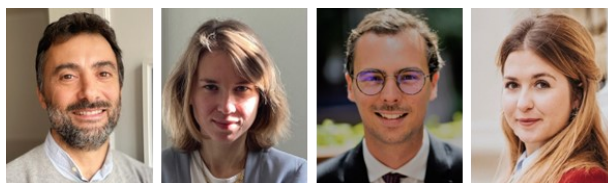


FDI screening in advanced economies: anatomy of a rise*



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JEL codes: F21, F23, F52, F55.

In recent years, most advanced economies have adopted or tightened their existing foreign investment screening mechanisms (ISMs), which empower national authorities to restrict foreign takeovers in strategic sectors. In 2019, the EU adopted a regional cooperation framework on FDI screening. We fill in a gap in literature by developing a synthetic index suitable for cross-country comparisons. We analyze which countries have the strictest regimes and document how macroeconomic characteristics and geopolitical factors shape the restrictiveness of national ISMs. To assess the impact of screening on transactions, we build a comprehensive database mapping the outcome of screening decisions. Although a large number of transactions is subject to review, the number of blocked transactions is limited, suggesting that ISMs strike a balance between openness to FDI and protection of national interests.

*Authors' note: The views expressed are those of the authors and do not necessarily reflect those of the Banque de France or the Banca d'Italia.

The rise of foreign investment screening in advanced economies

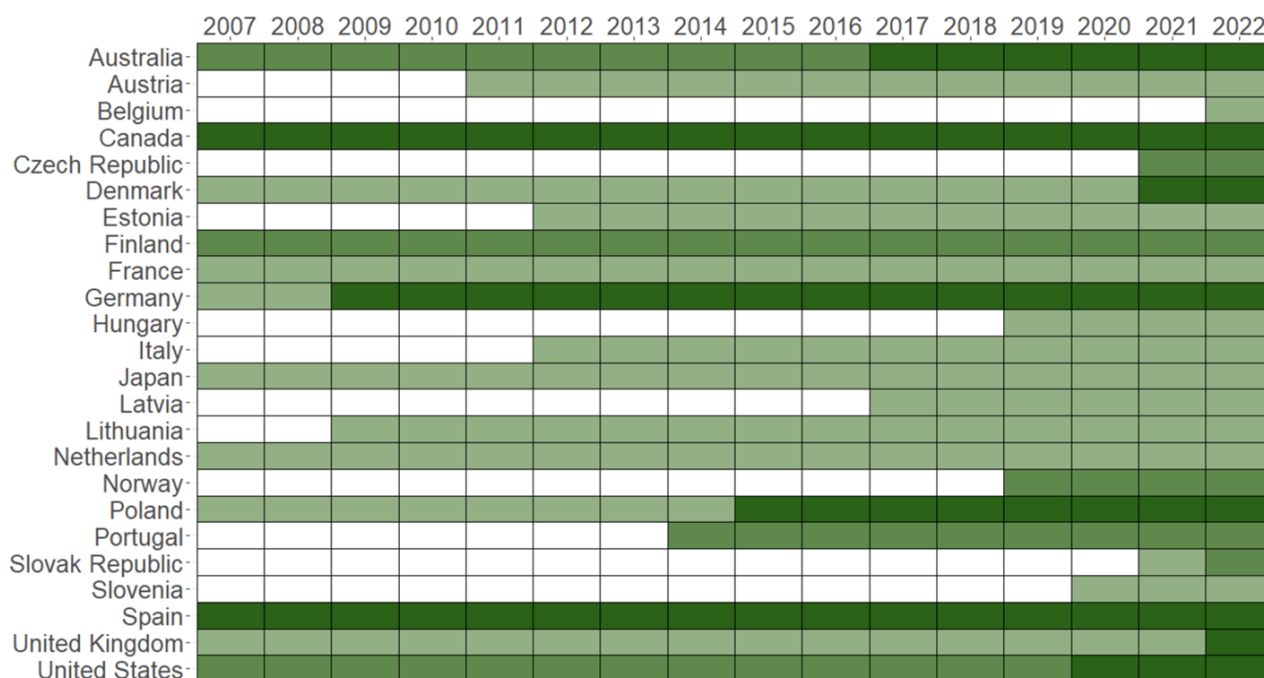
Over the past decade, most advanced economies have adopted or tightened their existing investment screening mechanisms (ISMs), which empower national authorities to review, and potentially condition or prohibit, acquisitions potentially threatening national security.

