deals led by firms from the advanced economies. In the 10 years since 2005, however, the average value of cross-border M&A deals by Chinese firms has been 76 percent larger than the world average. And in the last three years, they have been twice as large as the world average (which is approximately US$100 million). Given that the turning point in previous MNE investment cycles has been marked by average deal sizes approaching US$150 million, China's outward FDI has qualities that suggest a correction is possible.

Another area of potential imbalance concerns the ratio of international divestment to cross-border M&A. As discussed in earlier sections on regional trends, international divestment has generally been on the rise in recent years, in particular in European countries, reflecting adjustments that firms are making in the organisation of their international operations to reflect major shifts in the world's economic centre of gravity, among other factors. The one important exception to this trend is found in the outward cross-border M&A from the emerging market economies (Figure 9).

Two distinct stories are apparent. First, the EU economies have divested almost as much as they have invested (through M&A) internationally (including cross-border investments within the EU) in the past three years, so their divestment-to-investment ratios have been close to 100 percent. Second, the emerging market economies have divestment-to-investment ratios below their historical average (27 percent) with a ratio of 21 percent in 2014. Within this group, however, China again stands out as the main reason the emerging market economies differ from the non-EU advanced economies. Since around 2008, international divestments by Chinese firms have been negligible, averaging 5 percent, well below a historical average of 22 percent for all countries. It seems implausible that Chinese firms will be able to sustain their current levels of international investment without at some point engaging in more international divestment more in line with the way most other firms are constantly reworking the architecture of their international operations and using the proceeds from divestments to finance new investments.

In terms of the outlook for global FDI, the sustainability of outward investment from China will be an important variable going forward. China accounted for 8 percent of total global cross-border M&A in 2014. There are currently three plausible channels through which one might expect China's outward cross-border M&A to shrink. First, the absolute value of its outward investment activity could be expected to slow down. Second, the size of deals by outward Chinese investors might at some point be expected to decline. Third, cross-border divestment by Chinese outward investors, currently also at unusually low levels, might also be expected to rise at some point.

Some support schemes for clean energy may lead to competitive distortions[3]

In the past decade, governments have provided substantial support to clean energy that has benefited both domestic and international investment (OECD, 2015). Globally, policy support, some but not all in the form of specific support for domestic investment or FDI in that sector, to clean energy amounted to US$121 billion in 2013 (OECD, 2014a). At least 138 countries had implemented clean-energy support policies as of early 2014 (REN21, 2014). Several countries have also supported clean energy by reducing barriers to international investment and trade, such as *de jure* restrictions on FDI and import tariffs.

Largely driven by policy support, new investment in clean energy increased sixfold between 2004 and 2011, reaching US$279 billion in 2011, before declining in 2012-13. Solar and wind energy have received the largest share of new investment flows — US$114 billion and US$80 billion, respectively, in 2013. International trade and greenfield FDI have strongly contributed to the growth of solar and wind-energy sectors, as well as to the integration of these industries into global value chains. Both industries — and especially solar photovoltaic energy — are now characterised by the emergence of global production networks.

Since the 2008 financial crisis, however, the perceived potential of clean energy to support domestic growth and employment has led several Organisation for Economic Co-operation and Development (OECD) countries and emerging economies to design green industrial policies aimed at protecting/favouring domestic clean-energy manufacturers, especially in the solar photovoltaic and wind-energy sectors. In the post-crisis recovery context, policymakers have done so notably through setting local-content requirements. These typically require solar or wind developers to source a specific share of jobs, components or costs locally to be eligible for policy support or public tenders. Such requirements have been designed or implemented in solar and wind energy in at least 21 countries, including 16 OECD countries and emerging economies, mostly since 2009.

3 While we have chosen to focus on clean-energy schemes, one reviewer highlighted government use of export barriers (Indonesia, Brazil, Argentina, etc.) to develop specific industries in the domestic market.

