A Multilateral Framework for Investment?¹

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EXECUTIVE SUMMARY

1. The internationalisation of production and consumption has been the defining feature of the world economy since the mid-1980s. Foreign direct investment (FDI), broadly defined as the creation of enterprises abroad or the acquisition of substantial stakes in existing enterprises, now represents a major form of cross-border capital flow. More firms than ever in more industries and in more countries are expanding abroad through direct investments. Although most FDI originates in and flows to industrialised countries, over the past decade, developing countries’ share of global FDI flows has followed an upward trend.

2. Today, most countries let in FDI. This is in part the result of an acceleration of the liberalisation of domestic investment regimes during the 1990s, particularly by developing countries. However, countries tend not to grant unrestricted rights of entry to all investors and to all types of investment. Restrictions on investment typically remain in those sectors considered of national interest, such as telecommunications, health services, and other public utilities. Developing countries, in particular, impose restrictions on entry and on the operation of foreign firms in order to enhance the economic impact of FDI.

3. The economic rationale for regulating FDI, instead of granting unfettered market access to foreign operations, derives mainly from the fact that FDI typically takes place in concentrated industries and that such FDI generates externalities. Host countries, therefore, see a scope for government intervention so as to close the gap between private and social returns from these investments. In the main, national FDI policies are directed to influence the nature and the impact of FDI, particularly with regard to externalities and spillovers in the domestic economy.

4. The principal issue in the debate on the desirability of a multilateral investment framework (MIF) is the trade off between any restrictions on the national policy space that such a framework might imply and the pursuance of efficiency in the allocation of capital. Therefore, the debate between proponents and opponents of an MIF essentially boils down to a long-standing (and unsettled) question as to how far government intervention is necessary to improve investment allocation and economic performance, and to what extent such interventions may lead to further distortions and inefficiencies. In theory, the presence of market failures justifies government intervention and may be necessary to improve economic efficiency. In practice, government intervention frequently exacerbates distortions and hampers static and dynamic economic efficiency. At present, both theoretical and empirical research in the field of FDI is inconclusive, failing to clearly sustain a case in favour of - or against – restrictions on government intervention.

5. The European Commission (EC) is the strongest proponent of a MIF to be negotiated at the WTO. In contrast, India has been leading the opposition to further extending the international regulation of investment in the WTO. The WTO already includes agreements directly regulating FDI or national investment policies that have consequences for international trade. The General Agreement on Trade in Services (GATS) regulates FDI policies of member countries insofar as FDI represents a mode of supply of services. The Agreement on Trade and Investment Measures (TRIMs) prohibits a number of operational measures on investment that, to some extent, undermine the effects of trade liberalisation under the General Agreement on Tariffs and Trade (GATT).

6. Today’s proposals for further WTO obligations on investment would represent a significant expansion on binding multilateral rules on international investment. However, FDI, and investment more generally, are currently influenced at the international level by bilateral investment treaties (BITs) and by regional trade agreements (e.g. EU, NAFTA, ASEAN, etc). These latter agreements are legally binding on signatories, and together cover virtually all global FDI flows.

7. Proponents of a MIF claim that such an agreement would be necessary to overcome the deficiencies of the current patchwork of bilateral, regional, and multilateral rules on investment, so as to provide international investors with a system of transparent, stable, and predictable set of rules to facilitate these transactions. This, it is said, would not only benefit the countries where such investments originate by raising investment possibilities and returns, but also host countries which would benefit from higher international
investment flows to their economies resulting from a more favourable business environment. More generally, it is claimed that host countries would gain from MIF-induced positive changes to their institutions and economic systems, becoming more transparent and less prone to state-created distortions and corruption.

8. Opponents to a MIF argue that the current system of international rules on investment and unilateral measures provide all of the necessary legal foundations for international investment to take place, while leaving host countries the necessary flexibility to regulate investment so as to meet national development plans. In their view, a MIF would have the effect of limiting the scope for government intervention to an extent that is considered incompatible with the imperatives of economic growth and development. At the same time, they contest the claim that a MIF would lead to significantly higher investment flows.

9. Some recent economic analysis has focused on the likely global effects from further multilateral disciplines on the regulation of international investment flows. Although most of these studies show that the overall effects from a MIF are likely to be positive, they have not found clear and substantial economic gains for developing countries. Put differently, with the exception of benefits accruing to all countries from multilateral regulation of financial and fiscal incentives for FDI, the welfare gains of other multilateral initiatives on investment tend to principally accrue to Multinational Enterprises (MNEs) and their parent countries. In which case those countries almost exclusively representing the importing side of FDI, which includes most of the developing economies, would need to be compensated in other fields of multilateral negotiations, such as market access in industrial goods.

10. Focusing on the key issues outlined above, this paper summarises the main arguments put forward by the European Commission and the United States in their submissions to the WTO’s Working Group on the Relationship between Trade and Investment, together with the critiques offered by India, the main opponent of a MIF, and by some prominent commentators taking a stance on this issue. Rather than trying to resolve the current debate, the aim here is to offer the reader an interpretation of the main arguments raised in the ongoing discussions on this subject inside and outside the WTO. Ultimately, the question as to whether or not a MIF should be negotiated during the next WTO Ministerial Meeting depends on the specific provisions envisaged in a possible negotiating mandate, which have not yet been fully determined, together with a number of other factors, many of which lie far outside any potential investment negotiations. Given the complexity of the issues involved and the inconclusiveness of existing research, there is little faith that a consensus within WTO on a MIF will be reached, and ultimately that the adoption of a MIF would considerably improve the welfare of developing countries.
INTRODUCTION

After the resounding failure of negotiations on a Multilateral Agreement on Investment (MAI) by OECD members in the mid-1990s, the European Union and a few other industrialised countries have renewed their efforts to put formal negotiations on multilateral investment rules on the WTO agenda. Since 1996, when the WTO established a Working Group with a mandate to study investment issues in more detail, member states have been discussing the desirability of further multilateral disciplines on the national regulation of foreign direct investment (FDI). This chapter assesses the key arguments put forward by those favouring a new so-called multilateral investment framework. Particularly, it addresses the question as to whether a case for a multilateral agreement can be made on economic grounds.

This chapter is organised as follows: the first part summarises the key trends of FDI flows and international investment agreements during recent years. The second part summarises the proposals put forward by the European Commission (EC) and, to a lesser extent, the United States (U.S.), and the concerns voiced by India, the main opponent to new WTO investment disciplines. The third part turns to the pertinent economic analysis, and the fourth part concludes.
PART I

CURRENT TRENDS IN FDI FLOWS AND INTERNATIONAL INVESTMENT AGREEMENTS

I.1 Distribution of FDI flows:

The internationalisation of production and consumption has been the defining feature of the world economy since the mid-1980s. Foreign direct investment (FDI), broadly defined as the creation of enterprises abroad or the acquisition of substantial stakes in existing enterprises, now represents a major form of cross-border capital flows. More firms than ever in more industries and in more countries are expanding abroad through direct investment. It has been estimated that today worldwide some 65,000 trans-national corporations (TNCs), 90 per cent of which are headquartered in OECD countries, have established more than 850,000 foreign affiliates, more than half of which operate in non-OECD countries. Their combined sales of almost $19 trillion is more than twice as high as total world exports in 2001, and the worldwide stock of outward FDI increased from $1.7 trillion to $6.6 trillion from 1990 to 2001. Foreign affiliates now account for about one-third of world exports, and another third of world trade flows are between TNCs. The world’s largest TNCs dominate this picture and, mainly as a result of the recent surge in Mergers and Acquisitions (M&As), are consolidating their foreign assets and sales.3

UNCTAD (2002) identifies three main long-term factors behind the expansion of international production: policy reforms by an increasing number of countries that facilitate inflows of FDI; rapid technological change reducing communication costs and allowing more risk to be shared among greater markets; and increased competition compelling firms to reach new markets and to locate production where costs are lower. Investment decisions are also influenced by short-term changes in the business cycle. A sharp drop in global FDI flows, particularly of M&As, accompanied the recent slowdown of global economic growth and the increased uncertainty in world financial markets. As a result, the total value of cross-border M&As completed in 2001 ($594 billion) was only half that in 2000 (Appendix Table 1).4

The relative weights of different modes of entry of FDI have shifted in recent years. M&As gained importance while greenfield investments steadily lost ground. At a global level, more than 80 per cent of FDI inflows are now mergers or acquisitions. Trends in the mode of entry of firms investing in industrialised countries differ considerably from those of developing countries, where greenfield investment continues to dominate. However, widespread privatisation in developing countries during the 1990s has steadily increased the share of M&As in total FDI. For developing countries as a whole, in 2001 the ratio of M&A sales to FDI inflows was 42 percent, as compared to 13 percent in 1991.5

During the last decade the sectoral distribution of cross-border M&As has changed. Whereas in 1990 at the global level 50 percent of M&A took place in the manufacturing sector and 46 percent in services, in 2001 the percentage shares were 33 and 62 respectively.6 This trend is reflected in overall FDI as well. Finance, business services, transport, storage and communications saw particularly important increases in the number and value of M&A transactions (Appendix Figure 1 – M&A purchases by industry).

FDI remains highly concentrated among industrialised countries (Tables Appendices 2 and 3). In 2001, industrialised countries hosted roughly two-thirds of global FDI stock and accounted for more than 68 percent of FDI inflows. FDI flows to developing countries are very unequally distributed. In absolute terms, Latin America and Asia (mainly East Asia) receive the bulk of FDI, whereas Africa’s stock of inward FDI in 2001 amounted to a mere 2.3 percent of total worldwide FDI. Also within regions, FDI flows are highly concentrated (Appendix Figures 6 and 7).7 The developing economies hosting large amounts of FDI include China, Brazil, Singapore, Hong Kong, South Korea, and Mexico. However, the picture changes when FDI as a

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2 This section heavily draws from UNCTAD(2002) and OECD(2002).
3 UNCTAD (2002 – Overview: 1).
4 UNCTAD FDI/TNC database.
5 ibid.
6 ibid.
7 UNCTAD (2002).
Share of GDP is considered. On average, FDI stocks relative to domestic GDP in developing countries have exceeded the levels recorded in the industrialised economies (see Appendix Figure 2).  

Finally, not only is FDI becoming more important for developing countries in relation to GDP, it is also overshadowing other capital flows such as official development assistance (ODA) and export credits (Appendix Figure 3). FDI in developing countries was 10 times larger than ODA in 2000, in contrast to the latter half of the 1980s, when the two were roughly equal. Also for the least developed countries, where ODA has traditionally been the most important source of external financing, FDI flows are now almost as high (or as low) as bilateral ODA flows.  

Table I-1  
National regulatory changes, 1991-2001

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<tbody>
<tr>
<td>Number of countries introducing changes</td>
<td>35</td>
<td>43</td>
<td>57</td>
<td>49</td>
<td>64</td>
<td>65</td>
<td>76</td>
<td>60</td>
<td>63</td>
<td>69</td>
<td>71</td>
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<tr>
<td>Number of regulatory changes</td>
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<td>79</td>
<td>102</td>
<td>110</td>
<td>112</td>
<td>114</td>
<td>151</td>
<td>145</td>
<td>140</td>
<td>150</td>
<td>208</td>
</tr>
<tr>
<td>Of which:</td>
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<tr>
<td>more favourable to FDI</td>
<td>80</td>
<td>79</td>
<td>101</td>
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<td>194</td>
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<td>-</td>
<td>1</td>
<td>2</td>
<td>6</td>
<td>16</td>
<td>16</td>
<td>9</td>
<td>9</td>
<td>3</td>
<td>14</td>
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Source: UNCTAD (2002: 7 – Box Table I.2.1)

Inflows of FDI accounted for 60 per cent of total resource flows to developing countries in 2000, compared to 6 per cent in 1980 and one quarter in 1990.  

In sum, the following stylised facts emerge from recent trends in global FDI flows:

1. Rather than representing the creation of new enterprises, FDI flows to industrialised economies tend to take the form of mergers and acquisitions. This is increasingly true also for FDI to developing countries also.
2. FDI flows increasingly into services sectors, even in developing countries.
3. FDI mostly originates in and flows to industrialised economies. However, the importance of FDI flows to developing countries is increasing both as a share of GDP and fixed capital formation.
4. FDI flows to developing countries are concentrated in certain countries.

I.2 Domestic liberalisation and international agreements on investment

During the 1990s there has been an uninterrupted trend towards the liberalisation of national FDI regimes. Box I-1 summarises the main types of unilateral FDI liberalisation. UNCTAD (2002) reports 208 changes in FDI laws by 71 countries in 2001 alone, raising the total number of annual changes to its highest level since 1991 (see Table I-1). Of the changes effected in 2001, 194 are said to have created a more favourable investment climate. The Asian and Pacific region introduced the largest number of regulatory changes (43 per cent).  

There are two major factors underlying the unilateral liberalisation of FDI. First, the declining trend of official long-term capital flows and the frequent occurrence of international financial crises, particularly since the mid-1990s. Sudden reversals of short-term capital caused many countries’ demands for external financing to shift towards private long-term capital. The second factor is the potentially growth-enhancing features widely

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8 OECD (2002).  
9 UNCTAD (2002: 12).  
10 Ibid.  
ascribed to FDI. Potential spillovers to the domestic economy from FDI have been described in the literature and evidence presented of their importance in a large number of host countries. Given their almost insatiable demand for external finance, few developing countries are willing to forego a relatively stable mode of supply of private funds. However, as described below, many host countries have also found that FDI needs to be regulated in order to correct the market failures associated with it.\textsuperscript{12}

\section*{I.3 Bilateral investment treaties}

Long-term overseas investment in an alien territory is fraught with risks and costs higher than investment at home. Once invested, the national laws of the host country govern the investor and its operations. Typically, a foreign investors’ assessment of expected return to capital is strongly influenced by concerns of expropriation or the imposition of unfavourable rules concerning their operations. In the extreme case, such perceived risks have kept FDI from flowing to countries altogether, or have effectively imposed significantly higher costs on host countries. Typically, investors require guarantees of protection by means of Bilateral Investment Treaties (BITs). To date, BITs constitute the most important instrument for the international protection of foreign investment, providing foreign investors with a clear legal framework. If a BIT is concluded between a capital-exporting industrialised and a developing country, the former typically seeks to secure higher standards of legal protection for the investments of its firms than those offered under the latter’s laws. Moreover, since the early 1990s, developing countries have begun to sign BITs among themselves, so as to create a favourable climate for reciprocal investment flows.

\begin{center}
\textbf{Box I -1 Unilateral liberalisation of FDI policies}
\end{center}

\textbf{Definition:}

“FDI liberalisation is a dynamic process that involves the following:

\begin{itemize}
  \item[(a)] the tempering or removal of those market distortions that result from restrictions applied specifically (and, hence, discriminatorily) to foreign investors (e.g. barriers to entry and operations) and from the granting or withholding of incentives and subsidies that discriminate in their favour or against them;
  \item[(b)] the strengthening of certain positive standards of treatment for foreign investors (e.g. national treatment, most-favoured-nation treatment, fair and equitable treatment); and
  \item[(c)] the strengthening of market supervision to ensure the proper functioning of the market (e.g. competition rules, disclosure of information, prudential supervision).
\end{itemize}

“[…] Certain aspects of the internal normative framework, such as the existence of a comprehensive legal framework for business activities, are essential to give meaning and effect to the liberalisation of FDI. […]

\textbf{How far has FDI liberalisation gone?}

“Today, all countries admit FDI in principle. On the other hand, no single country grants unrestricted right of entry to all activities. However, the number of activities in which FDI is barred or restricted has been considerably reduced, especially in the manufacturing sector but also increasingly in natural resources and services, as most countries have gradually moved to open traditionally closed industries, often in the course of their privatisation programmes (e.g. telecommunications, public transport, other public utilities and the construction of public infrastructures, fishing, mining, oil and energy), although some restrictions remain. Ownership requirements and control restrictions (through, for example “golden shares”) are limited to certain strategic industries, particularly after privatisation (e.g. broadcasting). Fade-out requirements have virtually disappeared. Most countries have eliminated authorisation requirements for the entry of greenfield FDI, replacing them with registration, although some authorisation requirements and restrictions on the number of foreign firms allowed remain in many countries (both developed and developing) for some ‘strategic’ industries (e.g. banking and finance, air transport, broadcasting, telecommunications) and often apply to both foreign and domestic firms. There are also indications that certain operational conditions – such

\hspace{1cm} (continues)
as performance requirements or those relating to the hiring of foreign managerial personnel – are becoming less significant. Certain types of performance requirements have been reduced or have become more transparent as a result of international commitments and transitional measures under the TRIMs Agreement. […] Others, not covered under the TRIMs Agreement, have become more focussed and tend to discriminate less either in favour of or against foreign investors. […] Exchange restrictions on the repatriation of profits and capital have become exceptional measures reserved for cases of serious balance-of-payments difficulties in most countries. Most restrictions on outward FDI have also disappeared in developed countries and are being gradually reduced in a number of developing countries and transitional economies.

