INVESTMENT POLICIES AND ECONOMIC CRISES: LESSONS FROM THE PAST

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EXECUTIVE SUMMARY

The present crisis, the deepest and most widespread in our lifetimes, is causing economic hardship worldwide. As governments respond with emergency measures, their main concern other than restoring financial stability is to preserve employment in the face of a sharp economic contraction worldwide. In such a climate, governments need to remain mindful of the long-term and international repercussions of short-term remedies and risks of retaliation by other governments in face of protectionist measures. An open environment for international investment will not by itself bring about recovery, but it is an essential element of a return to growth and sustainable development in the future.

This paper reviews the experience of earlier crises – whether national, international or sectoral – to understand better both the nature of the various investment policy responses and their implications for international investment and long-term sustainable growth. These policy responses are then compared with recent measures announced to mitigate the current crisis.

The main findings of the review are as follows:

- Unlike with the "beggar-thy-neighbour" tariff escalation and competitive devaluations during the Great Depression, there has been little evidence of outright prohibitions on foreign investment during past crises. Indeed, in crisis situations, governments have tended to place a premium on capital, regardless of its origin. As a result, past crises have sometimes opened up opportunities for foreign investors in national economies, especially in banking but also in other sectors or across the board. The same seems to be true in the current crisis, with a greater tendency for governments to encourage rather than restrict inward investment.

- But an official welcome did not always imply public acceptance. Foreign investors were sometimes seen to be taking advantage of low relative asset prices by acquiring local firms at "fire sale" prices. A similar sentiment may emerge in the current crisis, creating public hostility to inward investment at a later date, particularly if foreigners divest themselves of local assets at a hefty profit.

- While policies adversely affecting foreign investors have been rare in previous crisis situations, many emergency measures have raised the possibility of discrimination against foreign-owned firms operating in the local economy. Emergency measures with possible discriminatory effects have included bail outs, subsidies and government spending more broadly, as well as tax, trade and competition policies. Foreign-owned firms in domestic economies may face discrimination during the current crisis.

- Crises have often led governments to try to keep domestic capital at home, without usually going so far as to restrict capital outflows. There have also been calls – both from the public and even within government – in the past to discourage or restrict outflows in order to preserve jobs at home. Certain conditions attached to emergency measures during the current crisis might have implications for the ability of local firms to invest abroad if by doing so there is a threat to jobs at home. The growing financial and ownership role of national governments in key sectors may also increase public pressure to constrain the freedom of local firms to invest abroad in the future.

- The long-term implications of policy measures enacted during a crisis have sometimes been more important than the short-term beneficial effects on the crisis itself. The much greater degree of global economic integration today implies that even seemingly small restrictions would have larger economic impact, harming not only partner country economies and collective efforts to recover from the crisis but also the economy of the country applying the measure.

Neither in the past nor at present have many measures been enacted to restrict international investment in the domestic economy. But many measures in the past have nevertheless affected the business climate by discriminating among firms on the basis of nationality of ownership, and there is a risk that measures implemented today could have the same discriminatory effect. With the benefit of the lessons from past policy errors and the level of international policy coordination today, governments have the opportunity not to repeat the beggar-thy-neighbour policies of the 1930s. Governments have a shared responsibility to work together to seize this opportunity.

I. INTRODUCTION

We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services…

G20 Declaration[1]

Our international trade relations, though vastly important, are in point of time and necessity secondary to the establishment of a sound national economy. I favour as a practical policy the putting of first things first. I shall spare no efforts to restore world trade by international economic adjustment; but the emergency at home cannot wait on that accomplishment.

President Roosevelt[2]

Economic crises can promote reforms because bad economic conditions make it clearer that existing policies are no longer sustainable…Crises introduce a degree of urgency in the decision-making process, weaken opposition to reform, and raise the cost associated with pre-reform institutional arrangements.

OECD 2006[3]

The world economy is in the midst of the most severe crisis in decades, if not since the Great Depression itself. Not only can OECD economies expect an aggregate decline in GDP in 2009, but other parts of the world are also increasingly affected. The spillover to the real economy has already translated into rising job losses in many countries with the number of unemployed in the G7 countries expected to double from its level in mid-2007 to reach 36 million by late 2010. Reversing this trend has to be a central priority, along with restoring confidence and stability in the financial system.

Keeping markets open for trade and investment is widely recognised as essential not only for containing and helping to resolve the crisis but also for sustainable long-term growth. As governments struggle to respond in an adequate and timely manner, vigilance is necessary to ensure that policy responses do not seriously harm living standards over time. The global scale of the financial crisis underscores more than ever before the necessity for international co-ordination to avoid any possible “beggar-thy-neighbour” measures.

As a way of better understanding how various investment policy responses might affect the conditions for global and sustainable recovery, this paper reviews the experience of earlier crises, whether national, international or sectoral. The review brings out not only the variety of policy responses which impinge on foreign investment but also the complexity of those responses, with some measures encouraging inward or outward investment while others dissuading such flows. Unlike with the “beggar-thy-neighbour” tariff escalation and competitive devaluations during the Great Depression, there is little evidence of outright prohibitions on foreign investment. Instead, what is revealed is a range of policies which implicitly or explicitly favoured domestic over foreign investment and domestically-owned firms over those controlled by foreign investors. The lessons for the current crisis are brought out at the end of this paper.