In assessing the potential risks posed by an FDI, most countries focus on two factors: i) the effects on strategic sectors (eg. critical infrastructure, critical technologies, supply of critical inputs, access to sensitive information, freedom and pluralism of the media...) and ii) whether the foreign investor is controlled by the government of a third country.

Figure 1 shows that an increasing number of advanced economies, which have traditionally been open to foreign investments, adopted or overhauled their existing ISMs from the early 2010s onward. Alongside these national developments, in 2019 the EU adopted a common FDI screening framework aimed at enhancing cooperation among country members while fostering a single foreign acquisition market.

Literature focuses on ISMs as a response to the rise of Chinese outward investment (Eichenauer et al., 2021), national security threats in Central and Eastern European countries from Russia (Danzman and Meunier, 2023a) and technology transfer associated with foreign acquisitions. For instance, Chan and Meunier (2022) show that EU countries with higher technological levels were more supportive of FDI screening due to concerns over unreciprocated technological transfer. More recently, the Covid-19 pandemic strengthened governments' commitment to preventing the sale of strategic domestic assets to foreign investors (Evenett, 2021).

Figure 1: The rise of investment screening mechanisms in advanced economies



Note: Most countries that did not have an ISM (white tiles) have adopted such mechanisms over the past decade (green). A number of countries have shifted from sectoral mechanisms (where the government has the authority to review a list of sectors, shown in light green) to a cross-sectoral (green) or mixed mechanism (dark green), where the government can review investments in any sector and subject a specific list of sectors to stricter review requirements.

Source: PRISM database; © 2023b; Sarah Bauerle and Sophie Meunier.

Heterogeneity of national screening mechanisms

Assessing the impact of ISMs requires a major effort of data collection. Despite the expansion of the literature on ISMs, we are unaware of the existence of any indicator suitable for cross-country comparisons. Existing indexes on capital controls developed in the literature (e.g. the OECD FDI Regulatory Restrictiveness Index) exclude restrictions imposed for security reasons, which are at the core of contemporary investment screening mechanisms.

We make several contributions to the related literature:

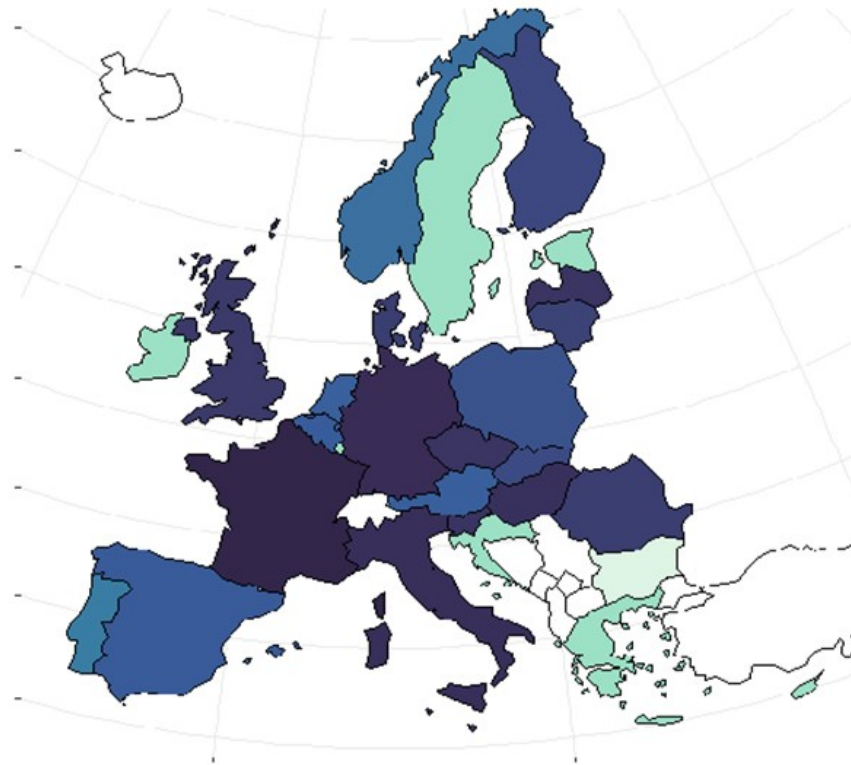
- First, we have built a comprehensive database mapping the main features of FDI screening regimes motivated by national security in major advanced economies.
- Second, we provide a composite index measuring the restrictiveness of national screening regimes.