**Strengthening positive standards of treatment**

“The standards of non-discrimination and national treatment of FDI after its entry into the host country are now reflected in the laws and international agreements of many countries (often with certain qualifications and exceptions), as are the principles of due process and fair and equitable treatment. Host countries, including many developing countries, are also granting foreign investors legal protection and guarantees against non-commercial risks. The number of developing countries that have signed bilateral, regional and multilateral agreements dealing with the treatment and protection of FDI after entry has increased dramatically in the 1990s, after most countries in Latin America and in Central and Eastern Europe took to signing them.

**Strengthening market controls**

“An increasing number of countries in all regions have adopted or are strengthening antitrust laws. The number of countries having competition laws has increased from less than 40 in 1980 to over 70 in 1997. Most have also established mechanisms to supervise international mergers and acquisitions, stock exchanges, and financial markets.

“In sum, the trend towards a liberalisation of FDI policies is indeed pervasive and has led to a convergence of FDI regimes, although numerous and at times significant differences remain. To the extent that FDI policy frameworks become similar, specific differences – other things being equal – become more important influences on the locational decisions of investment projects.”

Source: UNCTAD (1998: 95-6 - Box IV.2)

UNCTAD has been active in strengthening this pattern by assisting developing countries in the drafting and the signing of BITs. Consequently, the network of BITs is expanding constantly. In 2001 alone, a total of 97 countries have concluded 158 BITs, raising the total number of BITs from 1941 at the end of 2000 to 2099 by the end of 2001. Developing countries have intensified the practice of concluding BITs among themselves, including the least developed countries; the latter signed 51 BITs in 2001, 13 of which were among themselves and 24 with the rest of the developing world (Appendix Figures 4 and 5).

There are a number of similarities between the key provisions enshrined in BITs, as listed in Table I-2. However, some BITs go beyond these basic principles, particularly by granting the right of establishment to foreign investors (typically, the BITs concluded with the United States or Canada), or by prohibiting performance requirements with regard to local content, to exports, and to employment as conditions for the entry by foreign investors.

In general, BITs do not affect the formal right to regulate the admission of foreign investors, but they do provide strong rights for investors and a variety of obligations on host governments once the investment has been made. Nevertheless, typically a host government can continue to exercise its sovereignty to regulate all aspects of the foreign investment in its country, as long as the provisions regulated by the BIT are respected (e.g. non-discrimination, expropriation, transfer rules). For instance, foreign investors have to comply with all national legislation pertaining to environment or labour issues.

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14 For a list of performance requirements, see Box III.1.
Table I-2: Common elements of BITs:

<table>
<thead>
<tr>
<th>Definition of investment</th>
<th>- Usually a broad and open-ended definition of foreign investment is adopted.</th>
</tr>
</thead>
</table>
| Market access (pre-admission) | - Entry and establishment are subject to national laws and regulations.  
                               - BITs usually do not affect the right to regulate the admission of foreign investors. |
| Post admission | - Fair and equitable treatment of foreign investors (the “general treatment” clause).  
                   - Principle of national treatment of foreign investors, but often subject to qualifications and exceptions, e.g. for taxation, public order, national security.  
                   - Most Favoured Nation (MFN) treatment, subject to standardised exceptions. |
| Investor protection | - Right of the host country to expropriate foreign investors, subject to the condition that expropriation is non-discriminatory and accompanied by adequate compensation.  
                     - Guarantee of free transfer of payments, of capital and returns, related to foreign investment, often qualified by exceptions in case of balance of payments problems. |
| Dispute settlement | - State-to-state dispute settlement provisions, and increasingly also investor-to-state dispute settlement, such as BITs signed with the European Union. |


UNCTAD (1996) has highlighted the particularly development-friendly characteristics of BITs, since they “do not disregard the special development needs of individual treaty partners: they emphasise the importance of FDI for economic development; they generally recognise the effect of national law on FDI; and they contain exceptions or qualifications to some general principles (e.g. exceptions for balance-of-payments consideration in relation to the principle of free transfer of funds)”.

I.4 Regional investment agreements

In contrast to bilateral treaties, investment agreements at the regional level tend to have greater ambitions to liberalise entry and establishment of FDI and to eliminate discriminatory policies. Investment protection provisions have also been added more recently. Most of these agreements are legally binding, although the APEC investment principles are a major exception. These investment provisions are usually part of a broader regional trade and integration agreement (RTA). Major examples of RTAs including investment provisions are the ASEAN agreement, MERCOSUR, the EC Treaty, and the NAFTA treaty. Moreover, the proposed Free Trade Agreement of the Americas (FTAA) contains similar provisions. The provisions in these agreements vary considerably with respect to the definition of investment, right of entry and establishment, transparency, protection standards, etc. It is not the aim of this paper to describe and compare the key features of these investment agreements to any great extent. Here, only Chapter 11 of the NAFTA agreement is considered, as it served as the basis for negotiating the proposed MAI at the OECD. Table I-3 below lists the main features of Chapter 11 of NAFTA, and compares it with the key provisions included in the proposed MAI.

A broader comparison between the key provisions included in major existing bilateral, regional, and multilateral investment agreements are presented in Appendix Table 7. It shows that most regional investment agreements are highly intrusive into domestic regulation, including provisions on capital access, standards of treatment, and protection standards. Since virtually all the major home and host countries of FDI are members of at least one regional investment agreement, the regulation of FDI flows by these agreements is likely to be almost universal.

16 The NAFTA treaty between the United States, Canada, and Mexico came into force in 1995 and becomes operational in 2005.
| TABLE I-3: Key provisions in Chapter 11 of NAFTA and the proposed MAI |
|-----------------------------|---------------------------------|-----------------------------------------------------------------|
| **Discipline**              | **NAFTA Chapter 11**            | **Proposed MAI (OECD)**                                         |
| **Scope of application**    | - Asset-based definition of investment.  
|                            | - Closed definition: states what is included and what is not.  
|                            | - Only assets having certain characteristics are defined as investment and thus covered. | - Asset-based definition of investment, including every kind of asset owned or controlled, directly or indirectly, by an investor.  
|                            |                                | - Open definition: lists items that are included and implies that non-listed items are also covered. |
| **Investment liberalisation**| - National treatment and most favoured nation treatment granted to both the pre and post-admission phase of the investment process.  
|                            | - Top-down model of liberalisation.  
|                            | - Absolute prohibition of a number of performance requirements. | - Similar to NAFTA Chapter 11.  
|                            |                                | - Absolute prohibition of the use of an even greater number of listed performance requirements than NAFTA. |
| **Investment protection**   | - Host states are required to compensate investors in the event of expropriation of their investment.  
|                            | - Includes both direct and indirect expropriation, such as governmental measures having an equivalent effect to a direct expropriation.  
|                            | - Member states are required to provide fair and equitable treatment and full and constant protection and security while ensuring a minimum standard of treatment of that required by international law. | - Similar to NAFTA Chapter 11. |
| **Dispute settlement**      | - Contains both state-to-state and investor-to-state dispute settlement procedures. | - Similar to NAFTA Chapter 11. |
| **Investment incentives**   | - Largely ignored.  
|                            | - The provisions on performance requirements explicitly condone the use of incentives if linked to certain performance requirements. | - Similar to NAFTA Chapter 11. |


I.5 Multilateral investment agreements

Despite recurrent pressures from certain industrialised countries - particularly the United States, the Members of the European Union, and Japan - as of today, there is no comprehensive, multilateral investment agreement in existence. The most recent attempt to negotiate an investment agreement among OECD members failed. In 1995 an OECD Council Meeting at the Ministerial Level agreed to commence negotiations along the lines of NAFTA, so as to set “high standards” on investment liberalisation and protection, backed up by an effective process of dispute settlement. The principal features of the proposed Multilateral Agreement on Investment (MAI), shown in Table I-3, were basically the same as those of Chapter 11 of NAFTA, including a broad definition of investment.

The MAI negotiations broke down three years after they had started.17 There had been several issues of substantial disagreement among OECD members (including the scope of the agreement and cultural exceptions) and fierce opposition by a coordinated group of NGOs concerned about the impact of the proposals for a MAI on labour and environmental standards and, more generally, on the potentially negative effects of economic globalisation. The political climate for the conclusion the MAI turned particularly unfavourable after the July 1997 outbreak of the financial crises in Thailand and its spread to other countries.

17 In 2002, OECD released a comprehensive collection of documents relating to the MAI negotiations, which can be accessed on the organisations’ website (www.oecd.org/daf/mai).
in East Asia. Instead of capital flowing in, a sudden reversal of $105 billion\textsuperscript{18} of loans and portfolio capital brought the crisis-stricken economies virtually to a standstill or worse. Over-borrowing and a mismatch of maturities are widely blamed as the main culprit of this crisis. FDI, in contrast, was shown to be more stable than portfolio or bank loans. Against this background, and in the presence of concomitant pressures from NGOs and disagreements among OECD Members about some key MAI provisions, the negotiations broke down.

Several lessons from the failure to complete the MAI negotiations are of interest for future initiatives on rule making on investment:

1. Collective action by powerful NGOs and developing countries’ growing awareness of the risks accompanying wholesale, as opposed to strategic, financial liberalisation are strong factors influencing the outcome of negotiations, even if the latter take place in fora with the exclusive membership of rich industrialised countries. Arguably, any new international agreement that were to assign more rights to the business community at the cost of restricting sovereignty over national development policies is likely to encounter fierce and organised opposition from civil society.

2. Any agreement that seeks to include financial flows other than long-term FDI is likely to be unacceptable not only to most countries from the developing world, but also to many industrialised countries.

3. The large number of reservations by OECD members on proposed MAI provisions demonstrates that even this relatively homogeneous group of countries found it difficult to agree on an issue as sensitive as the regulation of international investment. In a sense, the MAI proposal may well have been over-ambitious in its scope, and it might have been better to allow for an incremental approach to reform.\textsuperscript{19}

I.6 Existing investment provisions in the WTO framework – GATS and TRIMs

The WTO, which came into being after the conclusion of the Uruguay Round negotiations in 1994, contains two major agreements that directly address investment issues: the Agreement on Trade-Related Investment Measures (TRIMs), and the General Agreement on Trade in Services (GATS). Three further agreements arguably have indirect effects on investment: the Agreement on Subsidies and Countervailing Measures (ASCM), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), and the Government Procurement Agreement. Since investment is not the primary focus of these agreements, this section addresses only TRIMs and GATS.\textsuperscript{20}

I.6.1 The TRIMs Agreement

Trade-related investment measures are frequently imposed by governments to either encourage or compel foreign investors to achieve certain national priorities. They relate to trade-distorting restrictions imposed by the host country on multinational enterprises\textsuperscript{21} that operate in its territory. The most commonly used TRIMs are requirements on local content, on trade and foreign exchange balancing, on export performance, on joint venture or equity participation, on manufacturing limitations, and on remittance restrictions. The WTO recognises that some TRIMs might cause trade distortions and violate the principles of the General

\textsuperscript{18} The essential shock was the large, dramatic, abrupt reversal of capital flows to East Asia. From +$93 billion to the five countries mostly hit in 1996 to -$12 in 1997, equivalent to 11% of their combined GDP (Radelet and Sachs, 1998).

\textsuperscript{19} Similar observations have been made by a number of authors, including Kurtz (2002), Nunnenkamp and Pant (2002).

\textsuperscript{20} Outside the WTO, a number of agreements and arrangements have been concluded or established that bear on the regulation of investment, including the Multilateral Investment Guarantee Agency (MIGA), which is part of the World Bank Group, offering insurance coverage to foreign investors for political risks in developing countries; the International Centre on Settlement of Investment Disputes (ICSID), another World Bank Group institution, facilitating the settlement of disputes between private investors and host countries; the OECD Guidelines on Multinational Enterprises and UNCTAD’s Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, governing the conduct of multinational enterprises; the Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, containing principles on employment, training, conditions of work and life, and industrial relations. See UNCTAD (1996) for further details.

\textsuperscript{21} Precisely, the TRIMs agreement is not confined to policies targeted at foreign firms. A panel report on a dispute concerning the Indonesian automotive sector has established that the “TRIMs Agreement is not limited to measures taken specifically in regard to foreign investment”, but covers also domestically owned enterprises. See Bora (2002) for further details.
Agreement on Tariff and Trade (GATT). Consequently, the TRIMs Agreement was inserted as an annex to the GATT at the conclusion of the Uruguay Round. It requires countries to phase out TRIMs that have been identified as being inconsistent with GATT rules. More specifically, the TRIMs Agreement, dealing exclusively with investment measures related to trade in goods (not in services), prohibits performance requirements inconsistent with Articles III (National Treatment) and XI (General Elimination of Quantitative Restrictions) of the GATT. The agreement contains an illustrative and potentially non-exhaustive list of TRIMs deemed to be inconsistent with these articles, including local content and trade balancing requirements, and export restrictions. Developing countries were granted a prolonged phase-out period for existing TRIMs that are inconsistent with the agreement. Also, Article 4 of the agreement permits developing countries to temporarily deviate from the agreement for balance of payments purposes.

I.6.2 The GATS

Foreign investment in the services sector is affected by the General Agreement on Trade in Services (GATS), which covers FDI insofar as it represents a mode of supply of services through “direct commercial presence” in a member state. GATS imposes on all members transparency and MFN treatment, subject to derogations. The so-called “positive-list” approach adopted in GATS allows members to provide for national treatment exclusively in sectors they have decided to open up to international investors, with conditions or qualifications. GATS has thus been widely praised as a development friendly approach to liberalisation.

UNCTAD (1996) notes, “by covering all factors of production, including the temporary movement of natural persons, the GATS opens opportunities for increased services exports from developing countries, and innovation of considerable importance to these countries. Furthermore, by using a positive list approach […], each country can strategically negotiate the individual service industries or transaction that it is ready to open up […], in pursuance of long-term progressive liberalisation.”

I.6.3 TRIMS and GATS as a departure from BITs

GATS and the TRIMs Agreement have resulted in a certain degree of investment-related liberalisation by WTO Members and of investment protection. Moreover, both agreements impose certain obligations on transparency. The TRIMs Agreement constrains the use of performance requirements by host country governments, departing significantly from the provisions included in BITs, which usually do not. GATS provides investors with MFN treatment, national treatment, movement of personnel and transfer rights in service sectors selected by members. Given the selective nature of the positive-list approach, GATS represents a clear departure from the BITs standard, which usually does not allow specific exceptions to non-discrimination obligations. Another difference is that GATS does not include provisions on investment protection normally included in BITs, other than the right of a foreign service supplier to make international payments and transfers. Moreover, the WTO Dispute Settlement Understanding (DSU) governs disputes arising in GATS, while BITs usually provide also for investor-to-state dispute settlement.

The TRIMs Agreement and the GATS are less invasive of the domestic policies of host countries than most regional trade agreements are. NAFTA, for instance, contains an outright prohibition of performance requirements, and has a sweeping cross-sectional approach to key provisions, including those relating to MFN and national treatment. Even so, some consider the TRIMs agreement as a failed attempt to enshrine investment issues in the WTO framework, as it merely clarifies the application of existing GATT provisions. Bora (2002), for example, states that

22 See Box III.1.
23 Members are required to publish and notify the Council for Trade in Services all laws, regulations and administrative measures relevant to the agreement in the case of committed service sectors (see also Nunnenkamp and Pant 2002).
24 Members are allowed to list specific and/or general exceptions. The latter usually relate to reasons of public health or morality, bilateral tax treaties, incompatibility with an economic integration agreement, etc.
26 Notable exceptions being BITs concluded by the United States or by Canada.
“the agreement is a rather modest attempt to disciplining policies that are targeted at foreign enterprises, and it was the outcome of conflicting positions about the extent to which investment issues should be covered by the WTO”.27

Other commentators, for example Morrissey (2001), have argued that the TRIMs agreement imposes restrictions on government actions but no reciprocal restrictions on the actions of MNEs, although the latter may be just as trade-distorting as TRIMs. These issues are discussed in more detail in Part III below.