II. A REVIEW OF PAST CRISES

Crises vary greatly in their duration and in their geographical and sectoral scope. The most common form of systemic crisis arises in the banking sector or as a result of a currency crisis. The IMF estimates that since 1970 there have been 42 systemic crises in 37 countries. While many of these crises have been national, there has frequently been some contagion to other countries in the region or to other emerging economies. In addition to these financial crises, there have also been broader crises such as the Great Depression, as well as a series of sectoral crises such as those following the oil shocks in the 1970s.

The following section reviews a variety of past crises to examine how home and host governments responded in terms of their policies towards foreign investment and also to assess the implications for foreign investors. Key findings include:

- There are few cases of restrictions on FDI inflows imposed as a result of a crisis. Indeed, in crisis situations, governments tend to place a premium on capital, regardless of its origin. As a result, crises have sometimes opened up opportunities for foreign investors in national economies, especially in banking but also in other sectors or across the board.

- Acquiescence does not always imply popular acceptance, however. Foreign investors are sometimes seen to be taking advantage of low relative prices of assets to acquire local firms at "fire sale" prices. This can create public hostility to inward investment at a later date, particularly if foreigners divest themselves of local assets at a hefty profit.

- While policies which adversely affect foreign investors are rare in crisis situations, there are many emergency measures which raise the possibility of discrimination against foreign-owned firms operating in the local economy. These measures relate to bail outs, subsidies and government spending more broadly, as well as to tax, trade and competition policies.

- Crises often lead governments to try to keep domestic capital at home, without usually going so far as to restrict capital outflows. Emergency measures and any conditions attached to them might have implications for the ability of local firms to invest abroad if by doing so there is a threat to jobs at home.

- The long-term implications of policy measures enacted during a crisis are sometimes more important than any short-term effects they might have on the crisis itself.

- Crises have a variable impact on global FDI flows. While some national crises have sometimes seen a rise in FDI inflows, more general crises such as in the 1930s or 1970s and many national ones have seen sharp drops in outflows or inflows. In most cases, existing foreign investments are preserved, and it is only the rate of expansion which is affected – though there are some examples of divestment.

The Great Depression[4]

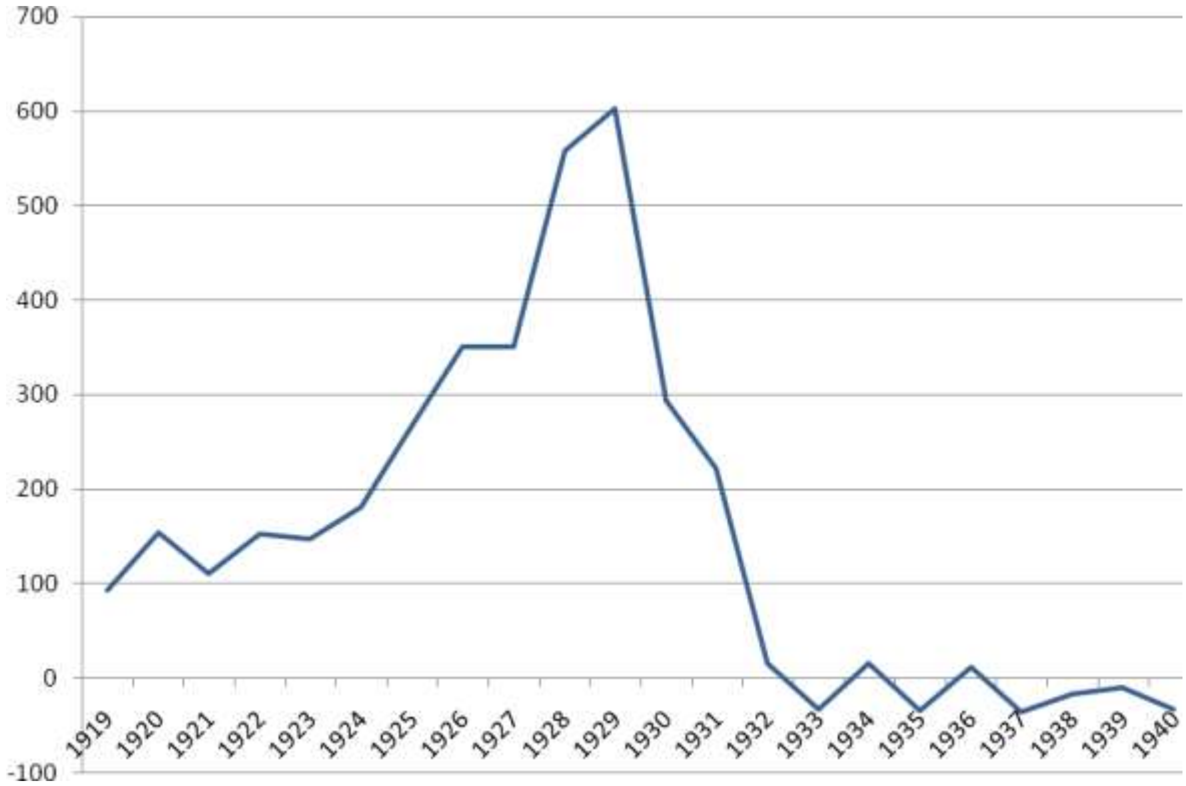
The depth and global scope of the current crisis have led many to draw parallels with the Great Depression of the 1930s. While the comparison is not always apt, the period of the 1930s does nevertheless provide an interesting test case of policy responses at a time of severe systemic stress in the global economy. The damage caused by tariff wars and competitive devaluations has been widely documented; what has received less attention is the impact of policy changes on foreign direct investment – both inward and outward.