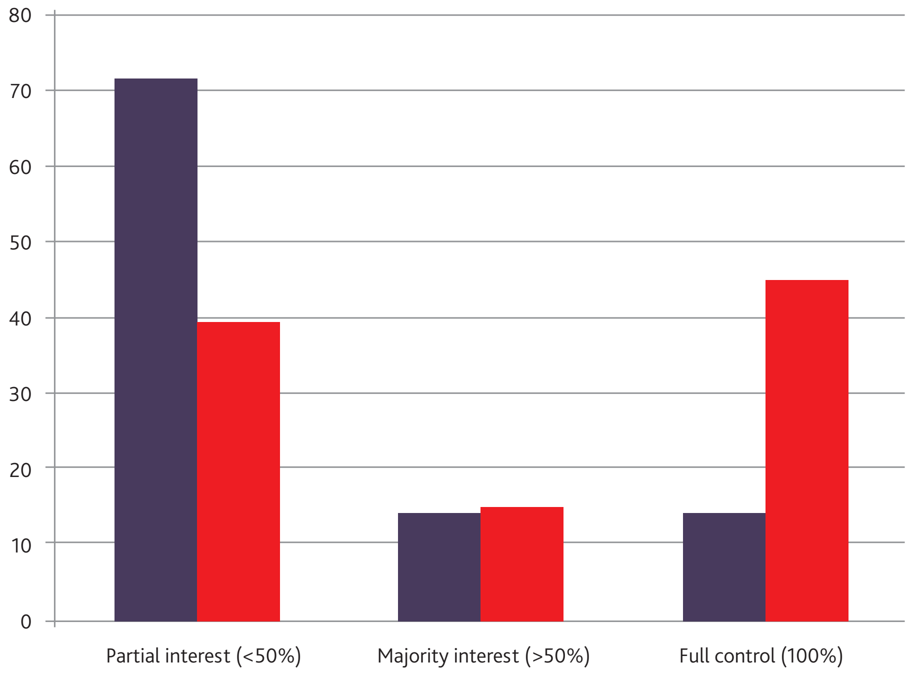

FIGURE 7:

Deal characteristics: state-owned and privately owned enterprises, 1997-2013 (percent)

LEGEND:

State-owned enterprises

Privately-owned enterprises

Source: Dealogic, M&A Analytics database, OECD calculations.

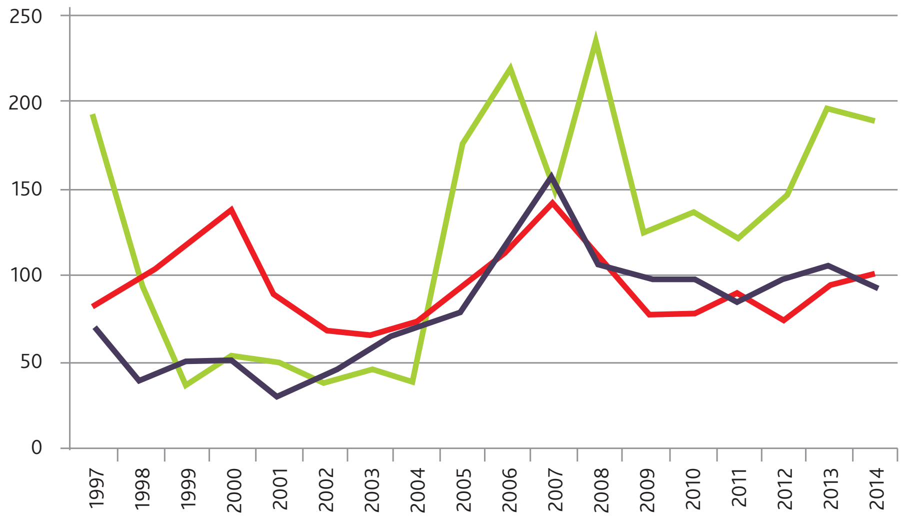

FIGURE 8:

Average cross-border merger and acquisition deal size, different country and country groupings (US$ millions)

LEGEND:

All deals

China

Emerging markets without China

Source: Dealogic, M&A Analytics database, OECD calculations.

