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# Protectionist Trends in Foreign Direct Investment in The European Union – A Risk Based Analysis of Transacting with The European Union

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## Abstract

The idea of a global economy and market have become a reality in the 21<sup>st</sup> century with traditional ideologies of protectionism and strong notions of economic sovereignty becoming less prevalent by the day. Most countries in the world recognize the importance of global commerce and the need for entering into international relations. The relevance of such international relations including commercial dealings is so prevalent that it has now been incorporated as a criterion for establishing statehood itself in Customary International Law.

In contrast to this trend of globalization in recent years several countries have relegated back to a highly protectionist approach in terms of receiving Overseas direct investment or outward foreign direct investment (“ODI/FDI”). This protectionist approach is significantly affected by factors including the nationality of the investor, the area in which the investment is being made, the quantum of investment and possibilities of control, etc. This paper attempts to forge ties between each of these factors to determine whether the European Union is becoming increasingly protectionist in terms of receiving foreign direct investment. The lack of such determination has conjured a rather sanitized image of the EU market towards FDI leading to losses. Therefore, the author further attempts to estimate the impact of such protectionist trends on the viability of deals by assessing the prevalent unsystematic risks.

The authors in this paper shall *firstly* assess the meaning and advantages/disadvantages of protectionism to explore the rationales behind countries adopting a protectionist FDI policy, *secondly* the author shall map the relevant factors affecting inward FDI in the European Union (“EU”) based on examples of several transactions undertaken or blocked in a five-year lookback period to gain insight on countries that are receptive to FDI and the sectors they extensively regulate. Lastly the authors shall estimate trends in the EU FDI regime and provide suggestions to avoid losses in terms of the pre-approval process.

**Keywords:** Foreign Direct Investment, Protectionist, Regulation, Risk, European Union.

## Introduction

With the steady and fast development of capital markets in India, Indian business moguls have been increasingly traversing international markets in terms of investments and business lending. Investments made outside India have undergone a significant change in terms of geographical and sectoral composition in the past few decades. For example, in September 2019, OYO Rooms acquired a controlling stake in the data science firm called ‘Dynamic’ based in Copenhagen, Denmark [1]. The Reserve Bank of India (“RBI”) has been prompting in effectively facilitating and regulating overseas direct investment and lending transactions via its extant framework for foreign exchange related transactions.

ODI and FDI is largely regulated by the relevant sectoral regulators of the countries receiving the investment (“host country”) in addition to the RBI. Every commercial deal involving ODI/FDI requires extensive amounts of due diligence considering such deals entail large financial commitments in terms of approvals, documentation, raising funds, planning, discussions, and negotiations etc. (“pre-approval process”). The last step of effectuating such a deal after extensive expenses have been incurred in the pre-approval process is to secure the approval of the regulator of host country. It is therefore necessary to assess the trends of inward FDI across countries prior to initiating the pre-approval process to assess the viability of the deal and the possibility of blocking of the deal by a foreign regulator. This can help ensure that adequate steps are taken to successfully complete the transaction and to avoid the unnecessary costs of the pre-approval process in cases of high probability of blocking in light of the protectionist under-currents in the global FDI arena.

Although, with globalization most modern nation states have adopted a largely open market policy it is evident that in the recent times there are protectionist undercurrents in the FDI regimes adopted by most EU states. These conservative and restrictive FDI regimes mimic the pre-World War-II (“WWII”) protectionist trends prevalent

in the EU due to political imbalances and unrest. This paper shall explore the prominent ideological backings for such protectionism and shall also assess the factors affecting such regimes.

In the course of conducting the present study and paper the authors have assessed and analyzed a large amount of existing literature on the subject. The first prominent existing literature is titled “Foreign investment prohibitions in Europe – a few takeaways from recent cases?” [2]. This article highlights the protectionist nature of inward FDI transactions in the EU with specific reference to Germany by taking into consideration Germany’s FDI policy and recent transactions which have been blocked by the regulator in Germany for various reasons.

However, the article has adopted a narrow microscopic view to the research question by assessing policies and transactions in Germany predominantly. Moreover, although the said article assesses the practicalities of FDI transactions in EU it does not assess the academic ideologies supporting such protectionist trends and approaches undertaken by regulators. In the authors opinion assessment of this ideology helps ascertain with greater accuracy the outcome of a deal and has been specifically addressed in the present paper.