One of the most enduring lessons of the 1930s is not that economic nationalism can exacerbate a crisis – although it almost certainly does – but rather that measures enacted during such a crisis can continue to impair global economic integration well after the crisis has abated. The broad measures introduced during the Great Depression in the form of tariff hikes and capital controls had a devastating effect on world trade and flows of FDI. For many countries, trade as a share of GDP did not return to the level it had achieved in 1929 until the 1970s. The same is true in many cases for FDI. The international investment position of the US, for example, did not return to the same level as a share of GDP as it was in 1930 until the 1970s.

In terms of policy measures, the overall impression is that foreign firms were not directly targeted for discrimination in most countries during the 1930s, but global flows of FDI nevertheless fell victim to the general collapse of economic activity and the rising economic nationalism and militarism which characterised the period. Potential foreign investors were also hampered by policy changes in other areas, such as the abandonment of the gold standard by all major economies over the course of the decade and the imposition by some countries of capital controls. At the same time, numerous and disparate policy changes influenced both inward and outward direct investment in many subtle ways as described below.

International capital mobility contracted sharply as a result of the Depression and, with few exceptions, global flows of FDI collapsed in the 1930s. This was particularly the case for investments in continental Europe. Firms did not necessarily withdraw from foreign operations but they lacked both the funds and market growth incentive to expand.[5] One study looking at establishments by foreign investors by host region suggests that, while the US and UK markets continued to receive some new investments, continental Europe saw a substantial drop in inflows.[6]

Table 1. US Direct Investment Abroad, 1919-1940
(USD million)



Source: US Department of Commerce

Looking at the possible role of policies behind this collapse, the picture that emerges is complex. Few policies were directed specifically at foreign-owned firms or at overseas investments by local firms, but many strongly influenced both inward and outward direct investment. Many companies received government support in one form or another during the Depression, but, as in the current crisis, in nearly every case the motive was to keep the enterprise alive rather than to convert it into an aggressive competitor.[7] Foreign direct investors were sometimes guilty by association with foreign portfolio investors who were blamed in some circles for the onset of the Depression, but there were no policies covering FDI equivalent to those which restricted trade. As with the current crisis, there was no general move to restrict foreign takeovers – partly because foreign firms were as illiquid as those at home and partly because any long-term capital from almost any source would have been welcomed. At the same time, there was no evidence of liberalisation of rules covering outward or inward direct investment.

At the time, a clear distinction did not exist – either in policy terms or with respect to balance of payments reporting – between direct and portfolio investment. "During the entire period 1933-1939, the overarching views in the United States toward inward foreign investment – both portfolio and direct investments – were negative, in line with the notion that 'foreign' could only be bad."[8] The precipitous withdrawal of foreign capital was widely seen as having contributed to the crisis, particularly in Germany[9] and in the United States.[10] Even some foreign direct investors in the United States were accused by an official of "gambling on our going off gold".[11]

A number of countries imposed *de facto* or *de jure* **exchange controls** restricting outward investment and discouraging inflows (since profits could not easily be repatriated). The German government, for example, imposed stringent restrictions on capital exports from 1933 to 1939, and a 1936 decree prohibited German firms from reinvesting abroad the profits of their foreign subsidiaries. This had been the principal means of financing German business abroad in the 1930s.[12] The UK government had already discouraged overseas investment in various ways since 1914, and this policy was continued after the war, according to the UK Treasury, "to protect foreign exchanges and to conserve capital for development within the United Kingdom".[13]

Exchange controls were intended partly to defend parities under the gold standard which one by one all major countries abandoned. Prior to this in the United States, public and private bonds owned by foreign investors had often contained a gold clause which stipulated that they were payable in dollars or gold. This clause was repudiated by Congress in 1933, leading to "a violation what many foreign (and domestic) critics deemed fundamental property rights".[14]

Some countries imposed **horizontal restrictions on FDI**. In 1931, the Japanese government's policy of welcoming foreign capital was reversed: foreign capital was to be either phased out or indigenised, and foreign firms were prevented from exercising control over the management of their joint ventures.[15]

In terms of **sectoral restrictions on FDI**, many laws were enacted by the US government in the 1920s covering radio, shipping and aviation. During 1933-39, these federal laws were "reaffirmed, more strictly enforced, and extended",[16] but new sectoral measures were generally not imposed.

Other reforms which go beyond the remit of this paper but which nevertheless affected foreign investment were in the area of **tax** and **competition policies**. In the United States, for example, the 1936 Revenue Act taxed foreign firms differently from domestic ones and the National Industrial Recovery Act (1933) allowed firms to set prices in exchange for wage setting agreements. Wilkins (2004) argues, "[b]y far the most significant overall US public policies in the 1930s that affected inward FDI were those associated with the implementation of antitrust measures. These were general policies, but they had a differential impact on foreign multinational enterprises".[17] In general, the more permissive attitude towards international cartels in many countries in this period meant that firms often chose to forego direct competition abroad through FDI.

Banking crises and foreign investment in the banking sector

Banking crises in OECD and non-OECD countries have sometimes been accompanied by an increase in the foreign presence in the banking sector as a result of a relaxation on rules limiting foreign entry. Encouraging takeovers by foreign investors has been used in banking crisis resolution programmes in the Nordic countries, Hungary, Korea, Mexico and Slovakia, among others. Individual examples are provided below.