Part II
A Multilateral Framework for Investment: proposals and critiques

After the First Ministerial Meeting in Singapore in 1996, the Working Group on the Relationship between Trade and Investment (WGTI) was set up with the mandate to study the relationship between trade and investment. In November 2001, at the Fourth Ministerial Meeting in Doha, WTO members decided to launch negotiations on a multilateral investment framework after the Fifth Session of the Ministerial Conference, subject to an agreement on the modalities of those negotiations at the latter conference in Cancun. Investment matters have been put on the WTO agenda by a number of industrialised countries, in particular by the European Commission and its member States (EC). A number of developing countries, among them India, Pakistan, Malaysia, and Egypt, have strongly opposed commencing formal negotiations. The following sections give account of the key points of dispute, by summarising the submissions to the WGTI by the European Commission, the main demandeur, and India, the main opponent. A further section is dedicated to the United States’ proposal for an agreement with even broader coverage than that envisaged by the EC.

II.1 The Doha mandate on investment

The Doha Declaration specifies that any negotiated commitments considered should be modelled on those made in services (GATS), that is, taking a positive-list approach, rather than making broad commitments and listing exceptions (the so-called negative-list approach). Paragraphs 20-22 of the Declaration the matters for discussion within the Working Group:

“20. Recognizing the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade, and the need for enhanced technical assistance and capacity-building in this area as referred to in paragraph 21, we agree that negotiations will take place after the Fifth Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations.

21. We recognize the needs of developing and least developed countries for enhanced support for technical assistance and capacity building in this area, including policy analysis and development so that they may better evaluate the implications of closer multilateral cooperation for their development policies and objectives, and human and institutional development. To this end, we shall work in cooperation with other relevant intergovernmental organisations, including UNCTAD, and through appropriate regional and bilateral channels, to provide strengthened and adequately resourced assistance to respond to these needs.

22. In the period until the Fifth Session, further work in the Working Group on the Relationship between Trade and Investment will focus on the clarification of: scope and definition; transparency; nondiscrimination; modalities for pre-establishment commitments based on a GATS-type, positive list approach; development provisions; exceptions and balance-of-payments safeguards; consultation and the settlement of disputes between members. Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest. The special development, trade and financial needs of developing and least developed countries should be taken into account as an integral part of any framework, which should enable Members to undertake obligations and commitments commensurate with their individual needs and circumstances. Due regard should be paid to other relevant WTO provisions. Account should be taken, as appropriate, of existing bilateral and regional arrangements on investment.”

Since the second half of 2002, discussions have intensified among WTO Members within the WGTI. Although some proposals have been advanced in the submissions by a number of countries, a draft agreement or draft
modalities for negotiations has yet to be proposed. In the case of the European Commission, a clear stance on this issue has been elaborated, which could represent the basis for future negotiations on a formal MIF.

II.2 Key elements of European Commission’s proposal for a multilateral investment framework

The key elements of EC’s proposals can be evinced from its recent submissions to the WGTI on the following matters: transparency, definition of investment, development provisions, pre-establishment rules, balance of payments safeguards, dispute settlement between members, and non-discrimination. These submissions are summarised below (see also Appendix Table 5).

II.2.1 Transparency (WT/WGTI/W/110)

In EC’s conception,

“transparency means information […] [and] is closely linked to the principle of fairness as well as economic efficiency and legal security. In the international trade and investment area the legal requirement of transparency on host countries means, in general terms, the requirement of making available the relevant ‘rules of the game’ in force in their territory. The ‘rules of the game’ cover the relevant laws and regulations as well as the procedural rules and formalities regarding investment.”

The EC further claims that there is a case for a multilateral framework to secure transparent, stable, and predictable conditions for long-term investment, as greater transparency is said to encourage higher flows of FDI by reducing investor perceptions of risk. Moreover, it is said that multilateral disciplines on transparency provide an objective benchmark for overcoming this sort of obstacle to FDI. Alternatively put, lack of transparency creates uncertainty about the existing legal regime on investment in a certain country. Potential investors, therefore, tend to have higher estimates of the risks associated with investment in a non-transparent country, leading to distortions (inefficiencies) in the allocation of capital and/or to deterring investing into certain countries or sectors altogether.

Lack of transparency not only concerns the information about rules and regulations as such, but also their application. The EC goes on to explain,

“the lack of clear rules is often the environment where private, secret and possibly corrupt deals and practices tend to prosper. Even when practices are not corrupt, the lack of transparency produces the inevitable perception that they might be affected by corruption. […] In sum, a non-transparent investment climate in any given host country does not allow foreign investors to take full advantage of the economic opportunities that could be expected from their venture abroad. This, in turn, will impede the positive feedback between FDI and growth in the host economy that would occur in a more transparent environment.”

Based on these considerations, the EC argues for a multilateral investment framework “that would at least match what is applicable for investors in services.” That is, similar to GATS, transparency provisions for investment should include elements relating to the publication and notification of “all relevant measures which pertain to or affect the operation of the Agreement” within strict deadlines. Also, WTO members should be obliged to respond promptly to other members’ inquiries regarding measures of general application, and also ensure procedural transparency, including the establishment of tribunals or procedures “for prompt and impartial review and remedy of administrative decisions affecting FDI.”

Developing countries with insufficient domestic capacity should be granted assistance in their efforts to implement the transparency provisions included in a multilateral framework. The EC notes that developing transparency provisions in a multilateral investment framework “[…] would not require WTO members to set

29 (WT/WGTI/W/110: 1).
30 (WT/WGTI/W/110: 2-3).
31 (WT/WGTI/W/110: 4).
32 Ibid.
33 (WT/WGTI/W/110: 5) - see also Appendix Table 5 on this point.
up any new administrative machinery or to commit additional budgetary or staffing resources.” Moreover, it is emphasised that transparency should not be seen as a set of additional burdens for the host country, as the latter will benefit the most from increased FDI. It would also be possible for developing countries to use transparency rules in a “pro-active” way, for instance as a means to promote their investment regime among the investor community.

II.2.2 Non-discrimination (WT/WGTI/W/122)

The EC notes that

“the non-discriminatory treatment of international investment is a necessary condition for the development of a level playing field for FDI worldwide, which would improve the allocation of capital and minimise distortions, releasing additional resources. […] Moreover, all countries have realised that in order to attract foreign investors they need to provide, as a pre-condition, a predictable, transparent and non-discriminatory regulatory framework, beyond macroeconomic and political stability, infrastructure, labour skills, etc.”

Hence, the EC proposes to extend the degree of treatment granted to investment in the services sectors by the GATS to the primary and the secondary sectors. A multilateral investment agreement should include a general MFN obligation, pre- and post-establishment and allowing for exceptions; a general, post-establishment national treatment (NT) obligation, including possible exceptions; and a specific market access-related NT obligation for the admission of foreign investments to those sectors listed in each country’s schedules of commitments, which would also list each member’s derogations to the applicability of the provisions on national treatment. Finally, the EC proposal envisages the possibility of including general, as well as subject- and country-specific, exceptions to MFN and NT.

The EC concludes,

“[…] while on the one side the above provisions would go a long way towards improving the legal security and coherence of international investment rules on the other side they would not prevent host countries and in particular developing countries from pursuing their domestic policies.”

II.2.3 Pre-establishment (WT/WGTI/W/121)

In this paper the EC emphasises the importance of having clear rules on the admission of foreign investors. Currently, governments have the right to prohibit or restrict the entry of FDI and to impose entry conditions to permitted FDI. Despite the widespread unilateral liberalisation of FDI regimes by host countries, the EC notes, there still exist significant barriers worldwide preventing foreign investors from entering domestic markets. Therefore, the EC paper goes on to note that,

“[…] admission rules may increase the legal certainty for companies that plan to set up an undertaking in a new host country by confining the wide area of discretion of host countries in a more predictable pattern. Generally speaking, open and transparent admission rules for foreign investment can significantly contribute to a better allocation of capital by creating a level playing field among potential host countries and among investors. At the same time, host-country governments usually keep a certain control on the entry of foreign investors in order to preserve national development goals, security, public health, the protection of the environment, safety and public morals. These two objectives are not incompatible and can co-exist in a multilateral investment framework, as they do already in most international investment agreements. […] While on the one hand most host countries wishing to attract FDI have liberalised unilaterally the entry conditions for foreign investors, on the other hand, it is only through international investment agreements that host governments are bound to provide the entry conditions that give investors the predictability and security they seek.”

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34 (WT/WGTI/W/110: 4).
35 (WT/WGTI/W/122: 2).
36 (WT/WGTI/W/122: 4).
37 (WT/WGTI/W/121: 2-3).
The EC concludes,

“ [...] the GATS approach provides a useful model for addressing pre-establishment rules in a multilateral investment framework. On the other hand, governments can keep full control of the sectors in which they wish to commit market access and NT to foreign operators and of the sectors in which they do not feel ready to do so. On the other hand, it provides a transparent and predictable picture of the rules affecting the admission and establishment of investors in each host country. This approach has the merit of incorporating enough flexibility to allow a gradual and progressive liberalisation of FDI, fully compatible with any development strategy adopted by WTO members.”

Finally, the EC notes that since the GATS already applies to about one half of worldwide FDI stocks and flows, which are in the services sector, and considering that it is in that sector where WTO members impose most market access and discriminatory restrictions, its extension to the secondary sector would not represent a major difficulty for host countries. As far as the primary sector is considered, the EC claims, a positive-list approach would guarantee sufficient flexibility to take into account country-specific circumstances.

II.2.4 Balance of payments safeguards (WT/WGTI/W/153)

The EC defines a balance of payments (BOP) crisis and related policy responses as follows:

“An unsustainable BOP situation in a given country may arise for a number of reasons and risks becoming a BOP crisis. One example of an unsustainable current account position is when the current account is in deficit, and the net imports of goods and services cannot be financed with a sufficient inflow of foreign capital or a reduction in foreign reserves. This may lead to an unsustainable BOP situation. The policy options available to the affected country include improving the current account, for instance by expanding exports or restricting imports (provided these restrictions are compatible with its international obligations and preferably not counterproductive in terms of future developmental objectives), or improving the capital account by encouraging capital inflows. The latter may be achieved by attracting more FDI or portfolio inflows. Borrowing, if sustainable in terms of future interest and capital repayments, from foreign banks, governments or international institutions is another policy option. Countries may also need to consider adjustments to their monetary and exchange rate policies.

In seeking to avoid serious BOP difficulties governments have sometimes taken restrictive measures on current transfers as well as on capital movements. However, such mechanisms involve costs and can introduce distortions for the country imposing them. Their adoption, or even threats of their adoption, can also provoke capital flight if investors want to ‘get out while they can’. A future IDF [Investment for Development Framework] covering FDI would necessarily have to preserve a possibility for safeguards although within well-defined and internationally accepted criteria.”

Recognising that developing countries’ financial systems are particularly fragile and exposed to instability, the EC proposes the inclusion of a provision allowing members to take safeguard measures in case of a BOP crisis, provided that such measures be taken exclusively

“ in exceptional circumstances, in a non-discriminatory manner, in full compliance with the Articles of Agreement of the IMF, for a limited period of time and [do] not go beyond what is necessary to address the BOP crisis. They should also be notified to the WTO, and subject to effective, multilateral review, to be carried out in co-ordination between the WTO and the IMF.”

More specifically, according to the EC a future investment agreement should provide:

“ - as a general rule, that members allow: all current and capital transfers related to established investments, and; as far as the making of new investments is concerned, all current and capital transfers related to those investments covered by the countries’ sectoral list of commitments.

- as an exception, a safeguard clause to preserve members in case of serious BOP difficulties.

38 (WT/WGTI/W/121: 4).
39 (WT/WGTI/W/153: 2).
40 (WT/WGTI/W/153: 1).
This provision should allow temporary restrictions on the outflows of current and capital transfers related to those investments covered in the IDF.

[...]

A safeguard provision allowing the imposition of investment restrictions for BOP reasons is an example of “escape clause” particularly relevant for developing countries. In any case, a BOP safeguard clause that allows members to take restrictive measures should only be allowed under exceptional circumstances, it should be clearly defined and include strict criteria. For instance, in our view, restrictions should:

- be non-discriminatory;
- be consistent with other relevant international provisions;
- be limited in time and phased out progressively;
- be applied in a way that does not exceed what is necessary to deal with the sudden difficulties;
- avoid unnecessary damages to the interests of other members;
- not be used to justify measures adopted to protect specific industries or sectors.”

II.2.5 Development provisions (WT/WGTI/W/140)

Here the EC focuses particularly on the concept of “flexibility for development”, and emphasises that the development dimension is a cross-cutting concern that is pertinent to the specific discussions on scope and definition, transparency, non-discrimination, and pre-establishment commitments contained in its submissions.

More specifically, the EC takes the view,

“[...] while most developing countries recognise the merit of providing an open and transparent investment climate in order to attract FDI, some of them also feel the need to maintain certain investment policies and measures aimed at promoting the development of specific sectors, regions, filling technology gaps or protecting minorities and cultural heritage. Regardless of the effectiveness or appropriateness of any specific policy, it is our firm conviction that any development policy and measures can and should be compatible with a multilateral investment framework.

By saying this, we believe not only that a MIF [multilateral investment framework] can and should be compatible with development objectives and policies, but in fact it could actually support them. Let us not forget that developed countries are both sources and destinations of the greater part of FDI flows worldwide. However, developing countries are those who most need FDI in order to make up for their lack of domestic capital and technology. A MIF would certainly benefit developing countries in particular by improving the legal security, transparency and credibility of their domestic framework.

Thus, should a MIF include meaningful provisions that enhance transparency, predictability and non-discrimination for FDI, those who will mostly benefit from it will be developing countries.”

The EC then goes on to explain its conception of flexibility:

“We wish to underline that flexibility for development is an important concept that should be taken into account in the negotiation of a MIF. However, if flexibility is understood as the right of a government to discriminate among investors, it will not be effective as a means to enhance development. Flexibility instead can be useful if it is seen as a broader concept which combines an appropriate policy space that governments require to pursue their national development objectives with the quest for an appropriate stable, predictable and transparent FDI framework through which firms are encouraged to operate.

41 (WT/WGTI/W/153: 4-5).
42 (WT/WGTI/W/140: 7).
Flexibility is to make up for insufficient financial and human resources and, in particular, institutional weaknesses, which put heavy restraints on developing countries. Flexibility may typically involve: lower levels of commitments; asymmetrically phased implementation timetables; exceptions from obligations in certain areas; flexibility in the application of – and adherence to – disciplines. As already discussed in this Working Group, international investment agreements can include each, or a combination of these approaches and instruments.”\textsuperscript{43}

The European Commission shares the WTO Secretariat’s view that

“the GATS is probably one of the most ‘development-friendly’ agreements in the WTO system because of its structure. […] It addresses the concerns and needs of developing countries through providing appropriate flexibility on an individual basis […], which allows each Member to undertake liberalisation commitments in a manner consistent with its development needs.”\textsuperscript{44}

These considerations lead the EC to recommend that a flexible, GATS-type structure (based on positive lists of commitments) be adopted for a multilateral investment framework, so as to allow some countries to make phased commitments on market access and NT, and also to attach to the latter conditions related to country-specific development objectives. The right to regulate in order to meet national policy objectives, and to include exceptions for public interest, should be explicitly recognized.

Finally, it is said, the Commission refers to its submission regarding foreign investors’ behavior,\textsuperscript{45} and cites the OECD Guidelines for multilateral enterprises as

“a useful example of how to ensure that MNEs conduct their activities in a responsible manner and in harmony with the policies of the countries in which they operate.”\textsuperscript{46}

II.2.6 Definition of investment (WT/WGTI/W/115)

The Commission submits that the exact definition of investment should depend on the substantive provisions included in the agreement. More specifically, it notes,

“the need to preserve the development objectives of host countries in a multilateral investment framework should not be addressed merely by narrowing the scope and definition but rather by including substantive provisions that allow all countries, and in particular developing countries, to pursue their development policies. […] In any case, WTO Ministers have agreed in Doha that a multilateral investment framework should focus on long-term cross-border investment, particularly foreign direct investment. It is under this understanding that the EC presents its views in this paper.”\textsuperscript{47}

As a starting point for discussions on the definition of FDI in the Working Group, the EC proposes:

“- Direct investment enterprises: all incorporated (subsidiaries and associates) or unincorporated (branches) enterprises in which a direct investor owns 10 per cent or more of the ordinary shares or voting power or the equivalent.

Should a direct investor control the company with less than 10 per cent of the ordinary shares the following criteria could be taken into account to determine whether a direct investment relationship exists: (a) representation in the Board of Directors; (b) participation in policymaking processes; (c) inter-company transactions; (d) interchange of managerial personnel; (e) provision of technical information; (f) provision of long-term loans at lower than existing market rates.