The authors have also referred to another relevant article titled “Foreign Investment: Rising tides of politics in regulation?” [3] This paper provides a detailed record of various transactions which have been blocked by regulators of EU states on the basis national security and other reasons. However, this paper does not assess the economic reasoning, advantages and disadvantages of trade-protectionism and its relevance in terms of FDI and international lending which has been addressed in the current paper. Moreover, the paper has emphasised on national security as the major factor for blocking of FDI deals whereas there are various other factors that affect such blocking which have been addressed in the current paper.

In light of the above recognized research gaps this paper primarily aims to assess whether the European Union market is becoming increasingly protectionist in respect of inward foreign direct investment and international lending transactions. It assesses the quantum of risk surrounding a ODI transaction by an Indian entity into the EU. Additionally, it also aims to assess the impact of factors like nationality of the investor, the area in which the investment is being made, the quantum of investment and possibilities of control on the viability of a deal. Lastly it aims to suggest practically viable precautionary measures which should be adopted to reduce the risk of blocking of a deal.

## **Meaning And Development of Protectionist Tendencies**

Protectionist ideology can be described as an economic policy that restraints free trade amongst two or more sovereign nations. Trade protectionism is a restrictive policy that is ideally nation centric and focuses on self-sufficiency and reduced imports by imposing high tariffs on imported goods, restrictive quotas, etc. [4] It generally refers to an anti-globalisation eco-political sentiment motivated by the idea of protecting ‘domestic businesses’ and ‘living wages’. Protectionism was the popular prevailing economic ideology until the 18<sup>th</sup> century.

However, with the increased popularity of industrial revolution in 1776 Adam Smith wrote the “Wealth of Nations” [5] who argued for ‘free trade’ as opposed to the existing Mercantilist policies favouring protectionism. Further, in 1817 as an effect of the wide array of unrest caused due to several wars from the 16<sup>th</sup> to 18<sup>th</sup> Century, David Ricardo wrote a book on “the comparative advantage theory” [6] which advocated countries to produce products based on efficiency and specialisation with the notion of expanding the world markets. Post the World-War I the League of Nations was established [7] to ensure that trade disputes were moderated by the participating countries to maintain political and economic peace. However, the failure of the League of nations was marked by the Great Depression in the 1930s [8] which resultantly drifted back to earlier established protectionist notions most evidently as the Smoot-Hawley Tariff Act was introduced in 1930 [9].

Post WWII there existed a wave of globalisation and free-trade with the idea of benefiting from dynamic gains in the long run, and based on the consequences of the Great Depression of 1930’s. Subsequently, the World Bank and the International Monetary Fund (“IMF”) were established with the Marshall Plan [10] to create a world economic society. Further the General Agreement on Tariffs and Trade [11] was enacted to ensure and enforce rules to regulate international trade which evolved into the World Trade Organization in 1995 [12].

## **Present State of The Protectionist Rhetoric**

Since the establishment of the WTO in 1995 the eco-political sentiment has been in favour of free trade and globalisation. With the adoption of the “General Agreement on Tariffs and Trade” [13] in 1947 and with several countries adopting the Liberalisation, Privatization and Globalisation (“LPG”) narrative, e.g. India in 1991 adopted LPG, free trade steadily became the new norm. The reason for this are not only the advantages of free trade but also the cost of returning to protectionism, for example, in 1930s, trade and foreign exchange represented 15 percent of global GDP, whereas in 2020, with tariffs dropping significantly over the period of time, it accounts for 50 percent of global GDP [14]. This implies that the longer a liberal trade policy has been established, the costlier it becomes to retrogress to protection [15]. It is however an interesting contrast to see that unlike the protectionism following the great depression, protectionism appears to have reduced post the 2008 recession. According to the WTO, protectionist measures reduced to just 0.2 percent of world trade between May and October 2010, from 0.8 percent between October 2008 and October 2009 [16].

However, with the increasing United States of America and China trade deficit exceeding almost 419 billion dollars in 2018[17], President Donald Trump had imposed significant tariffs on several Chinese products and on several imports from other countries [18] seemingly drifting back to a protectionist approach. Such protectionist approach is being met with severe retaliation and is characterised by ‘trade/ tariff wars’.