The motive for liberalisation was often to recapitalise the banking sector following a crisis, although the weaknesses in the sector which contributed to the crisis and the need to inject greater competition and efficiency are also likely to have informed the policy shift. IMF conditionality may also sometimes have played a role. A World Bank study of 100 developing countries between 1995 and 2002 found that those experiencing banking crises during this period tended to have a higher share of foreign participation in the banking sector in the aftermath of the crisis than those which did not face a crisis. A BIS survey found that "in Latin America, foreign bank entry played a key role in stabilising financial systems after the 'tequila crisis'".[18]

In many cases, in a systemic crisis there may be no well-capitalised domestic private banks able to take over failed banks, leaving the government with little choice (other than allowing outright failure) but to nationalise or to allow foreign takeovers. Crisis responses may sometimes have complemented liberalisation measures that were already programmed, albeit at a slower pace.

- The 1994-95 financial crisis in **Mexico** "led to a sharp deterioration in the quality of loan portfolios of Mexican banks, forcing the Government to implement a comprehensive financial sector support package. The recapitalisation needs of the sector led to an acceleration of the staged opening up to participation by NAFTA-based financial institutions foreseen in the NAFTA Treaty. By the end of 1997 more than two thirds of total banking sector assets were held by institutions with substantial foreign participation, having risen from near zero five years earlier."[19]

- After the crisis in **Finland** in the early 1990s, 60% of banks were owned by foreigners.

- As a result of the financial crisis in **Thailand** in 1997, the Thai government allowed foreign investors to hold majority stakes (previously limited to 25%) in Thai banks for ten years. Under the terms of Thailand's IMF structural agreement and the WTO financial services offer, the absolute amount of investments of foreign financial institutions entering the Thai market until 2007 were to be permanently grandfathered.[20] While the five largest Thai banks, accounting for 70% of the market are still locally-owned, foreign banks nevertheless contributed almost USD5 billion in FDI in 1998-99 (out of total FDI inflows of USD13.5 billion). Their presence has also led to reductions in cost structures and improvements in efficiency in the whole sector.

- Other countries affected by the Asian financial crisis also liberalised foreign investment restrictions in financial institutions. In **Indonesia**, two large private banks were bought by foreigners during the crisis. For three decades preceding the crisis, foreign investors were required either to form joint ventures or limit themselves to 49% ownership in a local bank. In the case of **Korea**, the government became the owner of more than one half of the banking system, but foreign investors also responded favourably to increased opportunities to acquire local banks (see below). Only **Malaysia** did not further liberalise entry norms for foreign investors at the time, although foreign banks already represented 23% of total commercial banking assets – one of the highest in the region.

- In **Turkey**, a currency crisis gave way to a systemic banking crisis in 2001, leading to the failure of many banks. As a result, the government implemented wide ranging reforms in the financial sector designed to improve not only the financial soundness but also the efficiency of the banking sector. Failed banks were merged with, or sold to, other banks or were liquidated. As a result of these policy responses, the share of foreign banks in the Turkish banking system measured by assets rose from 3.3% in 2002 to 19.8% in 2008. If foreign investment through the Istanbul Stock Exchange is included, the foreign share reaches 37.4%.

Liberalisation of the rules covering foreign entry, sometimes on a temporary basis, is just one aspect of the question of how governments respond to banking crises. In many cases, foreign banks already had a presence in the local market before the crisis, and how they were treated by the monetary authorities during the crisis has implications for the investment climate in the long run. At a workshop of the BIS Committee on the Global Financial System in 2005, "non-discriminatory treatment by host country authorities regarding liquidity support to foreign banks was identified as a key principle by some participants".[21]

The Korean financial crisis

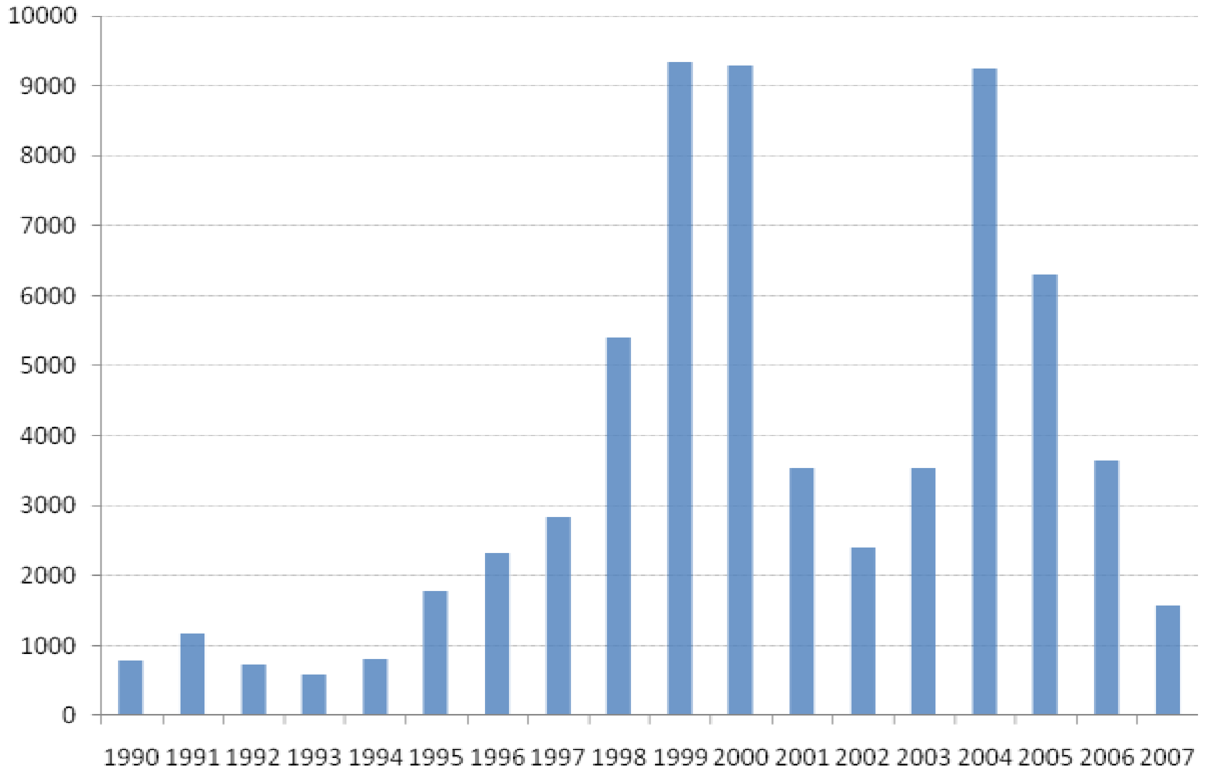
> *The response of the Government of Korea to the recent severe crisis and recession was not to resort to protectionist measures but rather to opt for far-reaching market-based reforms.*
>
> *Trade Policy Review* of Korea, WTO, 2000