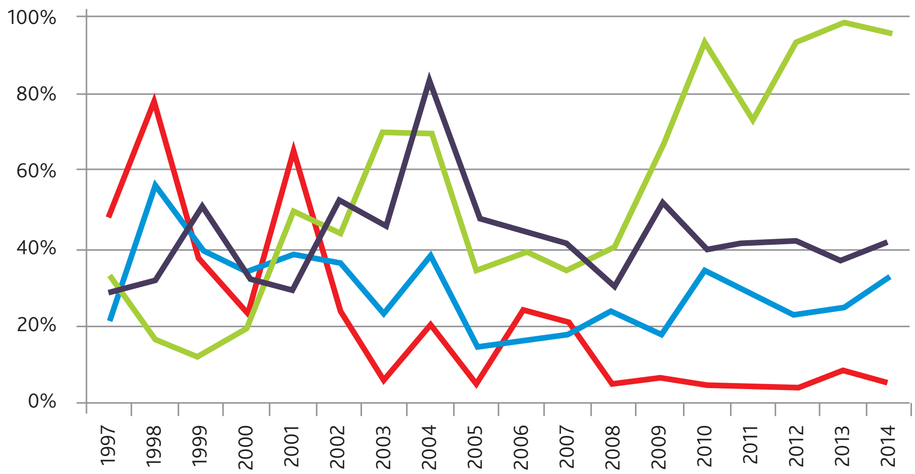

FIGURE 9:

Outward international divestment as a share of cross-border M&A volumes, by country and country groupings

LEGEND:

Emerging economies without China

China

European Union

Non-European Union advanced economies

Source: Dealogic, M&A Analytics database, OECD calculations.

In a context of global value chains, local-content requirements have hindered global international investment flows in solar photovoltaic and wind energy. At the same time, they have had mixed or negative results in achieving policy goals, such as local job creation.

The case of government support for clean energy highlights the potential for well-meaning government support programmes in new fields to cross the line, leading to distortions and, as in this example, restrictions on international investment. As mentioned at the outset, there is no evidence that governments have been veering toward protectionism in any sort of systematic way. However, as new technologies give rise to new industries, and as global value chains lead to new patterns of firm-level organisation across borders, protectionism in individual sectors can quickly give rise to spillovers resulting in economic inefficiency and distortions on a global scale.

Too little government involvement in some markets may be holding back international investment

One of the main areas where this is likely the case concerns competition policy. More jurisdictions than ever are applying competition law.[4] Although laws and procedures vary across countries, different regimes around the world are remarkably similar. Common elements include: prohibitions against cartels; reviews of mergers based primarily or exclusively on their effects on competition; and an ability to take action against firms with market power that behave anti-competitively.

The widespread implementation of competition laws and establishment of competition enforcement authorities has generally been a positive development, at least in principle. One of the major shortcomings of competition law and policy in practice is that, while international investment has increased dramatically since 1990, the enforcement of competition law has remained primarily a domestic exercise.[5] The increasingly cross-border dimension of business activities, together with the increase in the number of competition authorities creates additional complexity for cases with a multi-jurisdictional element (Figure 10). This complexity creates challenges for the effective and consistent enforcement of competition law. More important in the context of this chapter, in the absence of cooperation and consistent enforcement, international investors are faced with heightened uncertainty about their investment plans.

Cross-border mergers create scope for disagreement between competition authorities and can give rise to substantial costs when such disagreements occur. The implications for the outlook for cross-border investment by MNEs are twofold. First, the strictest standard for approving a merger will become the prevailing standard in many cases, potentially stopping mergers that would be approved by most jurisdictions even of truly global products. This means that what most countries determine to be a pro-competitive or innocuous merger may be stopped by one authority having a different view. As more authorities evaluate mergers, it is more likely that one of them will form a different judgment, even from the same facts.