There have been significant shifts world-wide in the last five years in terms of policy framework for extensive screening inward FDI in furtherance of the trade protectionist narrative. [19] Several countries have been traditionally viewed as being open to FDI and free trade have in the recent years moved towards stricter scrutiny of transactions as is evident from the new standalone FDI regime on the legislative agenda in the UK [20], and an EU Regulation on FDI screening mechanisms [21]. For example, in August 2016, the Australian government blocked a bid of 25.1 billion Australian Dollars by the Chinese State Grid company [22] for acquisition of stake in Ausgrid, by citing unspecified national security concerns. The decision in the current global backdrop resulted in accusations of trade protectionism being raised against Australia.

A similar protectionist trend has also been observed in the European Union in terms of inward foreign investment activity and international borrowing via foreign debt instruments. These protectionist trends are evident from the examples and factors elaborated below.

### Advantages And Disadvantages of Trade Protectionism

Trade protectionism has been long debated to be an advantageous and relatively stable eco-political policy however it has also been observed that *“trade protectionism is often based on arguments that are hard to support. The problem for trade negotiators, however, is that these arguments are usually equally difficult to refute.”* [23] Protectionism in theory and practicality has significant disadvantages in the long run which seem to outweigh the short run advantages.

### Advantages Of Protectionism and Their Critical Appraisal

Several economists have mooted advantages of trade-protectionism which include:

**Helps Protect sunrise industries:** It is argued that barriers to trade and inward FDI can effectively be used to protect new and developing sunrise or infant industries in the country. The primary idea being to protect low capital, rather smaller industries from being dominated by global giants and gives a chance to newly established firms to gain global competencies through its growth and development. Such growth would allow domestic industries to benefit from economies of scale and would help countries develop and move towards self-sufficiency. However, these barriers may result in retaliatory tariff increases or other measures which would be disproportionately detrimental to the economy. [24]

**Helps Protect sunset industries:** Protectionism is also argued to protect sunset or declining industries. It is used as a measure to enable such industries to enable them to decline slowly in a non-abrupt manner and avoid some of the negative effects of such exit. The most cited example of such protectionism is the ship building in the 1950-1980’s wherein a sharp decline was seen in the shipping sector in the United Kingdom. [25]

**Protect strategic industries:** Another prospective use of protectionist barriers is to protect strategic industries, such as energy, water, steel, armaments, and food that are traditionally considered as indispensable sectors. For example, the primary aim of the European Union’s Common Agricultural Policy [26] is viewed as attempting to create food security in the EU by protecting its agricultural sector and producing first for and what is required by the Countries in the EU. However, even in this case it is assumed that protected industries will make efforts to lower costs when provided protection and achieve efficiencies. It is likely that protected industries may even lose incentives to become efficient and lower cost.

**Protection against dumping:** An important argument in favour of protectionism is protection against dumping of products by other countries. Countries with cheap labour, technology and resources favouring mass production result in flooding of the domestic markets with cheap products. Such predatory dumping results in disallowing the infant domestic industries from growing and reducing incentives of persons from entering such sectors due to low return. **For example,** the Indian Mobile manufacturing industry, has only small Indian companies like I-ball, Karbonn Mobiles and Intex the Indian markets being flooded with Chinese Mobile Manufacturing companies like OnePlus, Redmi, OPPO etc. leaves no incentive for the Indian manufacturers. Although, protectionism may protect domestic industries a better option alternatively may be to develop strong anti-dumping regulations.

### Disadvantages Of Protectionism and Their Critical Appraisal

**Devoid of Long-run dynamic gains:** The famous quote of Dennis Robertson describing foreign trade as an *“engine of growth”* [27] makes it evident that the long-term dynamic gains from international and global free trade are missing in a protectionist approach. In the short-run protectionism allows infant industries to go but the reduced competition leaves no incentive for *innovation thereby reducing spending on Research and*

**Development to cut costs**, furthermore, the product quality will be expected to decrease in the long run with an increase in process due to *lack of substitutes* or competition for customers to choose. Reduced growth is also likely to lead to *higher layoffs and reduced investments*.