Policy changes as a result of the Asian financial crisis had a rapid impact on the Korean economy and allowed it to resume growth in a very short period of time. FDI in Korea took off (FDI inflows almost doubled in 1998 and again in 1999), allowing Korea quickly to rebuild its reserves. The economy responded rapidly to the policy medicine. After shrinking by 6.7% in 1998, the Korean economy rebounded by 10.7% in 1999.

Much of the liberalisation of FDI rules covered the service sector: finance, telecommunications, broadcasting and maritime and air transport. This was complemented by privatisation and trade reforms designed to increase competition within the domestic economy. Reform measures undertaken in the aftermath of the 1997 financial crisis brought a relaxation or elimination of many of the restrictions on the participation of foreign institutions in the Korean financial markets.

Rules governing the ownership of banks were eased, with both foreign and domestic interests permitted to acquire strategic stakes in Korean financial institutions, as the existing ceilings could now be exceeded on the basis of approval from, or prior notice to, the Financial Supervisory Commission. Foreign acquisitions of up to 100% were permitted from April 1998, although subject to additional review by the Financial Supervisory Commission in line with the increase in stakes beyond certain predetermined thresholds. Similar rules were imposed on domestic investors and parallel rules on ownership in securities companies were introduced in March 1998. Increased foreign participation and the resulting increase in competition were now seen as key to raising managerial skills in Korean institutions while building capital in the system. Foreign banks and securities companies were authorised to establish subsidiaries in April 1998. Laws were also enacted to strengthen the powers of boards of directors of banks and to enhance transparency in dealings with shareholders. Foreigners were permitted to become directors of bank boards as of May 1998. The government also announced a policy of ending direct interference in bank management. The Securities and Exchange Act was amended to facilitate hostile take-overs in the financial sector.[22]

Table 2. FDI inflows to Korea, 1980-2007
(USD million)



Source: OECD

In this way, foreign investment was an important element of the recapitalisation of the banking sector, with foreign firms announcing investments of USD 1 billion in Korean banks as of 1999. Several major banks now have significant foreign ownership.

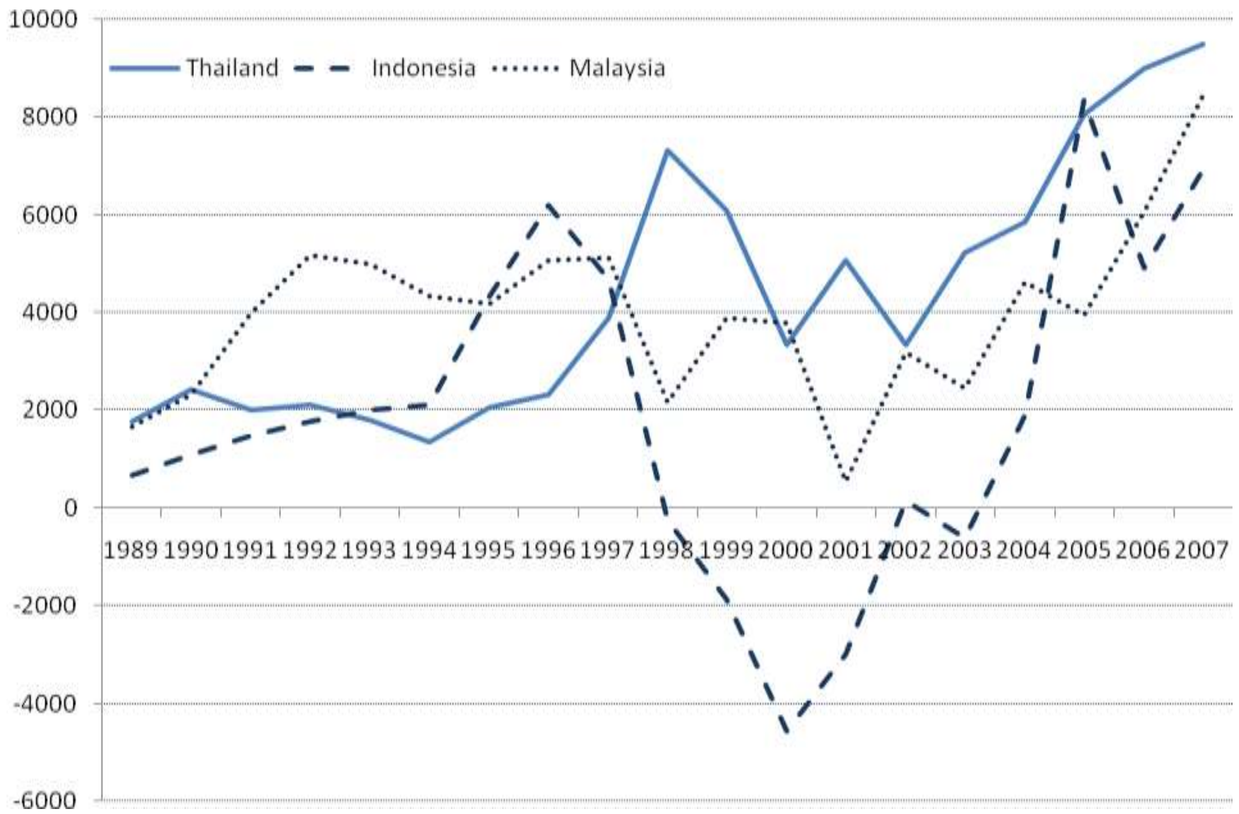
The motive behind the liberalisation was partly to attract foreign capital as a counter-cyclical measure in a crisis situation, but it was also based on the desire for structural improvements in the Korean economy by enhancing competition and introducing principles of corporate governance.