- Direct investment capital transactions: as defined by the IMF and the OECD, it comprises both the initial transaction between the direct investor and the direct investment enterprise and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated. This includes all operations that create or liquidate direct investments as well as those

\textsuperscript{43} Ibid.
\textsuperscript{44} (WT/WGTI/W/140: 3 – quoting WT/COMTD/W77).
\textsuperscript{45} (WT/WGTI/W/140: 81).
\textsuperscript{46} (WT/WGTI/W/140: 4).
\textsuperscript{47} (WT/WGTI/W115: 2).
that serve to maintain, expand or reduce investments, such as equity capital, long-term loans, reinvested earnings and other capital associated with various inter-company debt transactions.

- Foreign direct investors: this concept could include all natural persons and companies of WTO Members, including public or private incorporated or unincorporated enterprises, which engage in a direct investment enterprise - such as a subsidiary, associate or branch - in a country other than the country or countries of residence of the foreign direct investor or investors.”

The EC concludes by noting that it looks favourably at “applying a basic definition for the admission of foreign investment and a wider definition as regards the protection of established investment”.49

II.2.7 Settlement of disputes between members (WT/WGTI/W/141)

With respect to dispute resolution, the EC argues as follows:

“In line with all other WTO agreements, the EC believes that a future Multilateral Investment Framework (MIF) should include the possibility for members to resort to the WTO dispute settlement mechanism where they consider that other members have failed to observe their obligations under the agreement…”50

Moreover, the EC notes that

“The WTO system includes a strong and effective consultation and dispute settlement mechanism which contributes to the fair management of disputes among Members. The GATS, which already addresses around half of world FDI flows (under mode 3) is covered by the WTO DSU. For the sake of consistency, any possible dispute concerning a future multilateral framework on FDI to be negotiated and agreed in the WTO should also be fully covered by the WTO Dispute Settlement mechanism.

We believe that the appropriate forum to address possible disputes arising on the interpretation and application of a future multilateral investment framework to be negotiated and agreed in the WTO context should be the existing WTO Dispute Settlement mechanism. The relationship between the DSU and the State-to-State dispute settlement provisions of bilateral or regional investment Treaties may have to be addressed.”51

II.2.8 Key assumptions underlying the EC proposals

It appears that the submissions containing the key elements for a GATS-like MIF are based on a number of assumptions and arguments, which can be summarised in five points:

1. A multilateral agreement would secure transparent, non-discriminatory, stable and predictable conditions for long-term investment. It is only through international investment agreements that host governments are bound to provide the entry conditions that give investors the predictability and security they seek.

2. Besides representing a pre-condition to attract foreign investors, this would reduce investor perception of risk and create the necessary conditions among host countries and investors for a level playing field for FDI worldwide, which in turn would encourage higher FDI inflows, make the allocation of capital more efficient, reduce distortions, undermine actual or perceived corruption, and foster the positive effects of FDI on economic growth in the host country.

3. It is the host countries, rather than home countries, that eventually benefit the most from more transparency, as this will not only increase FDI, but also because other negative effects associated with lack of transparency – particularly on productivity, domestic investment and economic growth – will be ameliorated.

48 (WT/WGTI/W/115: 4).
49 (WT/WGTI/W/115: 5).
50 (WT/WGTI/W/115: 1).
51 (WT/WGTI/W/115: 3).
4. The GATS represents a development-friendly international agreement, because it guarantees flexibility, i.e. it allows countries to open up their economies to international investment in those sectors at a time, and in a manner, that governments themselves regard as being compatible with national development plans.

5. Therefore, the extension of GATS-type provisions to all economic sectors, beyond the tertiary sector only, would not prevent host countries from pursuing their domestic policies.

Much debate within the WGTI has been about whether or not the assumptions underlying the EC-stance on a MIF are justified on conceptual and empirical grounds. The next section discusses the main critiques of a MIF raised by some WTO members and a number of sceptical outside observers.

II.3 A survey of the critiques of the EC proposals

Arguments critical of the EC proposals have been developed along two lines. First, they directly address flaws and weaknesses in the logic underlying the EC concept papers. Second, they question the appropriateness of a GATS-style MIF on developmental grounds.

II.3.1 Some notes on EC’s concept papers

The persuasiveness of EC’s position on investment is partly undermined by the rather dogmatic approach it appears to have taken in justifying its proposal for a MIF. Rather than building its case on sound conceptual grounds and compelling empirical evidence, the arguments are seemingly based on conjectures. Attempts to provide definitions or explanations of key concepts are often inaccurate, or overly simplistic. For instance, the definition of a BOP crisis quoted above seems to neglect the most basic insights from the vast literature on the causes of - and remedies of - BOP crises. Similar inaccuracies can be found in other parts of the EC submissions.

Section II.2.8 has summarised in five points the implicit logic of EC’s submissions. It would appear that the concept of “transparency” is attributed paramount importance in EC’s justification for a MIF. It is worth noting, therefore, in its submission on transparency the EC refers to two pieces of empirical research: the TN SOFRES Business Survey, commissioned by the EC itself, and the Opacity Report by PriceWaterhouseCoopers. The EC paper notes that the TN SOFRES Business Survey was “conducted for the EC Commission in April 2000 among some of the biggest EU companies, showed that lack of transparency on local legislation and rules was considered the most frequent hindrance to investment by 71 per cent of the companies.”

The EC submission in question does not mention perhaps the more interesting results of this survey. First, smaller European businesses tend not to report that they had encountered investment barriers, while big businesses encounter barriers more often. Second, the United States is found to have about as many obstacles to international investment as Malaysia, Poland, and Indonesia. Third, among the 10 most awkward barriers to foreign investment, non-transparent national or local laws and regulations ranked fifth, with less than 20 percent of businesses considering them as awkward enough so as to prevent them from operating abroad. Fourth, only about 10 percent of EU-based multinationals have working knowledge of GATS, less than 10 percent of BITs, or the NAFTA Investment Chapter, and less than five percent of the TRIMs Agreement. Less than 10 percent have working knowledge of OECD Guidelines for Multinational Enterprises, and less than five percent of the Tripartite ILO Declaration. If most business people are unaware of the very investment provisions that are said to benefit their companies, it is unlikely that such business people are differentiating...
between overseas economies on the basis of the investment protection offered. However one may interpret these results, arguably they do not appear to make a particularly strong case for the proposed multilateral disciplines on transparency in investment.

The EC paper also refers to the PriceWaterhouseCooper Report on Opacity, which finds that “opacity”, measured as a weighted index of corruption, legal, judicial, economic, accounting and regulatory lack of transparency, can adversely impact the cost and availability of foreign capital. The report concludes that “opacity imposes significant costs on investors – be they individual or corporate- and on countries.” This result is not surprising. In fact, there is almost unanimous consensus among scholars and practitioners alike, that transparency, in its broad sense, is a necessary condition for markets to work properly. Also the fact that increased transparency is likely to curb corrupt practices is not much disputed. For example, research in the fields of information economics and the economics of the firm have demonstrated that a higher degree of transparency reduces agency problems and, more generally, is conducive to a more efficient allocation of capital. Furthermore, a substantial body of empirical research has demonstrated that corruption and more generally lack of transparency in the host country can have a significantly negative effect on the amount and form of FDI flows to that country. However, the results from empirical studies on the determinants of FDI, as summarised in Appendix Table 8, also show that it is mainly economic fundamentals – such as national income – that underlies investors’ preferences to invest in certain countries rather than in others. This is further sustained by clear anecdotal evidence on huge amounts of FDI flowing to notoriously non-transparent and corruption-ridden countries, such as China and Malaysia. In short, while it is reasonable to assume that international investors prefer countries offering a higher degree of transparency to invest in, and are sometimes deterred from investing at all in countries where transparency falls below a minimum acceptable level, there is no reliable empirical evidence that suggests that transparency is as important as economic fundamentals, such as national income. For instance, it may be argued that even more FDI would have flowed into China over the last decade had it been more transparent and less corrupt. This may be true or not, but it is certain that China would not have received all that FDI if it did not dispose of a huge domestic market, a vast amount of relatively cheap resources and assets, etc.

Similarly questionable is EC’s claim that it is the host countries, rather than home countries, that will benefit most from improvements in transparency. This must necessarily be true if a MIF does in fact increase transparency and overall economic efficiency in host countries, and the latter are less transparent, before the introduction of MIF, than home countries. However, this may not hold true if home and host countries have a similar degree of transparency; if a MIF fails to considerably improve transparency; or if investors fail to significantly adjust their risk assessments and keep the cost of capital to perceived non-transparent countries high. None of these possibilities seem to have been addressed in EC’s concept papers.

In sum, the evidence on the effects of improving investment-related “transparency” alone does not appear to make a strong case for a MIF. This is not to say that EC’s claim that a multilateral investment framework would secure more transparent, non-discriminatory, stable and predictable conditions for long-term investment is incorrect per se. What is mainly contested here is largely unfounded assumption that a MIF would have a significant impact on the amounts of FDI inflows to developing countries.

Although a MIF would increase stability and predictability of rules governing FDI, it is not clear why only a multilateral agreement would achieve these results. As further discussed below, a GATS-type investment agreement within the WTO framework would certainly provide investors with a clear indication on market access and conditions set out in each member’s schedule, together with more leverage to retaliate against non-complying members. However, bilateral investment agreements are also legally binding, and in some case also include provisions regulating entry conditions for FDI. Moreover, some allow for investor-to-state disputes, while a MIF within WTO would not. Furthermore, even if there were significant benefits from a MIF in terms of higher FDI inflows due to increased credibility and stability of rules, then it still has to be demonstrated that such benefits would more than outweigh the costs associated with the loss of flexibility for host countries to choose and condition investment projects on a case-by-case basis.

56 A point raised also in Singh (2001).
57 See point (1), Section II.3.1.
Related to the “transparency-argument” is EC’s claim that a MIF would create a level playing field among host countries and investors, resulting in a more efficient allocation of capital and fostering host country FDI-related growth. This logic seems to be anchored in a crude version of the traditional neo-classical paradigm, where any removal of distortions to the proper working of markets brings about a more efficient outcome. As will be further argued below, the implications of that paradigm certainly fail to apply to those instances where all its assumptions are clearly violated. This is particularly true in the case of FDI, which typically occurs in concentrated markets and is associated with market failures. Hence, a number of commentators have questioned the claim that a MIF would create a level playing field for FDI worldwide. Rather, some argue, it would strengthen the market power of those MNEs that already enjoy strong advantages over host countries’ domestic firms.

A crucial assumption underlying EC’s proposal for a GATS-type MIF is that the latter, by allowing progressive liberalisation of FDI flows tailored to their national development plans, is necessarily development-friendly. If this were true, the strong opposition to the proposal from a group of developing countries within the WTO would be unjustified. In order to make sense of these strongly opposing positions, it is essential to distinguish between what is defined here, rather loosely, as “absolute flexibility” (or development-friendliness) and “relative flexibility”. The former refers to full determination of national policies relating to FDI, both at the pre- and post-establishment phase. In contrast, the concept of “relative flexibility” refers to the maximum flexibility attainable with a multilateral agreement in place. By definition, a multilateral agreement on investment does constrain to some extent the degree of policy flexibility of adhering countries, as it aims at removing policy-related obstacles to what is thought to be the proper functioning of markets. It is doubtful whether a MIF can be designed in a way so as to distinguish between government interventions that are efficiency-enhancing and those which are not. For those having some faith left in the potential benefits from active government intervention in the developmental process, the development-friendliness of a multilateral investment agreement is measured in terms of the degree of flexibility it leaves to host countries in pursuing their development plans and policies. More specifically, UNCTAD (2000b) defines the concept of flexibility as

“the ability of IIAs [International Investment Agreements] to be adapted to the particular conditions prevailing in developing countries and to the realities of the economic asymmetries between these countries and developed countries.”

UNCTAD argues that flexibility of an IIA crucially depends on the combination of:

1. the development objectives set out in the text, usually the preamble, of an investment agreement;
2. the overall structure of an IIA, particularly with regard to special principles and rules, and modes of participation relating to developing countries;
3. the substantive content of an IIA, which needs to reflect development concerns and an overall balance of rights and obligations;
4. the application of an IIA, and particularly the interpretation of its provisions.

Among a number of international trade and investment agreements analysed by UNCTAD on the above criteria, it finds the positive-list approach adopted by GATS as the framework providing the highest degree of flexibility.

Given that proposals any MIF will not take a more concrete and detailed shape until negotiations are concluded, such an MIF cannot be fully assessed against the criteria set out by UNCTAD. Nevertheless, a GATS-type multilateral investment agreement, basically by allowing countries to decide the preferred timing, subjected sectors and the conditions of liberalisation to FDI, would indeed allow for a relatively high degree of (relative) flexibility. This is particularly evident when a GATS-MIF is compared to the highly inflexible OECD proposal for a MAI. The EC has made this distinction, as shown in Table II-1.

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59 See (4) and (5) in Section II.3.1.
60 UNCTAD (2000b: 1).
61 This is not to say that the overall balance of rights and obligations of a MAI would not ultimately depend on the inclusion of provisions such as binding rules on investor behaviour and on incentives.
Most commentators\textsuperscript{62} seem to agree that a GATS-type MIF compared to OECD’s proposed MAI does indeed represent a significant step forward, in terms of flexibility. Yet, the crucial point in the arguments put forward by the opponents of MIF is that developing countries need to retain a degree of absolute flexibility, which a potential multilateral investment framework would tend to constrain. Therefore, any country unwilling to give up policy flexibility at least to some extent, as it appears to be case with India, will be strictly opposed to any MIF.

In sum, EC’s arguments in favour of its proposal for a GATS-type MIF are not compelling, as they are not sustained on analytical and empirical grounds. This has left plenty room for opponents to reject a MIF on fundamental grounds with the key disputed matter being the alleged development-friendliness of a MIF. The views of such opponents will be considered in even greater detail next.

| Table II-1 Why, according to the EC, its proposals are different to the OECD-MAI |
|-----------------------------------------------|-----------------|-------------------------------------------------|
| **Provisions**          | **OECD Draft MAI** | **Potential Multilateral Framework on Investment** |
|                        |                  | **EC Position** |
| Definition of Investment - Scope | MAI proposed a wide definition of investment, including portfolio investment. | We propose FDI (Foreign Direct Investment) only. It may be difficult to define, but it is imperative to make clear that this is not a capital liberalisation code. It is not full assets based, and would not a priori include short term movements of capitals. |
| Expropriation | MAI went beyond customary international law on expropriation, including "indirect expropriation" (NAFTA-style language on "measures tantamount to expropriation"). | We propose, at a maximum, the traditional rules on expropriation (those contained in the BITs of our MS or of countries like India). |
| Type of liberalisation commitments | MAI provided for a right of admission (subject to exceptions: the so-called "top-down" "pre-establishment national treatment"). This led to 'negative lists' of limited sectors that could remain unliberalised. | We propose a GATS-style, "bottom-up" approach to admission of investors: the host country chooses whether or not to open a sector. This implies on the contrary a positive list approach of sectors that countries choose to liberalise when they are ready. |
| Right to regulate for States | From previous « top-down » provisions, MAI derived only limited right to regulate for States | The bottom-up approach allows States to keep their right to regulate, in a manner consistent with principles of transparency, non-discrimination, predictability and their development needs. |
| Provisions for development | MAI was criticised of not paying attention to the flexibility needs of Developing countries when signing up to international rules. | When deliberating a possible Investment Agreement in WTO, taking into account articles of the existing agreements, it should be possible to formulate flexible rules in a manner that respects development policies. |
| Dispute Settlement | MAI provided for investor-to-State dispute settlement. | We propose the WTO DSU and nothing else. |

\textsuperscript{62} Also including the most critical among them, e.g. Singh (2002), Kumar (1999).
II.3.2 Main arguments for opposing an MIF on developmental grounds, put forward by a group of WTO Members and outside observers

It appears from the submissions to the WGTTI that India is the country most strongly opposed to an international investment agreement. Although some developing countries, e.g. Brazil and Malaysia,\textsuperscript{63} have expressed their support for a GATS-type approach to investment, India’s position can be regarded, by and large, as being representative of the concerns of a broader group of low-income and least developed WTO Members. Appendix Table 6 gives detailed account of the main points raised in India’s submissions to the WGTTI and these include: concerns regarding the FDI-development nexus, the effects of a MIF on the amount of FDI inflows, the inclusion of development provisions and investor obligations in a MIF, the constraints on imposing performance requirements, and the exclusion of investment incentives. This section now turns to an account of some of the potential costs associated with a multilateral investment agreement, as highlighted by some prominent commentators.\textsuperscript{64}

1. A trade-type regime is not appropriate for investment

a) The principle of comparative advantage provides the conceptual basis for trade liberalisation. According to the former there exists a wide range of circumstances under which all countries benefit from international trade. According to Kumar (2001),

“unlike trade, FDI flows emerge because of differences in the levels of development and bundles of created assets. […] From the start, MNE entrants enjoy an edge over local enterprises, if there are any existing at all, because of their monopolistic ownership advantages. […] Therefore, offering national treatment to foreign enterprises would amount to discriminating against the latter. In most developing countries, the little local entrepreneurship that exists runs the risk of vanishing altogether if forced to compete with the mighty global corporations under ‘national treatment’.”\textsuperscript{65}

In these circumstances, the mechanical application of WTO principles of national treatment and market access would lead to exit by domestic firms, producer concentration, high prices, inefficiency and thereby harm economic development in developing countries. As a remedy, competition authorities in developing countries should be exempted from applying these principles, for instance, by allowing domestic firms to merge but denying mergers involving foreign multinationals. This would ensure more competition, increase efficiency at a global level and also positively influence host country economic development (Singh 2001).

b) FDI is a development and industrialisation issue, rather than a trade issue. With the exception of trade-related investment, already regulated by TRIMS and GATS, there is little justification to include investment in the WTO framework.

c) Moreover, some have argued that the “WTO does also not have the competence to deal with investment and development issues.”\textsuperscript{66}

2. Governments need to regulate FDI for it to be beneficial to the process of economic development

a) Studies examining the developmental impact of FDI have found that those countries pursuing selective policies with respect to FDI have generally had greater success in pursuing their developmental objectives than those that pursued more open policies. Kumar (2001) refers to UNCTAD’s conclusions in their literature survey on FDI and development, noting that

“the impact of FDI on development goes well beyond its linkage with trade […] and […] can be negative. The effect of FDI on development depends on the initial conditions prevailing in the host

\textsuperscript{63} Malaysia said that a GATS-type positive list approach would be in favour of developing countries, but also called for permanent exemptions from any obligation regarding admission of FDI.