**The export- import balance:** It is an established macro-economic concept that exports must fund imports, therefore if extensive protectionist trade barriers are imposed it would invite retaliation by such countries thereby decreasing exports. For example, in 2018 the USA increased import tariffs from 2.6% to 16.6% on 12,043 products covering approximately \$303 billion (12.7%) of annual U.S. imports. In response, trade partners imposed increased retaliatory tariffs from 7.3% to 20.4% on 8,073 export products covering \$127 billion (8.2%) of annual exports of USA. [28] Increased and free trade opens new markets and thereby helps fund deficit. For example, estimates suggest that lifting all existing trade barriers would increase income of USA by \$500 billion. [29]

**Long term macro-economic variable loss:** A research conducted by the National Bureau of Economic Research [30], explains the macro-economic effects of increased tariffs and how such protectionist measures would result in decreased output and productivity and increased unemployment and inequality in the long run thereby emphasizing the disadvantages of protectionist measures.

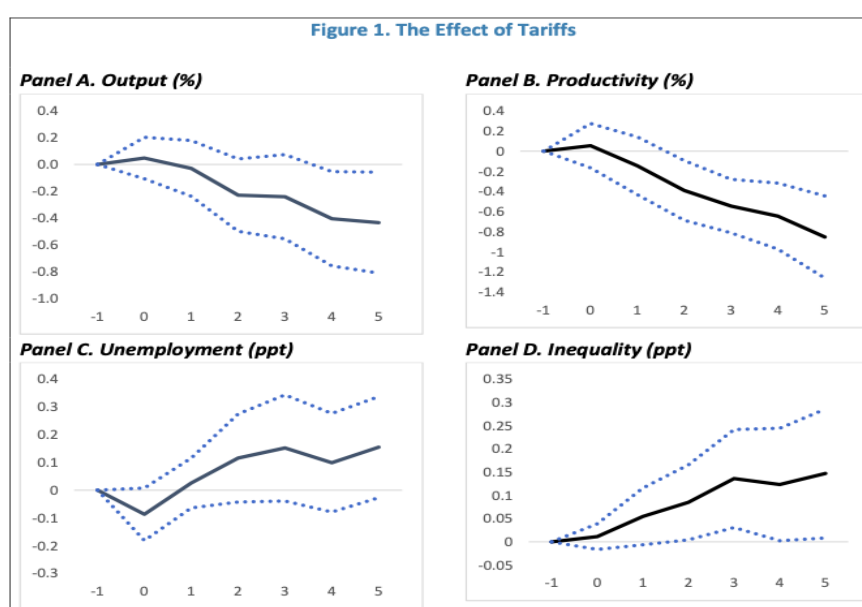


Chart No. 1[31]

## Protectionist Tendencies and Factors Determining Blocking of Investment and Lending Transactions In The European Union:

Regulation of trade and inward FDI has undergone a paradigm shift in the recent years it is for this reason that it has been a subject of constant discourse on the radar for cross-border acquisitions, investment and lending pitted against a backdrop of amplified protectionist rhetoric. As explained above this trend is not alien to the EU with investors around the world attempting navigate through the murky landscapes of investment and lending in EU based entities. Post the outbreak of the novel coronavirus SARS-CoV2 (“**COVID-19**”) pandemic, these protectionist trends have only increased considering that most countries were forced to attain self-sufficiency and the pandemic has increased hostilities. It is in this light that it becomes necessary to assess the recent trends in the blocking of inward FDI deals and funding transactions in the United Kingdom (“**UK**”) and EU.

## Wider Ambit Of “Sensitive Sectors” And Increased Need for Mandatory Approvals

Several jurisdictions have responded to the COVID-19 pandemic and increasing political tensions by introducing policy and legislative amendments to tighten their inward FDI regimes. This has had a multi-fold effect, *firstly*, several countries in the EU have generally reduced their trigger/approval requirement thresholds for various sectors, for example, in Spain and Italy which has led to increased regulatory review and blocking related barriers [32]. This poses special incremental risks to ‘sensitive purchasers’ which would include either investing entities that are state-owned or investing entities that belong to non-EU countries. *Secondly*, there are several sectors which were earlier accessible to foreign investors and have now been widely restricted for example the classification of the medical sector as sensitive or critical in Germany [33]. More recently, in May 2021 Germany also added 16 new sectors to the already hefty list of 11 sectors which are classified as sensitive sectors entailing

a mandatory filing requirement [34]. This significantly increases regulatory scrutiny and the discretion of states in blocking transactions.