Malaysia, Thailand and Indonesia

The Asian financial crisis also deeply affected three countries in Southeast Asia. Without going into an exhaustive account of how their policy responses differed, it is nevertheless interesting to see how differently they fared in terms of FDI inflows throughout the crisis period. A decade later, FDI inflows into all three countries had returned to the peak levels reached in the second half of the 1990s, but the trajectories of the three countries were very different in the intervening period.

Thailand liberalised most in response to the crisis, particularly in the banking sector (as described above), and was able to attract increasing amount of FDI at a time when foreign investors were otherwise steering clear of the region. Indonesia also initiated some reforms, but the economic crisis ultimately led to a political crisis which compounded any hesitation foreign investors might already have had about investing. Malaysia imposed exchange and capital controls. Although these were not supposed to affect FDI, they may have discouraged some firms from investing or reinvesting in the economy.

Table 3. FDI in three ASEAN economies affected by the Asian financial crisis
(USD million)



Source: IMF

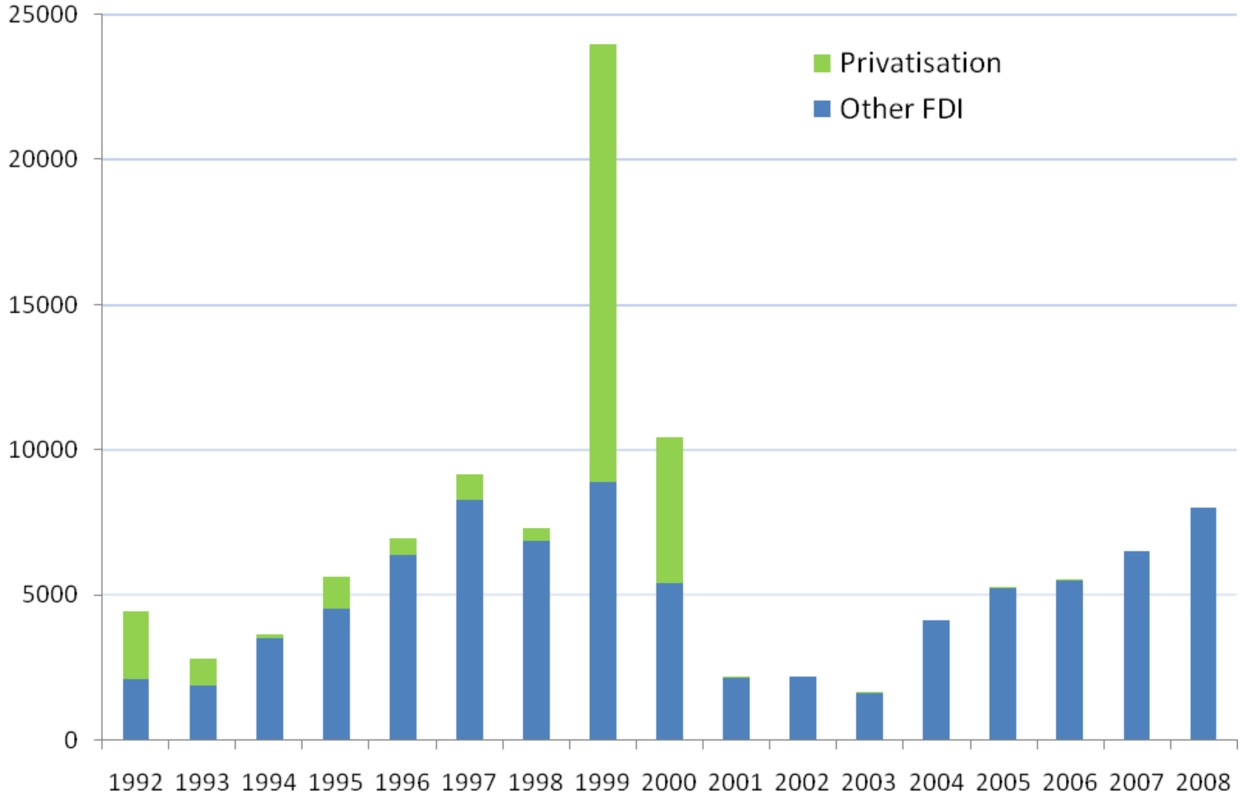
Argentina

Argentina faced a severe economic crisis between 1999 and 2002, with a cumulative decline in output of nearly 20%. The economic crisis precipitated a political one, with frequent changes of leadership, and public hostility towards foreign investors. Foreign direct investment which had been at record levels in 1999 plummeted to around USD 2 billion on average in 2001-2003. Foreign investors were deterred not only by the dire economic conditions at the time but also by the emergency measures which were proposed or enacted. These measures particularly affected sectors, such as banking and infrastructure, where foreign firms already had a substantial presence. By 1999, roughly one half of all banking sector assets were under foreign control, in addition to the significant minority stakes held by foreigners in a number of other financial institutions.[23] Foreign investors were also major providers of infrastructure services, having participated actively in the privatisation of these sectors in the 1990s.

Emergency measures affecting these sectors included the freezing of bank deposits and other restrictions on banking activities, the freezing and conversion to pesos of utility tariffs, a windfall tax on oil exports and a bankruptcy law.[24] Banking sector measures led to public demonstrations against the banking system. As a result of the crisis and the political response, some foreign investors announced either that they would withdraw from Argentina or else refrain from making further investments in the near future.[25]

Foreign investment has now recovered from the dearth of activity during the crisis period. If FDI as part of privatisation receipts is excluded, inflows have now regained their pre-crisis levels.[26] Much of recent inflows have involved new equity contributions and reinvested earnings in existing affiliates, compared to the prevalence of mergers in earlier years.

Table 4. FDI inflows into Argentina, 1992-2008
(USD million)



Source: IMF, Prosperar

New protectionism in the 1970s

The 1970s did not face a crisis on the scale of what is occurring today, but the steep decline in global economic activity after two decades of relatively impressive growth nevertheless led to many calls for policy responses to protect employment. Governments responded through a host of trade measures to protect domestic industries, and some also faced pressure to restrict the outward investments of local firms in the same desire to keep jobs at home. Since trade measures were directed against foreign producers, restrictions on outward investment were seen by some as a complementary measure to prevent domestic producers from shifting production abroad to serve the home market.