\textsuperscript{64} This part mainly draws from Singh (2001), Kumar (2001), Das (1999), and UNCTAD (various issues of the World Investment Report).

\textsuperscript{65} Kumar (2001: 7-8).

\textsuperscript{66} Kumar (2001: 8).
countries, on investment strategies of companies and on the host government policies. Governments, therefore, cannot be passive.\textsuperscript{67}

b) A large body of literature on the beneficial effects of FDI, in terms of technology transfer and spillovers, has demonstrated that the benefits are highest when FDI is carefully regulated. Furthermore, empirical studies have shown that FDI may fail to have positive effects on a country’s capital accumulation and economic development. According to one prominent scholar, “This is the reason why, other than Hong Kong, most successful Asian countries […] have not allowed unfettered FDI but have extensively regulated it. […] Developing countries need to regulate FDI closely in order for it to promote economic development and not to hinder it.”\textsuperscript{68}

c) On this view, therefore, a MIF could seriously prejudice economic development if it prevented the careful regulation of inward FDI.

\section*{3. A MIF would increase the volatility of capital flows}

a) FDI has become a predominant source of external capital for developing countries. International liberalisation of trade and capital flows has greatly increased their needs for external finance, while official capital flows have declined. As a result, developing countries have become more balance-of-payments constrained than before, which in turn has resulted in stronger competition to attract FDI. This has shifted the balance of power in the negotiations over FDI projects towards MNEs. Instead of addressing this imbalance, a MIF is likely to make it worse by giving developing countries less instruments to attract and discipline investors (Singh 2001).

b) Although FDI is widely considered as the most stable from of private capital flows, it would be wrong to consider it exclusively as “brick-and-mortar” long-term investment. Singh (2001) notes that unless developing country governments can adequately regulate the timing, quality, and total amount of FDI, FDI can lead to short- and long-term financial fragility, making these countries prone to financial crisis. Moreover, the presumption that FDI flows are more stable than portfolio flows need not be the case. For instance, Singh (2001) argues, a foreign direct investor’s assets can be in fact fully offset by locally-acquired liabilities, perhaps by borrowing in the host country’s financial markets. In this way, even though any “bricks and mortar” investments cannot easily flee a country, the financial funds associated with FDI can. Furthermore, a large part of some countries’ FDI inflows consists of retained profits, which are highly volatile because they depend on the business cycle. Besides, surges of FDI inflows can have disruptive effects by appreciating the exchange rate, thereby reducing a country’s competitiveness in the tradable sector. These considerations suggest that to the extent that a MIF would not permit regulation of FDI, at least as far as liberalised sectors are concerned, “it would subject developing economies to much greater financial fragility than would otherwise be the case.”\textsuperscript{69}

c) A MIF-enforced liberalisation would also make the management and forecasting of balance of payments flows largely dependent on factors that are not under control of the host countries themselves. Particularly in least developed countries, the extreme case of a dominant share of BOP flows being determined by a few MNEs operating on its territory cannot be discounted.

d) A MIF, by giving virtually complete freedom to multinationals, would fail to stimulate higher capital flows to those countries that need them the most to meet their development goals (Singh 2001).

\section*{4. There is an even stronger argument for regulation if FDI takes the form of M&A}

a) Although still predominantly “greenfield”, FDI to developing countries increasingly takes the form of mergers and acquisitions.

b) “When FDI takes the form of greenfield investment, it represents a net addition to the host country’s capital stock. However, FDI entry via an acquisition may not represent any addition at all to the capital
Box II-1: Examples of potential negative effects of FDI on host country development

Probably the biggest concern about more FDI felt by less developed countries is with regard to the market power. Most of FDI is channeled through multinational firms (MNCs) that are powerful in the global market. FDI adversely affects domestic entrepreneurship and particularly infant industries. It can do so in two ways: directly through more competition and indirectly through increasing the cost of scarce resources, e.g., domestic source of raw material and finance.

It is argued that FDI into cultural industries (like music, or rice for Japan for that matter) may “pollute” a country’s heritage. MNCs have a global perspective in mind and care about their growth in the global market. Hence they may use a particular host country as no more than a location for production or for distribution. In this case, the growth of such a host nation may not be significantly affected by the presence of FDI through MNCs.

There may also be informational problems. Free entrance to foreign markets would help MNCs to recycle their outdated technologies to uninformed and unsuspecting host countries. In other words, there may be technology dumping. On the other side, MNCs, due to their lack of information, may also make wrong, inefficient locational choices.

Inefficient competition in attracting FDI among potential host countries could also emerge. This would force host countries to offer tax holidays, thereby worsening the budgetary position of developing countries.

International trade and FDI may be substitutes. By inducing international prices to converge, free international trade in goods would narrow down the differences in factor rewards (through product and factor market linkages) and reduce the incentive for capital to move across countries. The reverse argument also holds.

There is also the pollution haven hypothesis. FDI would encourage firms from developed countries to move their outdated, pollutive industries to the “South”. This would worsen the environment in the South as well as the global environment.

FDI into skill-intensive sectors in developing countries would increase the relative demand for skilled workers and thereby raise the skilled-unskilled wage gap. Thus, the income distribution in these countries, presumably more unequal than in industrialised countries, would be further ‘worsened.’

Source: Das (1999: 12-16).

5. If there is a rationale for granting free market access and national treatment to capital it should also apply to labour

a) With freer mobility of capital provided by a MIF, and labour being essentially immobile, the distribution of income would further shift towards the owners of capital, with potentially negative consequences on labour standards and job security in industrialised countries (Singh 2001).

b) If there is a compelling economic argument favouring free movement of capital then, it is said, there is no reason why liberalisation should not include labour. Since the significant liberalisation of the latter is not

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on the negotiating agenda, the argument goes, where is the incentive for developing countries to negotiate the liberalisation of capital?

These arguments, together with those contained in India’s submissions (summarised in Appendix Table 6), provide some insight into why opponents of a MIF do not consider the latter to be development-friendly. Overall, it appears that opponents would not only reject EC’s proposal for a GATS-type MIF, but any multilateral investment framework constraining host countries’ policy options. A full degree of flexibility in defining and implementing such policies by host governments is seen as a necessary condition for effectively correcting market failures associated with FDI, so as to close the gap between private and social effects from investment. Essentially, these contrasting positions arise from the unsettled debate concerning the optimal degree of government intervention in markets. This discussion on international rule-making, therefore, has to address the fundamental question as to how far governments should be allowed to intervene in their markets, which has no clear-cut answer in economic theory, particularly in the case of markets characterised by imperfect competition and market failures.71,72

II.4 A recent reply by the EC to MIF opponents - Policy space for development (WT/WGTI/W/154)

Recently,73 the EC has submitted a new concept paper, that

“[…] addresses some of the concerns expressed in this working group regarding the need of host countries, and in particular of developing countries, to preserve policy space for the purpose of regulating in the public interest and for development purposes.”74

The EC notes that since

“[…] some members still fear that any investment framework would prevent developing countries from pursuing particular policies[,] we feel that the time has come to try to clarify and substantiate these statements. In particular, it would be useful to start by giving concrete examples of the policies that have been brought forward as impeded by the possible rules that have been proposed in the WGTI by several members. This paper aims at giving a concrete contribution to this debate.”75

The EC refers in this submission directly to the position taken by India, as reported in WT/WGTI/W/876 and WT/WGTI/W/18,77 where the latter emphasises its preference for BITs over a MIF, essentially because BITs


72 Nor can a conclusive answer be drawn from the existing body of empirical evidence on this fundamental dilemma. However, a rather strong consensus seems to have formed regarding one of the principles of practice of policy, which postulates that “if there is no forceful theoretical support for welfare enhancing effects of a policy intervention, the benefit-of-doubt belongs to the market, not to policy activism” (Das 1999: 17). That is to say, if some developing countries oppose a MIF on grounds of absolute flexibility of policy intervention, then the burden of proving such policies to be indeed welfare-enhancing, rather than distorting, is with the same countries. As a matter of fact, there are a few developing countries, mostly located in the East Asian region, that are usually mentioned as having successfully implemented “market-enhancing” interventions, resulting in high per-capita GDP growth rates and accelerating overall development. India, it must be noted, is usually mentioned among those countries that have largely failed in their attempts to do so since the early 1960s.

73 The EC submission WT/WGTI/W/154 was issued on 7 April 2003. Although it was published after the cut-off date for WTO documents to be considered in this chapter, and was made available on the WTO web-site only lately, this submission is being considered here because it directly addresses some of the concerns raised by MIF opponents.

74 WT/WGTI/W/154: 1.

75 Ibid.

76 WT/WGTI/W/8.

Paragraph 47: The representative of India introduced a written contribution (WT/WGTI/W/71) on India’s experience with bilateral investment treaties. India had concluded such treaties with 25 countries, had finalized treaties with nine other countries, and was in the process of negotiating treaties with seven countries. The contribution discussed the main features of such treaties, including provisions on the definition of investment, the scope of the agreements, MFN and national treatment, expropriation, compensation and repatriation, dispute settlement and the duration and termination of the agreement. Bilateral investment treaties had found favour with developing countries such as India because they did not restrict the ability of host countries to follow their own FDI policies in light of their unique needs and circumstances. Under these treaties, developing countries had the freedom to grant national treatment only in the post-establishment phase, subject to such qualifications as they deemed necessary.

Paragraph 48: The representative of the European Communities requested an explanation of what kind of qualifications to national treatment India considered useful as a policy tool. He also asked what was the relationship between India’s bilateral investment treaties
provide investment protection but do not grant market access, while the proposed MFI is mainly on rules for pre-establishment.\textsuperscript{78}

The EC notes that, “[…] according to these members, their policy space would be impeded mainly by pre-establishment rules”\textsuperscript{79}, and questions whether a MIF would prevent countries from using those policy instruments they consider as necessary to achieving host country development objectives.

The EC position on the alleged flexibility of a GATS-type MIF is then reiterated using the same logic followed in previous submissions:

“Under the GATS-type approach, members first decide, for each sector, whether to take commitments or not. If a member decides not to take any commitment in a given sector, it remains free to be as open or as closed to foreign investment as it chooses, at any given time. If it decides to take commitments in a given sector, then the member may include in its schedule of commitments limitations to National Treatment (NT) and Market Access (MA). The limitations to the NT principle and MA can also be included as horizontal commitments, which means that they may apply to all sectors of the economy, and not just to one specific sector. Even after taking commitments, a member may still modify or withdraw any commitment in its schedule, provided it follows certain procedures\textsuperscript{80}. Indeed, this may not always be straightforward in practice, but WTO members will be able to draw lessons from the GATS experience. Under this system, each member has to strike its own balance between providing certainty (thus, increasing the possibilities of attracting FDI) and retaining flexibility.”\textsuperscript{81}

\textsuperscript{77} WT/WGTI/M/18.

\textsuperscript{78} Developing countries also needed policy flexibility to determine the form of investment that would lead to the highest growth. He recalled that his delegation had already highlighted, at the last meeting of the Working Group, the need to focus on those investments that contributed to the expansion of trade, as clearly indicated by Ministers at Doha. The definition of investment would have important implications for the development dimension. Greenfield investments, for example, could be of more significance than mergers and acquisitions as they would have more beneficial multiplier effects on the economy. Likewise, developing countries would need to guard against the crowding out effect of foreign investment, as clearly pointed out in UNCTAD’s World Investment Report of 1999. Any movement of capital that caused serious damage to domestic industry, particularly small and medium enterprises, or that had adverse effects on employment, would need to be carefully regulated. Developing countries needed to retain the ability to screen and channel foreign investment in accordance with their domestic interests and priorities. Bilateral investment treaties had been favoured the world over for precisely the flexibility they provided to the host country in this regard.

\textsuperscript{79} See footnote 4, paragraph 49.

\textsuperscript{80} GATS Article XXI.

\textsuperscript{81} (WT/WGTI/W/154: 2-3).
The examples of policies aimed at increasing employment, of policies designed to generate and transfer technology, of policies aimed at protecting minorities, and of other host country policies are then listed to “show how certain specific policies can be dealt with under the GATS-type approach.”

Although further details can be found in this EC submission, it suffices here to note that the logic of argument appears to be the same as in earlier submissions, specifically:

1. Host country policies designed to generate the desired effects of FDI may or may not be appropriate. A number of well-known studies are cited to corroborate the point of view that they often are not.

2. Notwithstanding the above, if a WTO Member believes its welfare is increased by imposing conditions on FDI, it would still be able to do so under a GATS-type MIF. This is because either such policies could be applied in a non-discriminatory way without restricting market access (and therefore without even the need to list limitations in the country’s schedule of commitments), or, if such policies were discriminatory, the imposing country could include them as horizontal, i.e. economy-wide, or sector-specific limitations to their national treatment commitments.

3. Therefore, the EC concludes, countries would have all the flexibility they need under a GATS-type MIF, because “under this system, each member has to strike its own balance between providing certainty (thus, increasing the possibilities of attracting FDI) and retaining flexibility.”

The EC then goes on to counter the assumption made by some WTO Members that a MIF would enhance the crowding-out effect on domestic investment, and therefore worsen the negative effects FDI can produce on host countries. Noting that “[…] we have found no evidence in real life that there is any ‘crowding-out effect' problem caused by FDI,” the EC offers the following rationale:

“Even admitting that FDI crowds-out domestic investment, the second question to be asked is: what would be the impact of a multilateral framework on this? There are 2 alternative possibilities. Either: (1) a multilateral framework would enhance FDI flows, thus, allegedly increasing the risk of crowding-out domestic investment; or (2) a multilateral framework would not significantly increase FDI flows, hence with no impact on the “crowding-out” effect. What cannot be said is that, at the same time, a multilateral framework will increase the risk of "crowding out" domestic investment but it will not increase FDI flows for developing countries.”

In light of the above, those who might have expected from the EC a more compelling line of argumentation to support its proposal for a GATS-type MIF, may well feel disappointed. In substantive terms, very little has changed compared to the previous submissions summarised above. Much of the critique raised by opponents to the EC proposal is therefore unanswered by the responses given by the EC itself. It should be noted, therefore, that the EC appears to have failed in its acclaimed purpose to “[… ] try to move this fundamental debate towards a more concrete level, rather than continuing an abstract discussion between those who maintain that any investment rule would undermine their policy space and those who reply that this would not be true.”

Rather, the EC appears still be trapped in a given framework of argumentation. In particular, the above claim that it cannot be argued at the same time that a MIF would not significantly increase both FDI flows and the risk of crowding-out, overlooks the crucial point that it is the quality and the type of FDI, rather than its
quantity, that largely determines whether and for how long FDI is likely to displace or to encourage domestic investment.