One of the first countries in the EU which reacted to the COVID-19 pandemic by introducing a new FDI policy was Spain on 18 March 2020 [35]. It significantly tightened its FDI policy by requiring acquirers based outside the EU to obtain a prior approval for an investment exceeding 10% or more in equity backed securities or management rights in a company of Spanish origin in several sectors. Such reduction in the threshold for mandatory authorization requirement to a mere 10% stake acquisition by a non-resident operates even though in most cases such acquisition cannot constitute control [36]. Moreover, this approval requirement is mandatory in terms of all sectors including critical infrastructure and technology, healthcare, communications, energy and transport, if the investing entity is either directly or indirectly under the control of a foreign government [37]. This is a new requirement considering that prior to the pandemic approval was required only for specific sectors and FDI for all other sectors was earlier automatic [38]. Therefore, like Germany even Spain has adopted a rather strong headed approach with respect to FDI enhancing the protectionist rhetoric.

Other EU based jurisdictions like France, Germany and Italy have also followed this stricter FDI regimes. [39] This is set against the backdrop of guidelines issued by the EU, encouraging the Member States to enforce strenuous screening mechanisms to protect their critical assets from foreign takeovers during the pandemic. [40] This regime was necessary considering that capital rich countries like China and the United States of America (“USA/US”) were expected to acquire controlling stakes in several key areas across various jurisdictions due to widespread divestment fueled by the COVID-19 Pandemic. However, these protectionist trends have continued to be applicable for over 2 years now, highlighting the need to reassess investment strategies.

### **Wider And Ambiguous Notions Of “National Security” Based on Nationality of Investor**

It is well established from practice that inward FDI deals may be blocked by countries and their regulators based on national security concerns. Even in India, there are certain sectors wherein the approval of the Government is required either if the investment exceeds a certain threshold or on an absolute basis for inward FDI into India, for example, for investment into the banking and investment sector or into core investment companies. [41] It is in the approval routes that most governments extensively regulate inward FDI which leads to extensive uncertainty as there are ever evolving tides of political interference.

This regulation based on “national security” concerns is primarily based on two factors, *firstly*, the sector in which the FDI is proposed as was discussed above and *secondly*, the investing entity and its country of origin. Based on the later it has been an established trend for EU based jurisdictions and the UK to block investments of Chinese origin. [42] *For example*, the UK government recently blocked proposed FDI via acquisition of Impcross Limited which is a UK based company involved in manufacturing parts for military aircrafts by “Gardner Aerospace Holdings Limited” an entity under the control of Chinese entities and acquisition of Mettis Aerospace a UK based entity by Aerostar which is a fund established in China. The reasons for the said blocking were national security grounds and possible risk to public interest. This hostility of the EU towards China has risen further after the military exercises conducted by China in relation to the Taiwan Dispute. [43]

However, in recent times wider protectionist actions have been observed in the EU which are not directed only towards Chinese investments. For example, in 2021 the French regulatory authorities blocked the acquisition of Photonis a company of French origin, by Teledyne a US based company. This marked the first instance wherein a US origin FDI was blocked by France emphasizing an EU wide protectionist shift under the garb of national security. [44] Similarly, the French Minister also expressed that he was not in favour of the acquisition of a large retail foods and utilities company Carrefour by the Canadian giant Couche-Tard. [45]

An interesting detail herein is that the use of national security as ground for blocking deals is not limited to acquisition of majority stakes. For example, in 2018 Germany blocked the State Grid Corporation a Chinese entity from acquiring even a 20 percent minority stake in 50Hertz a German company providing high-voltage transmission systems quoting national security reasons.

The tensions of the Russia-Ukraine dispute have also resulted in the classification of Russia and all allies as sensitive countries by most EU nations. Governments have announced that a close scrutiny of Russian and allied country FDI will be conducted in order to enforce sanctions and other restrictive treatment. [46] Moreover, a Guidance Note from the EC indicated the screening of investments from Russia and Belarus. [47]

Italy has permitted a fresh review of acquisitions where EEA investors have a “controlling stakes” in sectors such as energy, transport, communications, agriculture, food, health, finance as well as non-EEA investors who have a minority stake in every “strategic” sector. This implies that the FDI Regulator of Italy has also now gained a stronghold over all FDI activity in Italy implying that all investments by Indian entities shall also be subject to great scrutiny significantly increasing the chances of blocking of deals.

The lack of a definitive list of sensitive and strategic sectors is bound to dilute the conception of national security into a politically motivated struggle for protecting competitive and technological advantage which is likely to have long term detrimental effect in economic growth.