The twin oil shocks in the 1970s gave rise to a "new protectionism" as governments defended their industrial base in key sectors: textiles, steel, televisions, footwear, ships and automobiles. Trade protectionism took many forms – voluntary export restraints, orderly marketing arrangements, trigger price mechanisms and anti-dumping duties – and was directed principally at exports from Japan, Korea and Chinese Taipei.

The threat of protectionism was not limited to imports. Multinational enterprises were viewed with suspicion, even at home. They were accused of exporting jobs, avoiding taxes and allowing vital technologies to leak abroad. In the United States, the Burke-Hartke bill of 1973 would have discouraged outward investment by local firms in order to preserve jobs at home.[27] It was defeated only after a long and acrimonious debate in the US Congress. According to one of the sponsors, Senator Hartke, the purpose of the bill was "to stem the outflow of US capital, jobs, technology and production".[28]

Many restrictions existed on inward direct investment at the time. An OECD survey of restrictions found that formal authorisation procedures existed in all but six of the then 24 OECD member countries.[29] The main thrust of policy at the time in both OECD and non-OECD countries seems to have been to maximise the economic rents from inward investment, such as through performance requirements. There is no evidence that the two oil shocks made host governments more restrictive in the OECD area.

In the 1970s and 1980s, governments also bailed out or subsidised firms in the automotive sector, including Chrysler (US), Rolls Royce and British Leyland (UK) and Renault (France). There were also government subsidies in various countries to sectors such as timber, energy, minerals, airlines and shipbuilding.

III. EMERGENCY MEASURES DURING THE CURRENT CRISIS WITH A POTENTIAL IMPACT ON INVESTMENT

How do policy responses during the current crisis compare with earlier decades? Emergency measures can be divided into three categories: restrictions on new foreign investments, including on foreign takeovers of local firms; discrimination against existing foreign investment; and impediments to outward investment by local firms. Each one will be considered in turn.

Policies towards inward investment

Many emergency measures are still evolving, but so far there is little evidence of growing restrictions on inward investment or of rising hostility towards any particular category of investor. Some governments and businesses have actively courted sovereign wealth fund (SWF) investors from the Middle East or Asia, and OECD and partner countries have welcomed investments from SWFs as a positive force for development and global financial stability. Ministers representing 35 recipient countries have adopted a Declaration to express their commitment to preserve and expand an open international investment environment for SWFs. In spite of this welcoming policy stance, SWFs have generally been reluctant to take on the role of "investor of last resort". Some SWFs have acquired large stakes in major banks such as Citigroup and Barclays but otherwise their forays into Europe or North America have been limited both by the substantial paper losses they have already incurred on existing foreign asset holdings and by the declines in oil prices and export earnings which are the two traditional sources of funds for SWFs.