Despite the controversies outlined in the preceding sections, there is one fact opponents tend not to dispute: by and large, FDI takes a special place among the various forms of private capital flows, being characterised mainly by its long-term nature and by the potentially positive externalities and spillovers that under certain conditions may benefit host countries’ economic development. In particular, given the frequent occurrence of national and international financial crises since 1990, observers tend to clearly distinguish between FDI and more short-term, often highly speculative, types of capital on the one hand, and between FDI and debt-creating financial instruments on the other. Similarly, institutions such as the International Monetary Fund (IMF), which had been advocating wholesale capital account liberalisation over a decade, appear now to be taking a more cautious stance on the issue, recognising the potential dangers associated with the liberalisation of certain types of short-term capital flows. If negotiations on FDI alone appear to be difficult, any discussions involving portfolio capital flows are likely to be even more controversial. It is noteworthy, then, that the United States’ proposal for a MIF includes potential provisions on portfolio capital flows as well as FDI.

II.5 The United States’ proposal for a broader definition of investment in MIF

After more than four years without making a formal submission, in September 2002 the United States (U.S.) has contributed to the ongoing discussions in the WGTI with the submission of a paper outlining its views regarding the coverage of investment that a WTO investment agreement should encompass. In contrast to the EC’s proposal, which envisages the inclusion of only FDI flows in a possible MIF, the U.S. strongly advocates the inclusion of portfolio flows as well. The U.S. proposal is reproduced in full in Appendix Box 1. Here, only the main points are briefly outlined and discussed.

1. The paper first argues that “portfolio investment is vital for economic growth and development,” listing some of the main functions of financial markets in the process of accumulation of capital and economic growth. Both the crucial distinction between the functions of bank-based financial intermediation and those of stock markets, emphasised by the broad literature in the field, and the important qualifications made on the desirability and pace of stock market development in the developmental context are not discussed in this submission. Such qualifications would shed light on the fact that stock market development may well play a secondary, if not harmful, part in developing countries. Roughly put, the effects of portfolio flows on host economies are highly contested in the literature as they are not associated with potentially beneficial effects of positive externalities and spillovers as in the case with FDI; and also because portfolio flows are characterised by a higher degree of liquidity and therefore, volatility, compared to FDI.

While omitting any discussion of underlying contrasting theories on financial sector development and its effects on economic growth, the U.S. paper goes on to state the reasons why portfolio investment should be covered by a MIF.

2. The U.S. notes that portfolio investment covers a broad range of financial instruments that are in common use worldwide and question “whether it is worth negotiating an investment treaty that leaves such a wide array of investments without coverage.”

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89 (WT/WGTI/W/142). Previous WGTI submissions by the United States all date back to 1998 or earlier, and do not contain elements from which the United States position on the MAI issue could be evinced (see WT/WGTI/W/55, WT/WGTI/W/32, WT/WGTI/W/29, WT/WGTI/W/27, WT/WGTI/W/14).
90 (WT/WGTI/W/142: 2).
91 The main functions of the financial system in the economic process include mobilisation of savings, allocation of resources, exertion of corporate control, facilitation of risk management, and the performance of other services facilitating the working of markets. The reader is referred to Levine (1997) and Pagano (1993) for two excellent papers on the main issues concerning the functions of financial systems and the financial development - economic growth nexus.
93 (WT/WGTI/W/142: 2).
3. It is further argued that “offering fewer protections to portfolio investors than direct investors increases the risks associated with portfolio investment, raising the cost of borrowing foreign capital, which is a drag on the economy.” A recent IMF study of 38 developing economies is cited, finding that in the period 1980-1999 capital account liberalisation led to greater capital inflows (including portfolio flows) to these countries, which, if well-managed, led to more investment and higher economic growth.

Two remarks should be made at this point. First, it is not clear that the IMF paper cited by the U.S. supports the contention made in this submission; that is, higher protection of FDI relative to portfolio finance would result in higher costs of the latter. Moreover, the precise lines of causation needed to support this contention remain unexplained. Second, this IMF paper emphasises that benefits from capital account liberalisation only occur if appropriate and well-developed institutions are in place to ensure the prudent management of capital flows. The growing cautiousness and qualifications by the IMF on the beneficial effects from capital account liberalisation are becoming increasingly evident, and have been even more strongly emphasised in another recent IMF publication, which is summarised in Appendix Box 2. Similar qualifications are expressed by a huge body of literature assessing the economic effects of capital account liberalisation. Indeed, strong concerns have been raised about the inappropriateness of econometric methodologies typically applied in empirical studies on this issue, undermining their reliability.

4. In the US submission it is claimed that “it is not always possible to decide what constitutes a portfolio investment.” Therefore, the U.S. notes, if there are instances that are not easily identifiable as either FDI or portfolio investment, a case-by-case analysis would be necessary, complicating matters and potentially leading to disputes among WTO members.

Here, the U.S. does have a point. Depending on the actual scope and the precise wording of a definition of FDI to be adopted in a MIF, the distinction between FDI and portfolio capital is likely to become a matter of dispute in a number of instances. It may be argued that this should encourage great attention be given to drafting a workable, clearly interpreted definition of FDI. However, this is hardly on the face of it an overwhelming argument justifying the coverage of portfolio capital by a MIF.

5. The U.S. notes that “portfolio investment is a concomitant of direct investment”, and therefore “an agreement limited to FDI denies the benefits of the agreement to portfolio investor partners and to the portfolio operations within a direct investment and thus will act to discourage FDI”. This argument suffers a flaw similar to the preceding one. Essentially, although there are obviously portfolio flows that are part of the operational aspect of FDI and should be accordingly dealt with, this does not change the fact that most portfolio flows are of speculative nature. Therefore, the inclusion of portfolio capital in a MIF should be treated as a separate matter, although the linkages to FDI may well be explored further.

6. It is argued that “restrictions on portfolio capital flows to capital-starved countries is not a long-term solution to financial instability.” Taking the view that the Asian financial crisis mainly originated from a lack of prudential financial supervision in many borrowing countries, leading to over-exposure in short-term capital and currency mismatches, the U.S. concludes that this should not speak against capital account

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94 (WT/WGTI/W/142: 3).
95 “International Financial Integration and Developing Countries”, World Economic Outlook, IMF, October 2001, pp. 152-159.
96 The IMF, it should be recalled, can hardly be considered an institution tending towards cautiousness in advocating economic liberalisation if concerns relating to its benefits are not clearly demonstrated.
97 IMF (2003)
98 Mainly, the critique points to the inappropriateness of widely applied cross-section and panel analyses in highlighting a reliable causality link between financial openness and economic growth. For example, Demetriades and Hussein (1996: 387) demonstrate that “causality patterns vary across countries and, therefore, highlight the dangers of statistical inference based on cross-section country studies which implicitly treat different economies as homogeneous entities”.
99 (WT/WGTI/W/142: 3)
100 ibid.
101 It should be noted that the definition of investment envisaged in the EC proposal for a MAI (Appendix Table 5 - “direct investment capital transactions”) does include portfolio flows that are part of the operations of FDI investment.
102 ibid.
liberalisation or short term lending, but rather point to the importance of having efficient supervisory institutions in place.

Although this characterises one part of the explanation of the last Asian financial crisis, this argument misses another important matter: the role of investors in the build-up to a financial crisis. Whether due to herding behaviour, fundamental economic reasons, or perhaps a combination of these factors, the fact is that all capital that possibly could leave the crisis-ridden countries tends to do so, causing severe, and in some cases long-lasting, economic and social disruptions. FDI was the only form of capital displaying some stability during those months of severe financial distress, and in its aftermath. Portfolio capital, besides playing a central role in the boom-cycle of the financial euphoria prevailing in that region during the mid-1990s, was quick to leave as soon as the ‘feast’ was increasingly likely to come to an abrupt end. Therefore, in relation to international financial crises the relevant question as to whether or not to include portfolio capital does not concern the volatility of these flows, but rather the mechanisms that could be built into a MIF to prevent such crises from happening again. The U.S. leaves this question unanswered, and concludes instead that the solution would be “to improve financial supervision, surveillance, and risk analysis, such as through standards developed by the Financial Stability Forum, which was established shortly after the Asian financial crisis to strengthen international financial cooperation and stability.”

It is not further specified in how far this directly relates to a discussion on a MIF, except for the acclaimed intent for the U.S. to “exploring with our colleagues how best to realize the advantages of portfolio investment coverage while responding to the challenges, for example, through technical assistance and capacity building in the areas of bank supervision and regulation.”

7. The U.S. submission concludes with the claim that “excluding portfolio investment defeats the purpose of an international investment agreement.” This is because there is said to be little doubt about the positive role of FDI and portfolio investment in promoting sustainable growth in developing countries and because a commitment to investment liberalisation and protection must include portfolio capital in order to be fully credible. Both of these latter claims are not compelling as they disregard important qualifications in the relevant literature and the second claim, in particular, lacks in any basis on evidential grounds.

To sum up, the United States is intent to advocating a MIF that includes and protects portfolio flows along the lines of BITs concluded by the U.S. The brief discussion in this section has expressed considerable doubts on the merits of doing so. On both theoretical and empirical grounds, the portfolio capital-growth nexus is controversial, and proponents are certainly aware of the limited impact an argument built on shaky grounds could have. Moreover, other characteristics of this U.S. submission deserve mentioning. First, Paragraph 22 of the Doha Ministerial Declaration clearly emphasises the inclusion of exclusively long-term capital flows in a possible MIF. Second, the EC proposal explicitly excludes portfolio capital, most likely because of the lessons learnt from the failure of OECD negotiations on a MAI and may also reflect in part a large consensus among most high-and low income countries alike about the potential dangers associated with speculative capital. Lately, within the WGTI, Members’ submissions have reiterated a widespread reluctance to extending coverage to any form of capital other than FDI, and reinforced the point that differences in view on FDI alone are substantial.

Part III turns now to the main arguments in favour of a multilateral investment agreement as highlighted in a recent scholarly literature. In contrast to Part II, which focussed on the debate between proponents and opponents of a MIF, the remainder of this chapter centres on the more analytical aspects of the debate. The purpose of Part III, then, is to see whether there are different—and perhaps more compelling—rationales for a Multilateral Investment Framework than those advanced in this section.

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103 (WT/WGTI/W/142: 4).
104 (WT/WGTI/W/142: 4-5).
105 (WT/WGTI/W/142: 4).
106 See Section II.1.
Part III
A brief review of the main theoretical arguments for a multilateral investment framework

In the scholarly literature, five principal arguments have been put forward in this regard:

1. The transaction cost argument: firms may confront significant transaction costs and increased uncertainty from differences in national rules governing FDI and the patchwork of existing BITs. A multilateral investment agreement would lower such transaction costs, leading to improved allocation of FDI and higher welfare.

2. The uncertainty argument: investors may avoid a country because it has a history of frequent policy reversals, or whose commitments to reform are not deemed credible. A multilateral investment framework would anchor investors’ expectations and lead to increased FDI inflows.

3. The political economy argument: a multilateral investment agreement would serve as a means for governments to overcome the impediments to reform prevented by certain domestic constituencies.

4. The international policy spillovers argument: domestic law and regulation of FDI may have negative effects (spillovers, externalities) at a global level, leading to distortions in the allocation of investment, and/or to coordination failures which result in inefficient outcomes. A multilateral framework could overcome these problems, increasing global welfare.

5. The “grand-bargain” argument: suppose as FDI importers, developing countries are unlikely to gain much from a MIF. The latter could consider offering concessions on investment policies and at the same time demand reciprocal concessions in other fields of WTO negotiations where they can gain substantial benefits.

The following sections assess these arguments in turn, with the exception of the transparency argument, which was already analysed in Section II.3.

III.1 The uncertainty argument

Some commentators have argued that a MIF, besides making national policies more transparent, could help raise investor confidence in a country’s policy reform programmes, thereby stimulating higher FDI inflows. Hoekman and Saggi (1999) note,

“governments seeking to attract FDI may be pursuing all the ‘right’ policies without generating a significant ‘supply response’ because of a history of policy reversals. If investors are risk averse, they may avoid the country altogether, impose large risk premia, not transfer ‘sensitive’ technologies, etc. International agreements may then serve as a mechanism through which governments make irrevocable commitments and ‘guarantees’ against policy reversals, thereby anchoring expectations of investors”.

Clearly, investor confidence is a necessary condition for FDI particularly in the case of greenfield investments which usually involve significant amounts of sunk investment. Once an investment is made, the host country may have incentives to renege the agreement with the investor ex-post, and directly or indirectly expropriate rents from the investor. Given the sunk costs involved, the MNE would not have much choice but to accept the new conditions imposed by the host, as long as the former continues to accrue some positive benefit.

For investment to take place, therefore, it is essential that a commitment mechanism be in place, so that the host country can credibly bind itself not to expropriate, or more generally degrade investments, ex post.

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107 Hoekman and Saggi (1999: 2).
108 Such a situation is usually referred to as the “hold-up risk” in game theory.
109 It is a standard result of game theory that by binding itself not to defect on an agreement, which appears to make the agent worse off by sacrificing flexibility, may turn out to be in fact welfare improving for the same agent. However, studies in the field of incomplete contract theory have also shown that under certain circumstances it can be welfare improving to renegotiate the original contract, rather than to comply.
There is reason to believe that an international agreement would create a strong incentive for signatories to comply, particularly by providing for trade sanctions to punish non-compliance. However, there are a number of alternative ways that a country has to credibly commit to obligations, including bilateral investment treaties. Further investment protection is usually guaranteed in these treaties by provisions on international arbitration. Moreover, there is a strong case for arguing that a country will try to keep intact or increase its reputation in international financial markets and so will have a sufficiently strong incentive not to behave in any way that could undermine the flow of future investment.\footnote{110} If a country values its reputation, and many do, then the expectations-anchoring argument for a MIF would largely be undermined.

In sum, the arguments in favour of a MIF on credibility grounds have certainly some appeal, but are ultimately not compelling. Moreover, there is no hard evidence to support the hypothesis that a MIF would significantly increase FDI flows to countries that have already entered binding bilateral investment agreements, which overall seem to provide an adequate degree of investment protection. As far as host country commitments are concerned, the literature does not explain why existing multilateral commitments, particularly of progressive trade liberalisation within the WTO framework, are not considered by international investors to be a sufficient signal for long-term commitment and credibility.

\section*{III.2 The political economy argument}

Some have argued that an international agreement on investment could represent a necessary means for governments to overcome otherwise insuperable political impediments to removing costly restrictions on FDI flows. Indeed, it is frequently observed that developing countries’ governments are unable to overcome opposition by certain local groups that are powerful enough to protect so-called unproductive rents. Such rents may be associated with distortions to the efficient allocation of capital, with deleterious consequences to host economies. Moreover, these rents are frequently accompanied by rent-seeking activities, including bribery and corruption. In such a context, the argument goes, with governments lacking power to impose a change on the status quo, an international agreement can in principle be helpful to overcome such resistance mainly for three reasons. First, once signed international agreements may offer the necessary political change on the status quo, an international agreement can in principle be helpful to overcome such resistance mainly for three reasons. First, once signed international agreements may offer the necessary political scapegoat when reformers face powerful local constituencies. Second, if an investment agreement is embodied within the WTO framework, it could be part of a larger package that offers significant benefits that can help “pay off” or compensate current beneficiaries of investment protection. Alternatively, those benefits can help galvanise other economic interests in favour of a comprehensive WTO package, where investment liberalisation is seen as the “price” of reforms abroad. Third, it is argued, that a MIF could have stronger binding effects on current and future governments as compared to a bilateral agreement. This last point is related to the credibility argument mentioned above.

The validity of the political-economy argument largely depends on one’s assessment of the role of rents and rent-seeking processes in the development process. Broadly speaking, in the standard neo-classical framework,\footnote{111} the presence of rents typically signals inefficiency, and the best policy is to remove them altogether. Rent-seeking activities, on the other hand, are associated with a waste of potentially productive resources, adding to costs associated with the presence of rents. Some strands of economic theory distinguish between rents that are productivity-enhancing from those that are not. Accordingly, governments may do well by allocating super-profits to certain capitalists, as long as the latter have an incentive, or are forced, to use those rents productively.\footnote{112} Logically, if rents can be growth-enhancing, so can rent-seeking activities, provided that the latter make sure rents are being allocated to those firms or industries that positively contribute to long-term growth, and are withdrawn from those that do not. It should be noted that only a few

\begin{itemize}
  \item A point raised by Singh (2001). This argument is weakened if reputation is specific to local managers rather than directly to the country (Markusen 1998). Hoekman and Saggi (1999) have questioned the relative importance of multilateral binding rules as compared to the use of a variety of existing institutions devoted to the arbitration of disputes, such as the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID), the International Chamber of Commerce (ICC), and the UN Committee on International Trade Law (UNCITRAL).
  \item “Standard” in the sense of basic, without, for instance, considering the insights from new institutional and information economics, which are fields that have developed within the neoclassical framework, but distancing themselves quite radically from some of the assumptions of the latter. More sophisticated analysis in the neo-classical framework does in fact recognise the potentially positive effects played by economic rents in the development process. See, for example, Hellmann, Murdock, and Stiglitz (1999).
  \item Khan and Jomo (2001).
\end{itemize}
states, and then only in the presence of a combination of specific circumstances, have managed to control this complex process in a welfare-enhancing way. Hence, the reluctance by many authors to view rents as growth-enhancing, except in well-defined circumstances, and the reluctance by many others, scholars and policy-makers alike, to view rents indiscriminately as welfare-reducing.