### **Indirect Prohibitions Resulting in Tacit Blocking:**

There is yet another significant trend that is becoming increasingly popular in the EU and UK in terms of inward FDI Regulation and blocking. It is now a common practice for EU based regulators to insist on abandonment or withdrawal of applications instead of direct imposition of prohibitions. This technique of indirect blocking although effectively meets the end goal of the protectionist rhetoric it is not accounted for as a “blocked transaction”. For example, in the acquisition of Mettis Aerospace by Aerostar and Ligeance Aerospace Technology Co Ltd. the application made to the United Kingdom Competition and Markets Authority, was eventually abandoned in three months on unknown grounds. [48] Similarly, several other deals have been abandoned by investors due to delays by the regulators in giving approvals.

Another example of such indirect prohibitions is evident in France, wherein as per the ‘Montebourg decree’ an investor is required to consult the government and receive a formal authorization called a “blessing” for investing in a wide range of sectors including energy, water, defence, transport, communications, space operations, cyber security, artificial intelligence, robotics, additive manufacturing, semi-conductors’ quantum technologies, energy storage and biotechnologies. It is pertinent to note that such government approval is in addition to other approvals required from the relevant FDI regulator or other market regulators. Moreover, non-compliance with such requirements warrants payment of hefty administrative fines. Most importantly, such process largely increases the discretion of the government in the area of FDI allowing for political intervention and corruption. It may also be used to stall deals which would otherwise have been cleared by the relevant regulator within the time span provided in their regulations.

Therefore, in planning investments in the EU and UK it is therefore relevant to take into consideration such indirect blocking in addition to direct blocks which may be preempted relatively easily.

### **Conclusion And Suggestion**

From the above discussion it is evident that several states within the EU and the UK have adopted largely protectionist approaches towards the regulation of inward FDI. There have been several recurrent instances wherein the regulatory authorities in Germany, France, Italy, Spain, and other European countries have *firstly*, adopted highly restrictive FDI policies which is a primary protectionist measure, *secondly*, they have also actively blocked several deals on questionable grounds of national security even for cases of acquisition of minority stakes, and *thirdly*, have created room for discretion of non-regulators enabling political intervention in FDI. The COVID-19 pandemic has only aggravated the said situation by forcing countries to gain high self-sufficiency and protect local companies.

It is further evident that the protectionist approach of such states is largely influenced by the nationality of the investor for example, Russia or China; the stake of investment including even minority stakes, the sector of investment for example, healthcare or similar sensitive sectors and lastly, any other political, economic, or social considerations, for example, in India FDI into Gambling and Betting including casinos is not permissible as it promotes such addictive games. [49] Therefore, it is abundantly evident that due to a combination of several interlinked factors EU and UK’s policy in terms of FDI and foreign lending has become increasingly protectionist in the past few years.

Therefore, in light of the above research study and conclusions the authors suggest the following steps be adopted before undertaking the pre-approval process.

*Firstly*, the authors suggest that the parties carry out extensive due diligence of not only the target company but also of the host country by engaging local legal service providers. This shall help gain better insight into the behavior of the FDI regulator.

*Secondly*, factors including any possible affiliations with entities from sensitive countries for example, Russia, China, Belarus etc. must be considered before beginning the process. For example, if an Indian Company has a Russian subsidiary or has as its core business partner a Russian entity there shall be a higher risk of blocking of the deal as per the current policies of the EU and hence extra caution must be taken in such regard.

*Thirdly*, adequate attention must be paid towards the list of sensitive sectors as declared by the relevant FDI regulators from time to time to ensure whether a particular investment may ancillary be covered under a sensitive sector, for example, nitrogen gas and liquid nitrogen have several applications both industrial and medical therefore if an application for authorization is not adequately specific it may be scrutinized as falling under the sensitive sector of medical devices as opposed to the non-sensitive sector of manufacturing.

*Fourthly*, another relevant factor to be taken into consideration is the quantum of investment and whether it may constitute “control” over the target company. Such control may be determined based on the quantitative or qualitative tests as have been prescribed by the host country. Therefore, based on the relevant applicable test it would be necessary to determine whether the quantum of shareholding being acquired constitutes control, or whether other contractual rights given to the investor including affirmative voting rights, right of first refusal etc. constitute control.

In the authors opinion due consideration over the above-identified criteria significantly reduces the risks of loses in the pre-approval process by enabling parties to effectively assess the viability of a deal vis-à-vis the protectionist undercurrents surrounding the FDI market in the EU.

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