The identification of potentially threatening transactions relies on combinations of several criteria and parameters. The ISM restrictiveness index covers five dimensions reflecting the restrictiveness of national laws:

- investor-related parameters (eg. origin of investors subject to review or enhanced scrutiny for investors controlled by foreign governments) and territorial scope of the ISM (eg. extraterritorial scope of national legislation);
- sectoral scope and coverage of greenfield investments;
- transactions subject to review and thresholds triggering a review;
- screening procedure (eg. mandatory vs voluntary notification requirements, length of the review process...);
- enforcement and sanctions for non-compliance (eg. authority to impose conditions on planned transactions, invalidity of transactions implemented without approval...).

The ISM restrictiveness index ranges from zero (relatively less restrictive ISM) to one (relatively more restrictive ISM). The index highlights several findings:

1. The most restrictive mechanisms are found in Australia, Japan and Canada, which have been filtering investments for a long time.
2. The index is helpful for tracking the pace of legislative convergence within the EU where, notwithstanding regulatory effort, substantial differences remain (see figure 2).
3. Restrictive ISMs can coexist alongside an otherwise liberal investment environment. Indeed, some of the most restrictive countries, such as Australia and Canada, are also attractive to foreign investors, as reflected by foreign investment inflows.

Figure 2: Restrictiveness and heterogeneity of national investment screening mechanisms

Note: Dark (light) blue: relatively more (less) restrictive ISM. Green: consultative or legislative process expected to result in the adoption of a new mechanism.

Impact of FDI screening on transactions

Assessing the impact of FDI screening on transactions is challenging for a number of reasons, including the lack of publicly available information. To assess the impact of FDI screening on planned transactions, we analyze the outcome of screening decisions. We focus on national governments' statistics on foreign investment applications and screened foreign investments. We highlight several findings:

- Owing to the broad scope of national ISMs, a large number of transactions is subject to review. In the USA and in the UE, screened transactions represented about 20 % of the total number of FDI transactions in 2022. This share is close to 50% when greenfield investments, which do not fall within the scope of most national screening laws, are excluded.
- ICT, manufacturing and financial activities are particularly subject to screening in the EU and the USA, reflecting the focus of most ISMs on critical technologies and critical infrastructure.
- Although a large number of transactions are subject to review, the number of blocked transactions is extremely limited.
- Overall, the ISM restrictiveness index is consistent with enforcement practices. The most restrictive countries are those with the highest percentage of transactions that are either prohibited, withdrawn or authorized with conditions.

Conclusions

We make several contributions to the literature.

1. We have built and index measuring the restrictiveness of national ISMs suitable for measuring cross country differences and regulatory convergence.
2. Restrictive ISMs can coexist alongside an otherwise liberal investment environment.
3. We provide a tentative assessment of the impact of ISMs on transactions. Although a large number of transactions are subject to review, the number of blocked transactions is limited. However, the limited number of blocked transactions could also reflect the deterrent effect of ISMs.

Determining whether the recent tightening of ISMs has affected foreign investment flows is challenging. Indeed, foreign investment screening is one of many factors that could influence FDI inflows. Literature suggests that the key determinants of FDI flows are sound macroeconomic conditions (investment returns, access to markets...), together with institutional factors (good governance, low sovereign risk and a stable legal system). In this respect, transparent foreign investment screening regulations might improve the perceived transparency of government regulations. ■

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