Notwithstanding these considerations, it may still be argued that a MIF may be necessary for governments otherwise unable to overcome domestic pressures from rent-earners that are in fact retarding growth and development. This may well be the case, but it remains difficult to envisage how this argument would be played out in the context of the WTO. Would those countries opposing a MIF be seen as unable to overcome powerful domestic lobbies? Conversely, could this line of argument be extended to implying that those countries demanding a MIF are not able to overcome pressures from their domestic business-community in search of rents that may come at a cost of host countries’ welfare? As a matter of fact, even within advanced ‘democracies’, power and interest usually prevails over social objectives.

In sum, the political economy argument is a sensitive one. The assessment of the role of rents played in the economy is highly controversial, even at a country-specific level. Notwithstanding theoretical and empirical controversy, it remains difficult to imagine a multilateral framework that helps reducing unproductive rents while simultaneously maintaining those that are growth-enhancing. Rather, all rents would gradually be wiped out, to the satisfaction of those who view them as purely distortionary. It appears, from the submissions of low-income countries like India, that it is precisely on these grounds that a MIF is being strongly opposed.

III.3 The international spillovers argument

The arguments discussed so far all relate to the potential of a MIF to lead to higher degrees of transparency, credibility, and commitment, as compared to the standards already prevailing in bilateral and regional agreements. Sanna-Randaccio (2000) rightly notes that such arguments call for rules negotiated within WTO and that are primarily meant to “lock in the results of unilateral liberalisation of national FDI policy or to adopt standards prevailing in bilateral agreements.” Arguably, such rules would mainly reflect the interests of the international business community, so as to have guaranteed market access and investment protection at a multilateral level. As shown above, transparency, credibility, and commitment are also EC’s key arguments in favour of a MIF. However, it has just been argued that none of these arguments is ultimately compelling, as they do not make a clear case for cooperative action, at a multilateral level.

Some recent papers have thus pointed towards an alternative set of arguments in favour of a MIF. More specifically, they have questioned whether a MIF would represent a means to overcome international policy spillovers, i.e. the effect of host country policies on other countries, particularly the home countries of FDI, and vice-versa. In other words, according to these authors, the crucial question in addressing the desirability of a MIF is whether or not its provisions are directed at eliminating market distortions and international policy spillovers caused by host countries on the one hand, and to eliminate market distortions created by foreign investors and home countries on the other hand. The logic of argument in these papers evolves mainly within the Walrasian neoclassical framework underlying the first welfare theorem, some features of which are briefly outlined next.

Economic theory establishes that cooperative action is called for if individual actions taken by rational agents—including governments—result in sub-optimal collective outcomes. An outcome is said to be pareto-inefficient if it is possible to propose some form of action (including an external credible commitment device, such as an international agreement) that raises the welfare of at least one agent or group of agents without making anybody else worse off. Conventional economic theory establishes that a Pareto-inefficient situation may arise in the following instances:

113 Most notably, a number of East-Asian countries. See, for instance, Wade (1992), Amsden (2001), and Khan and Jomo (2001).
114 Typically, in the case of scarce natural resources.
117 Essentially, it states that a Walrasian general equilibrium always yields a Pareto efficient allocation of the social endowment.
118 This section, rather than simply summarising the main findings of the papers surveyed, lays out the logic followed in the latter, without necessarily arriving at the same conclusions.
1. the presence of market failures or exogenous distortions, such as policy interventions offsetting the efficient working of markets;

2. a coordination problem, even in the absence of other market failures.

On this perspective, therefore, the desirability of a multilateral agreement on foreign direct investment depends on whether it represents the appropriate remedy to these causes of inefficiency, so leading to a gain in overall welfare without making some countries worse off. Both sources of inefficiency are considered in turn.

III.3.1 Market failures and/or domestic policy distortions

In theory, if markets were working properly, the so-called first best policy would be not to intervene at either the national or the international level. Here *laissez faire* ensures a Pareto efficient, welfare maximising outcome. In reality, market failures are the rule, rather than the exception. Production by multinational enterprises (MNEs) typically takes place in concentrated industries and may involve a variety of externalities and spillovers. In the presence of such market failures, there is a clear economic rationale to intervene in the market, so as to improve on an inefficient market outcome.

Intervention may take a variety of forms. Abstracting from other than investment-related industrial policies, interventions may, for example, relate to bargaining between the host and the investor over the economic surplus from the MNE’s operations in the domestic territory. Such economic super-profits (or rents) can be the result of market power accruing, for instance, from market concentration. FDI will only take place if the MNE perceives a gain and these firms attempt to use their market power to appropriate most of the rents themselves. However, the host nation wants to ensure that it derives benefits from the investment. Hosts respond by using TRIMs and other Host Country Operational Measures (HCOMs, see Box III-1) to capture rents for their economy or, more generally, to ensure that the domestic benefits from FDI are maximised. HCOMs can be justified as attempts to fill the gap between social and private rates of return for foreign investments that create positive spillovers, such as knowledge transfers, or to deal with other market failures. From an economic theory point of view, such interventions can be welfare enhancing, but ultimately the outcome from intervention is indeterminate, depending on country-specific circumstances.

Empirical evidence, however, tends to demonstrate that only certain HCOMs have benefited host countries implementing them. Moran (1998), for example, has argued that frequently HCOMs do not stimulate host country growth, and can even hinder it, particularly if they are targeted at protecting inefficient industries. However, Moran and other prominent commentators, such as Rodrik (1987), recognise that certain HCOMs, particularly export performance requirements, can increase host country welfare by shifting rents from the foreign investor to the domestic economy. Similarly, Bhagwati (1998), well known for his market-friendly views, has concluded that FDI policy, such as performance requirements, is an area where “host countries should be free to make their own choices, based on their own (even if oft harmful) assumption about externalities and spillover effects on their national economies.” As a general rule however, mainstream consensus on best policy practice requires that interventions, if necessary, should target market failures as directly as possible. For example, the introduction of strict competition policy is seen as a more appropriate measure to regulate market concentration than the use of restrictive investment policies.

It should be emphasised that there is no consensus on this matter in the economics literature. Notwithstanding such inconclusiveness, it can be argued that in those instances investment policies do in fact raise host country welfare, a multilateral agreement imposing restrictions on the use of such measures could possibly raise the welfare of capital exporting countries by increasing MNE’s return, but would not achieve a Pareto efficiency improvement, since the host countries’ welfare would be reduced. This argument applies to all HCOMs including those prohibited by the TRIMS agreement.

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119 For the time being, this analysis abstracts from distributional effects within countries.
120 An externality exists where the utility of a consumer or the production possibility of a producer is directly affected by the actions of another agent in the economy.
122 Also emphasised in Hoekman and Saggi (1999), Das (1999).
At the global level, even when HCOMs do benefit the domestic economy, they have the potential of adversely affecting trade and investment flows with neighbours. If all countries were to effectively restrict FDI inflows, there could in theory be scope for cooperation. Yet, the benefits of such cooperation would accrue exclusively to those countries that are large net exporters of capital and those net importers with welfare-reducing policies in place. Taken to the extreme of a zero-sum game, where all benefits accrue to capital exporters and are mirrored by welfare losses to capital importing countries, no cooperative solution could exist.

Besides market failures, the efficient working of markets may be impeded by domestic distortions such as protective trade measures. In this case, an application of the theory of the second best leads to the conclusion that government intervention does not necessarily lower welfare and may well be welfare-improving instead. In this case, there is no clear-cut case for government intervention or for non-intervention.\textsuperscript{123} In sum, whether market failures or distortions, the preconditions for an international agreement curtailing the use of HCOMs to be welfare improving globally are not necessarily present.

Even in the absence of a coordination problem that can be directly remedied by an international agreement, there is one other set of circumstances where an agreement to curtain the use of HCOMs that raise developing countries’ welfare can in fact beneficial be beneficial to all. Hoekman and Saggi (1999) describe the situation as follows:

“developing countries squarely represent only the host country view of FDI. Consequently, it will be very difficult to devise an international agreement on investment that is welfare enhancing for developing countries that successfully employ policy strategically. In this case a cooperative solution would require that the negotiating agenda be expanded to include issues of interest to developing countries”\textsuperscript{124}

In other words, developing countries could enter a “grand-bargain” and link the investment-related issues with other issues that offer them substantial benefits. The merits of such an argument are discussed in section III.4 below.

\begin{boxedtable}
\begin{tabular}{|p{0.9\textwidth}|}
\hline
\textbf{Box III-1: Host country operational measures prohibited by international agreements} \\
\hline
Host country operational measures (HCOMs) are those concerning the operation of foreign affiliates in the home country’s territory. They cover all aspects of investment and usually take the form of either restrictions or performance requirements. They are usually adopted to influence the location and character of FDI and, in particular, to increase its benefits in the light of national objectives.

1. HCOMs explicitly prohibited at the multilateral level, i.e. by the TRIMs Agreement:
   \begin{itemize}
   \item Local content requirements
   \item Trade-balancing requirements
   \item Foreign exchange restrictions related to foreign exchange inflows attributable to an enterprise
   \item Export controls
   \end{itemize}

2. HCOMs that are prohibited, conditioned or discouraged by interregional, regional or bilateral agreements, but not at a multilateral level:
   \begin{itemize}
   \item Requirements to establish a joint venture with domestic participation
   \item Requirements for minimum level of domestic equity participation
   \item Requirements to locate headquarters for a specific region or the world market
   \item Employment performance requirements
   \item Export performance requirements
   \item Restrictions on sales of goods or services in the territory where they are produced or provided
   \item Requirements to supply goods produced or services provided to a specific region or the world market exclusively from a given territory
   \item Requirements to act as the exclusive supplier of goods produced or services provided
   \item Requirements to transfer technology, production processes or other proprietary knowledge
   \item Research-and-development requirements
   \item Measures contrary to the principle of fair and equitable treatment
   \end{itemize}

\textsuperscript{123} See Lipsey and Lancaster (1956) for the original formalisation of the theory of the second best.

\textsuperscript{124} Hoekman and Saggi (1999: 9).
\end{boxedtable}
3. HCOMs that are not prohibited (illustrative list):

- Restrictions on employment of key foreign professional or technical personnel, including restrictions associated with the granting of visas and permits
- Requirements to establish a joint venture with domestic participation
- Public procurement restrictions (e.g. foreign affiliates are excluded as Government suppliers or subject to providing special guarantees)
- Restrictions on imports of capital goods, spare parts, manufacturing inputs
- Restrictions/conditions on access to local raw materials, spare parts and inputs
- Restrictions on long-term leases of land and real property
- Restrictions to relocate operations within a country
- Restrictions to diversify operations
- Restrictions on access to telecommunications networks
- Restrictions on the free flow of data
- Restrictions relating to monopolies or participation in public companies (e.g. an obligation to provide a public service at a certain price)
- Restrictions on access to local credit facilities
- Restrictions on repatriation of capital and profits (e.g. case-by-case approval, additional taxation or remittances, phase out of transfers over a number of years)
- “Cultural” restrictions, mainly in relation to educational or media services
- Disclosure of information requirements (e.g. on the foreign operations of TNCs)
- Special requirements on foreign firms in certain sectors/activities (e.g. on branches of foreign banks)
- Operational permits and licences (e.g. to transfer funds)
- Special requirements on professional qualifications, technical standards
- Advertising restrictions for foreign firms
- Ceilings on royalties and technical assistance fees or special taxes
- Limits on the use of certain technologies (e.g. territorial restrictions), brand names, etc., or case-by-case approval and conditions
- Rules of origin, tracing requirements
- Linking local production to access or establishment of distribution facilities
- Restrictions related to national security, public order, public morals, etc.
- Training requirements
- Import restrictions, local sales requirements
- Linking export quotas to domestic sales

Source: UNCTAD (2001b)

III.3.2 Inefficiency as the result of a coordination problem

A strong argument in favour of a multilateral agreement on investment derives from the fact that incentives aimed at attracting FDI impose negative spillovers on the rest of the world. The extant literature typically examines this matter as a prisoner’s dilemma problem, with the finding that only with binding commitments will governments maximise collective welfare. If a nation’s government enters a bidding war to attract FDI, principally because it rationally expects other governments do to so, then it is quite possible for governments to pay a higher price for having FDI allocated to their countries than would have been the case. In this situation, investment incentives represent a transfer of resources from the host countries to MNEs and indirectly to their parent countries, as well as a distortion in the worldwide allocation of capital. Enforcing rules on subsidies to foreign investors by means of an international agreement could avert this socially sub-optimal outcome.
Box III-2: Investment incentives

Definition:

“Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprises by (or at the direction of) a government, in order to encourage them to behave in a certain manner. They include measures either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs of risks. They do not include broader non-discriminatory policies, relating to the availability of physical and business infrastructures, the general legal regime for FDI, the general regulatory and fiscal regime of business operations, free repatriation of profits or the granting of national treatment. While these policies certainly bear on the location decision of TNCs, they are not FDI incentives per se. The main types of incentives used are fiscal incentives (e.g. reduction of the standard corporate income-tax rate, investment and reinvestment allowances, tax holidays, accelerated depreciation, exemptions from import duties), financial incentives (e.g. government grants, subsidized credits, government equity participation, government insurance at preferential rates) and market preferences (e.g. granting of monopoly rights, protection from import competition, closing the market for further entry, preferential government contracts). Other types of incentives frequently used include preferential treatment of foreign exchange and subsidised dedicated infrastructure and services.”

Economic rationale for incentives:

UNCTAD points out that incentives are mainly used to correct market failures to reflect the wider benefits arising from externalities in production, and to reflect the gains that can accrue over time from declining unit costs and learning by doing. However, they also have the potential to introduce economic distortions that are analogous to subsidies on trade, and they involve financial and administrative costs.

Source: UNCTAD (1998: 102 - Box IV.4)

Although this is perhaps the most convincing argument in favour of multilateral rules, there are a few caveats that Hoekman and Saggi (1999) have identified. First, a case for international coordination exists only if incentives are actually effective in altering the distribution of FDI flows. If not, countries have no incentive to offer such inducements, and there is no case for international collective action. Second, if there are potentially important externalities and spillovers to the domestic economy from FDI, and investors lack information about country-specific investment possibilities, incentives may act as an important signalling device as to where the return to investment is highest. In this case, incentives may raise locational efficiency of FDI and raise world welfare, though still with the distributional effects related to the transfer of rents from host countries to investors. Here, the analysis of investment incentives ceases to be a prisoner’s dilemma. Third, investment incentives may take a number of forms, and are often delivered by using a combination of fiscal, financial, and other instruments. Therefore, an international agreement disciplining the use of incentives would necessarily need to be very intrusive by regulating, for example, domestic tax policies, competition policies, etc.

Besides the concerns raised above, there are a few considerations that have not yet been clearly addressed. One refers to considering the bidding war as a prisoner’s dilemma problem. It seems that some commentators are increasingly applying the prisoner’s dilemma in a metaphorical sense, rather than considering its precise implications. For example, it should be noted that there exist alternative means to bring about the socially optimal outcome than a collective agreement not to offer subsidies. In fact, if a prisoner’s dilemma game is repeated over time, there may be an incentive by the players to cooperate as long as the expected long run gains from cooperation (offering no investment incentives) more than offset the short run gains from not cooperating (offering incentives). Therefore, from a purely game-theoretical point of view, an explicit agreement with its enforcement machinery—which is what the WTO provides in the international trade context—is not necessary to achieve the optimal outcome\(^{125}\). At a practical level, however, so long as investors are attracted by incentives and potential host countries believe they are, then there appears to be indeed a

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\(^{125}\) Whether or not cooperation emerges spontaneously depends also on the relative size of the payoffs and how much policymakers value the future compared to the present. Yet another non-coercive solution is the “morality solution”, where reciprocal trust is a sufficient condition for cooperation to emerge. Arguably, the latter is a rather unlikely solution to emerge, especially if one takes a dim view of the motives of short-term oriented policymakers.
strong case for international coordination. The case for coordination would be even stronger in the case of investment diversion from developing to industrialised countries caused by uneven competition in the “incentives war” between these two groups of countries.\textsuperscript{126}

In sum, so far it seems that the restriction on the use of investment incentives is the single strongest rationale for international collective action. Given the economic interests at stake perhaps it is unsurprising that there has never been much momentum for international rule-making on this matter. The OECD’s MAI largely ignored the incentives issue, and today’s proponents of an investment agreement at the WTO seem not to have given it much consideration. Arguably, MIF proponents are likely to gain on two fronts from investment incentives. First, they have the financial muscle to successfully compete for those FDI projects where incentives do count. Second, government outlays on incentives are partly compensated by the rents accruing to domestic MNE’s profiting from the incentives paid to their subsidiaries abroad.