Second, the uncertainty created by a system in which any given cross-border M&A deal has to be reviewed by possibly dozens of different agencies, with different approaches and priorities, effectively raises the bar in terms of the willingness of firms to go ahead with deals, and may have a chilling effect on merger dealmaking. To the extent that mergers enable sharing of good practices across borders, such efficiency enhancing effects of mergers would be limited.

4 The International Competition Network (ICN) now has 126 members from 111 jurisdictions.

5 The most notable exception to this is the European Commission's DG Competition, with competition powers across the EU that are actively exercised on a regular basis.

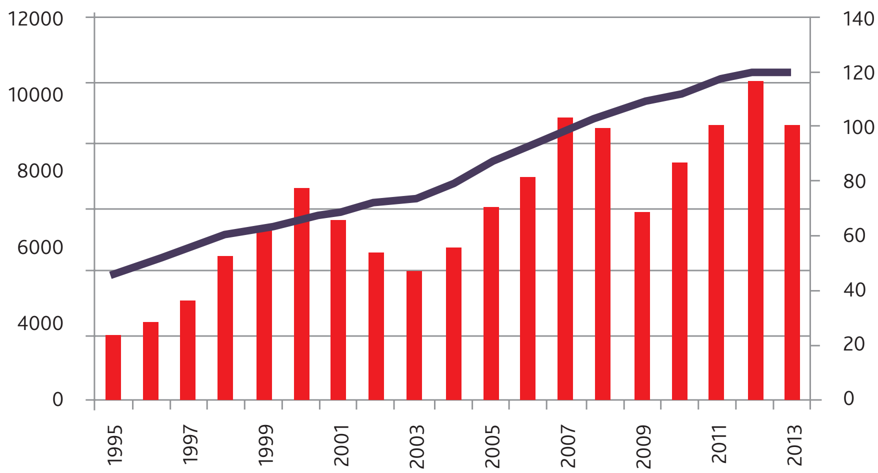

FIGURE 10:

More competition authorities dealing with more cross-border mergers and acquisitions

LEGEND:

Number of cross-border merger and acquisition deals

Number of competition authorities (right axis)

Source: OECD calculations based on Challenges of International Co-operation in Competition Law Enforcement, OECD (2014) www.oecd.org/daf/competition/challenges-international-coop-competition-2014.htm.

CONCLUSIONS

One of the overarching themes of this paper has been the reorganisation of the international business landscape in the wake of the global financial crisis. Emerging markets have become more deeply integrated into the global economy through international investment, while many advanced economies have experienced sharp declines in their international investment flows (inward and outward), particularly in the EU. Some countries and regions have even experienced instances of what could be described as investment de-globalisation. For example, in 2014, the EU's inward FDI position declined by US$700 billion.

Another theme of this paper is that various factors not traditionally associated with international investment policies or IIAs are playing an increasingly important role in shaping international investment and the international investment policy landscape. The examples we provided included the growing prevalence of SOEs as players in the global marketplace, the lack of coordination of competition policy agencies in merger reviews, and the potential for market disruptions on a global scale arising from government efforts to support and establish leadership in "cutting edge" sectors. The example given was clean energy.

In sum, the international investment landscape is undergoing major change and is being shaped by new factors outside of the traditional "boundaries" of investment policies and IIAs. This broader context needs to be taken into account when considering the challenges the international investment regime might need to address and, by extension, how it might need to evolve. Indeed, a danger in the current discussion is precisely that it is very much focused on the trees and less so on the forest. Perhaps even more fundamentally, there are reasons to believe that the way the current international investment policy regime is organised could mean that it will progressively cover less international business activity should MNEs shift toward more non-equity modes of organising and controlling their international operations. From a policy perspective, this would have implications on both the "protections" side and the regulations side.

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