Discrimination against foreign-owned firms

Emergency measures include *i.a.* rescue packages and subsidies to key industries, loan guarantees to stimulate demand for consumer durables and "buy national" provisions in stimulus packages. Apart from the implications for trade policies from these measures, there is a potential risk of discrimination against foreign-owned firms or "transplants" in national economies, should they not benefit from the same measures or under the same conditions. Non-eligibility for capital assistance for financial institutions incorporated under national law but controlled by foreigners would be an example. These same issues could arise in any sector receiving government assistance, but much of the policy discussion has tended to focus on the automotive sector.

Automotive sector

Like steel in earlier decades, the automobile industry is characterised by substantial policy-related exit barriers in many countries – the relative importance of the sector within some national economies is such that governments and electorates take the view that firms in this sector are "too big to fail". Even before the crisis, it was estimated that global capacity in this sector exceeded demand by 25%. Moreover, consumers have opted to forego purchases of new cars during the crisis, and as a result the sector has been one of the most adversely affected.

Many governments have developed policy responses to assist the sector, including in the United States, France, Germany, Canada, Spain, Sweden, the United Kingdom, Italy, Russia, China and Brazil. Absent a full survey of stimulus measures across countries in this sector, this aid appears, in most cases, to be offered to both foreign- and domestically-owned producers. Indeed, in some countries almost all production is already foreign-owned. The aim is to preserve domestic employment at all costs, regardless of the ownership of the firm. Nevertheless, there is a risk that targeted interventions discriminate against "transplants" either *de jure* or *de facto* as a result of conditions attached. Government measures have generally been to offer loan guarantees to stimulate demand and funds to develop greener car technologies, but some have offered direct cash injections as an alternative to bankruptcy. Of the countries listed above, only Russia has sharply raised tariffs.

Government bailouts may affect the pattern of the capacity reduction that is, in any case, inevitable in the sector by influencing which firms reduce capacity and by how much. This, in turn, influences all aspects of sectoral operations, including international investment flows. Although such policies may, over the medium term, succeed in supporting the market positions of weaker firms, they also "risk delaying necessary structural adjustment to new circumstances and creating costly dependence on public support."[30] The experience in steel suggests that using public funds to shield non-competitive producers from market pressures does not create "champions" that are durably viable in markets.

Greater government involvement in the operations and investment decisions of firms

Even if governments refrain from further restrictions on inward investment and provide assistance to all firms in a sector indiscriminately, there are issues for future global integration which arise from the enhanced financial and ownership role of national and provincial governments in domestic firms. Government involvement in key industries is a broad issue with manifold implications. Of most interest in the context of international investment and the scope for further integration is how this involvement will influence the international investments and operational behaviour of firms.

At a time of rising unemployment will firms receiving assistance face political pressure to favour domestic over foreign production to serve the local market? Will takeovers of these firms by foreign competitors also be resisted out of fear that post-acquisition rationalisation will reduce domestic employment? Will these firms be allowed to fail in the future if it implies that their market share will be recuperated by foreign-owned transplants?

These questions are not only hypothetical. In past crises, there has been pressure to keep capital at home, and outward investment has sometimes been seen as exporting jobs. This notion was prominent in the 1970s but has also reappeared more recently in the context of outsourcing and industrial "hollowing out". Will the government's financial leverage in these companies and sometimes even a direct ownership share give greater weight to these fears in policy discussions?

NOTES

1 Washington, 15 November 2008

2 Inaugural Address, 1933

3 Høj et al. (2006), p. 9

4 Much of this section will rely on the example of the United States. Not only was the US economy one of the most adversely affected, but there are also many more studies of US policies than for other countries. US policy responses were also less affected than elsewhere by rising nationalism and militarism which ultimately overshadowed all other considerations concerning the treatment of foreign investors.

5 The stock of US FDI abroad fell only from USD 7.6 billion in 1929 to USD 7 billion in 1939, while inflows into the United States actually rose from USD 1.5 billion to USD 2 billion over the same period.

6 Vaupel and Curhan (1974).

7 Chandler (1990), p. 600.

8 Wilkins (2004), p. 350.

9 The UK Macmillan Committee report and the analysis of the depression written by Bertil Ohlin for the League of Nations both considered that the diminution of capital exports from the US to Germany in the late 1920s contributed to the economic decline in Germany that then spread to other European countries (Temin 1971, p. 240).

10 A *Fortune* article from 1933 stated "It is a quite tenable thesis that the British [sales of securities] precipitated the New York Stock Exchange Crisis of 1929", quoted in Wilkins (2004), p. 299.

11 Wilkins (2004), p. 313.

12 Wilkins (2004), p. 412.

13 *Treasury Instructions to the Capital Issues Committee*, Cmd. 99, 1919.

14 Wilkins (2004), p. 353.

15 Kudo (1994), p. 168.

16 Wilkins (2004), p. 360.

17 Wilkins (2004), p. 363.

18 BIS (2005), p. 3.

19 OECD (2002), p. 88.

20 Montreevat and Rajan (2003), p. 18.

21 BIS (2005), p. 9.

22 OECD (2002), pp. 86-7.

[23] Dages et al. (2000), p. 21.

[24] UNCTAD (2002), p. 63.

[25] See UNCTAD (2002, pp. 63-65) for some anecdotal evidence.

[26] The exceptional level of inflows in 1999 resulted from the acquisition of the Argentine oil company YPF by Repsol of Spain for USD 13 billion.

[27] The bill would have eliminated the foreign tax credit for all foreign investment.

[28] Fatemi et al. (1976), p. 132.

[29] OECD (1982).

[30] OECD (2009) page 20.

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