\section*{III.4 The “grand-bargain” argument}

According to Hoekman and Saggi (1999),

\begin{quote}
"the ‘grand bargain’ argument is one of the \textit{raisons d’entré} of the WTO. In a nutshell, what the WTO process does is to allow countries to define a negotiating set that allows a variety of potential tradeoffs and deals to be crafted that are superior to the status quo ante. Because countries are restricted to the equivalent of barter trade in multilateral trade negotiations to achieve Pareto superior (cooperative) outcome, issues must be linked."
\end{quote}

Moran (1998) suggests developing countries could make concessions on the investment issue, as a \textit{quid pro quo} for concessions by industrialised economies in other areas of interest to them, such as market access in agriculture or industrial products. Hoekman and Saggi (1999) note that policies other than investment, particularly in terms of further concessions under the existing GATT and GATS agreements, are likely to be more valuable negotiating chips for developing countries.

Implicit in the grand-bargain argument is that developing countries have little to gain from multilateral rules on investment. Although this may be the case, if investment policy is one of the main pillars of national industrial policy, then matters differ. From the development perspective, if developing countries’ growth-prospects were to be negatively effected by multilateral rules on investment, many possible grand bargains are unlikely to be viewed favourably. This is not to say, however, that in a context of what some have termed the \textit{Realpolitik} of the WTO, the grand-bargain argument may well be stronger than any other mentioned in this paper.

\section*{III.5 An overview of the likely welfare effects of a MIF}

Table III-3 summarises the main welfare effects of a MIF, by focusing on the likely signs of the payoffs from multilateral rules on investment to a FDI-importing developing host country and an industrialised home country. For the sake of the following argument it is assumed here that industrialised countries represent the host country view of FDI, and developing countries the home country view. Following a similar classification as adopted in Sanna-Randaccio (2000), multilateral rules on investment are grouped into three categories, as shown in Table III-3.

1. Multilateral rules that lock in minimum standards already prevailing internationally

The case for these rules broadly coincides with the transparency, credibility, and political economy argument discussed above. The main assumption here is that MNEs and their parent countries would strongly benefit from a MIF locking in the results of unilateral host country policy reforms and standards contained in bilateral agreements, particularly regarding market access and investment protection standards. Developing countries are assumed to benefit from the welfare-enhancing results of irrevocable policy reform itself, which

\textsuperscript{126} Although it should be noted that competition for FDI is mainly at a regional level, and among countries offering similar fundamental conditions, mainly relating to traditional gravity factors.

\textsuperscript{127} Hoekman and Saggi (1999: 18).
<table>
<thead>
<tr>
<th>Table III-3: Welfare effects of MIF</th>
<th>Likely welfare effect</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(1) Multilateral rules that lock in minimum standards already prevailing internationally:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Developing host country</td>
</tr>
<tr>
<td>Resulting in:</td>
<td></td>
</tr>
<tr>
<td>(a) Increased credibility, commitment of national policies</td>
<td>++ / -</td>
</tr>
<tr>
<td>(b) Lower transaction costs</td>
<td>+</td>
</tr>
<tr>
<td>(c) Stronger enforcement rules</td>
<td>+</td>
</tr>
<tr>
<td>(d) More transparency</td>
<td>+</td>
</tr>
<tr>
<td><strong>(2) Multilateral rules addressing market distortions created by host countries’ policies, constraining the use of:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Developing host country</td>
</tr>
<tr>
<td>Host country operational measures</td>
<td></td>
</tr>
<tr>
<td>(a) Efficient measures</td>
<td>-</td>
</tr>
<tr>
<td>(b) Inefficient measures</td>
<td>+</td>
</tr>
<tr>
<td>Investment incentives</td>
<td></td>
</tr>
<tr>
<td>Reducing:</td>
<td></td>
</tr>
<tr>
<td>(a) Investment diversion</td>
<td>+</td>
</tr>
<tr>
<td>(b) Transfer of rents from Host to MNE</td>
<td>+</td>
</tr>
<tr>
<td>(c) Lack of transparency</td>
<td>+</td>
</tr>
<tr>
<td>(d) “Incentive wars” (pure coordination problem)</td>
<td>+</td>
</tr>
<tr>
<td><strong>(3) Multilateral rules addressing market distortions created by foreign investors:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>MNEs’ surplus/rents</td>
</tr>
<tr>
<td>Competition policies</td>
<td></td>
</tr>
<tr>
<td>(a) International co-operation by national competition authorities</td>
<td>-</td>
</tr>
<tr>
<td>Investor behaviour</td>
<td></td>
</tr>
<tr>
<td>(b) Binding rules on investor behaviour</td>
<td>Developing host country</td>
</tr>
<tr>
<td></td>
<td>+</td>
</tr>
</tbody>
</table>

**Notes:**

(+) and (++) denotes a positive welfare effect, (-) a negative effect.
(0) denotes zero effect, as seen by the players (developing and industrialised countries) according to their payoff structure (the welfare effects). This does not imply the global welfare effect would actually be zero.

(?) From a developing country perspective, higher commitment and credibility can have strong positive effects in terms of stabilisation of long-term development plans, particularly in the face of obstruction by powerful local constituencies. Besides the overall benefits at the domestic level, the international investor community is likely to respond to decreased uncertainty/risk with more and higher-quality FDI inflows to the country. On the other hand, more commitment comes at the price of less flexibility, to some extent, which some developing countries may view as a potential danger to long-term economic development.

(?) Positive, insofar developing countries are also FDI exporters.
(?) The global effect depends on the positive effects at the national level, in terms of long-term welfare effects and economic growth prospects, and the negative effects, both from a home country and global prospective, from the conditions on FDI. Obviously, from a pure development perspective, the prohibition of beneficial host country operational measures has negative global effects. Therefore, “zero-sum” refers here to the payoff structure as perceived by the two players only.

(?) The global effect may well be positive or negative, depending on whether or not investment incentives act as signals increasing the efficient allocation of capital, or are simply distorting measures.
(?) Similarly to (?), the global welfare effect of a transfer of rents from a developing to industrialised country could be negative, particularly if the potential long-term implications for economic growth are considered (e.g. those arising from differences in return to capital).

(?) Likely to have strong positive effects on global welfare in terms of “long-term sustainability”. Yet, the negative effects of binding rules on investor behaviour may strongly reflect on their overall incentive to invest and the cost of foreign capital.

Source: Sanna-Randaccio (2000 – Annex Table), adapted and expanded by the author.
in turn would result in a more favourable environment for FDI, and therefore increased inflows. Global welfare effects are assumed to be positive, but the intensity of effects is an unsettled empirical question.

2. Multilateral rules addressing market distortions created by host country policies

This argument broadly coincides with the international spillovers argument outlined above. More specifically, the likely welfare effects of Host Country Operational Measures (HCOMs) and investment agreements are considered.

If a HCOM enhances the welfare of the host country, the effects of a MIF constraining its use is negative for host countries and is likely to be positive for home countries as their overseas investments are freed from the burdens of conditionality. The global effect, in the sense of the overall effect resulting from the interaction of host and home country governments represents in this case a zero-sum game. In contrast, if HCOMs are inefficient, their removal is obviously welfare-enhancing. Here, there is no case for cooperation, as development countries should have incentive enough to unilaterally remove welfare-reducing performance requirements. (Nevertheless, the political-economy argument might rationalise international collective action if clientist states retain inefficient measures.)

The effects of a MIF constraining the use of investment incentives crucially depends on a number of assumptions: that investment incentives tends to divert FDI towards the highest bidders; that industrialised countries have an advantage in the incentives race by having “deeper pockets”; and that developing countries are only hosts to FDI. Such simplifying assumptions allow to make the point that a MIF constraining the use of investment incentives would probably reduce investment diversion towards industrialised countries, and reduce the transfer of rents from host countries to MNEs and their parent countries.

With the exception of ‘wars’ over investment incentives, it appears from the above analysis that there is little case for international collective action on investment. However, Sanna-Randaccio (2000) and Moran (1998) have a point in noting that such a case may well arise if a number of issues are linked within the investment framework. For instance, host country operational measures could be linked to investment incentives, so creating an incentive for cooperation where there is none on either issue taken singularly (since they are zero-sum). This insight is not reflected within the debate at the WGTI. In fact, developing countries are traditionally opposed to giving up HCOMs, while industrialised countries have shown to be strongly reluctant to forego the use of incentives. Could both groups be persuaded to forgo their preferred measures under the auspices of a multilateral investment framework?

3. Multilateral rules addressing market distortions created by foreign investors

MNEs can have strongly distorting effects on host countries. Such distortions mainly result from anti-competitive behaviour on the part of MNEs, including Restrictive Business Practices (RBP) such as transfer pricing, price fixing, market allocation agreements, and tied-selling. Morrissey (2001) and Kumar (2001) have shown that RBPs are frequently as market- (including trade-) distorting as TRIMs and other HCOMs are, and therefore the rationale for outlawing the use of RBPs would be at least as strong as it is the case of TRIMs. Nevertheless, binding rules on RBPs do not exist at a multilateral level. Recently, China, Cuba, India, Kenya, Pakistan, and Zimbabwe have co-sponsored a submission to the WGTI (see Appendix Table 6) demanding binding rules on RBPs to be put on the negotiation agenda, and reinforcing so developing countries’ long-standing demand for constraints on MNE’s actions as a quid pro quo for further liberalisation on their part. Industrialised countries, on the other hand, do not seem particularly inclined to consider such a proposal, in accordance with MNE’s desire to face as few restrictions on investment as possible. As shown in Table III-3, this is yet another case where no cooperative international arrangement would be preferred by all parties, except in a context of issue-linkage with other provisions of a potential MIF.

In parallel to the WGTI, the Ministerial Declaration at Singapore has established a Working Group on the Interaction between Trade and Competition Policy (WGTCP) with a mandate to study the relationship between trade and competition policies. As it is beyond the scope of this chapter to deal with this issue in any detail, the interested reader is referred to Evenett (2003) for an analysis of the issues relating to the possible

128 Which is not the same as the cross-issue linkage as envisaged in the “grand-bargain” argument.
adoption of a multilateral framework on competition policy. It will be sufficient here to note that FDI and
competition are highly inter-related issues, as FDI takes typically place in concentrated industries. Host
countries are particularly concerned with the market power of MNEs, since they usually lack effective
national competition authorities and policies to deal with anti-competitive practices. Moreover, international
cooperation on competition policy, particularly on enforcement matters, is often necessary to deal with anti-
competitive behaviour in the global market place. Table III-3 shows that international competition rules
would result in a transfer of surplus from MNEs to consumers. Also, increased competition would raise
efficiency in production. Overall, the effect from increased competition is positive. Yet, governments in
industrialised and developing countries alike may well face opposition to cooperation on competition policy
matters if their firms are able to apply strong enough pressure (Sanna-Randaccio 2000).
Part IV
Conclusions - Is there a case for negotiating a multilateral framework for investment?

IV.1 Summary: why the case for a Multilateral Investment Framework is not convincing

Parts II and III of this paper have shown that most arguments in favour of a Multilateral Investment Framework (MIF) are not compelling. The papers submitted to the Working Group on Trade and Investment (WGTI) by the European Commission (EC) and the United States (U.S.) are largely based on conjectures, rather than being founded on compelling theoretical and empirical analysis. From the more conceptual approaches taken in recent papers by scholars assessing the likely welfare effects of a MIF, it appears that there is little case for further international accords on economic grounds, with the important exception of the regulation of incentives to attract foreign investment. The latter are largely considered as beneficial by industrialised countries and their multinationals, and fall outside current proposals for an MIF. Moreover, although a MIF may raise total global welfare, it does not necessarily represent a desirable option for all countries as it would largely undermine developing countries’ flexibility to regulate foreign investment in the domestic economy.

An assessment of whether or not the benefits from multilateral rules on FDI are likely to outweigh the costs associated with the partial loss of scope and flexibility of government intervention in regulating FDI will crucially depend on country-specific instances and, ultimately, on contrasting perspectives on the efficacy of such measures. However, as long as some countries continue to view Host Country Operational Measures (HCOMs) as a necessary instrument to ensure that FDI positively contributes to host country economic growth and welfare, and in the absence of compelling evidence against such measures, a MIF along the lines advocated by the EC would not necessarily represent a pareto-improvement over the current system of international rules governing FDI.

It is worth recalling that Paragraph 22 of the Doha Declaration requires that “any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest.” If Paragraph 22 is to be understood as requiring that a multilateral investment framework be as development-friendly as possible then this may be reconcilable with some constraint on policy flexibility, as implied by the basic features of the EC proposal’s proposals for a MIF. Having said that, if a MIF constrains the national policy space of host countries, then it should also include binding provisions regulating multinational enterprises’ practices.

If, in contrast, Paragraph 22 is read as requiring a framework on investment to be of benefit to all WTO members, then a MIF would have to be designed in a way so as to distinguish between HCOMs that are growth-enhancing from those that are not. Particular account of country-specific circumstances would be essential. It is not enough to have GATS-type country commitments and exceptions, as circumstances change and the policies that optimise the speed of development may change too. Arguably, such a high degree of flexibility is practically impossible to be achieved by an MIF, and would partly undermine the very aim of the latter, i.e. to provide a set of stable and transparent rules on FDI. Indeed, given the lack of any intellectual consensus on what policies maximize the benefits from FDI, then a MIF may lock developing countries into a sub-optimal set of policy choices. Lack of predictability of the rules facing foreign investors may well be the price of maintaining sufficient flexibility to optimally respond to evolving national circumstances.

IV.2 If a MIF, then why in the WTO?

It has been argued that WTO has almost global membership and therefore presents itself as the ideal forum for negotiations on sensitive issues such as investment. It is noted sometimes that the failure of OECD’s MAI negotiations was due, in part, to the fact that they were conducted by a group of industrialised countries, while the developing countries were expected to stand-by during negotiations and ratify the agreement upon its conclusion. The WTO, in contrast, as a member-driven and consensus-based organisation is said to offer the ideal forum where low-income members could raise their concerns and shape the outcome of negotiations in their favour. Not everyone shares this view. A number of influential NGOs have expressed their concerns about the decision-making processes in the WTO, which they consider flawed because of the limits upon
effective participation on the part of the smaller and poorer developing countries. Such concerns are echoed by an influential group of academic commentators. For instance, Helleiner (2000) claims that ‘consensus’ was achieved at Doha, as ever before, “through bilateral, behind-the-scenes pressures, dealing and bullying.”

He concludes that “the WTO simply must find a more credible and effective decision-making system then the possibly awkward, and abuse-prone, 140-country ‘consensus’-based system it now employs.” Whether or not such concerns are fully justified, as a matter of fact developing countries do have the opportunity to collectively oppose an agreement on MIF in WTO negotiations. However, developing countries are a largely heterogeneous group, and a compact coalition along the lines of India’s opposition is unlikely to be formed. Indeed, a look at the submissions to the WGTI shows that most low-income and least developed countries have not reacted to India’s comments. This may be because of a more accommodating stance taken by some developing countries, the outcome of effective persuasion by industrialised economies, but it is also likely to be the result of a lack of capacity to reply to complex matters by some.

IV.3 Conclusion

Two brief considerations should suffice at this point. First, from a broad field of studies on the effects of FDI and economic development a strong consensus has emerged that FDI requires active government regulation to maximise the benefits (and limit the negative effects) for host countries. Transferring away control over FDI from host countries to MNEs is therefore hardly a sustainable policy option, as long as corporate behaviour and responsibilities are not subjected to binding multilateral rules while host country actions are. Second, it appears that many of the positions taken by WTO Members are based on a number of unsupported assertions rather than on serious analyses of the likely effects of multilateral disciplines on investment on WTO members. Instead of talking past each other, it would be desirable if further discussions in the WTO’s Working Group on the Relationship between Trade and Investment involved a dialogue on the most equitable ways of creating and expanding those multilateral rules that an increasingly worldwide system of production and distribution is going to require.

129 Helleiner (2000: 3).
130 Ibid.
131 It should be noted, however, that some observers take a more optimistic view on the capacity of developing countries to influence outcomes from multilateral negotiations. Page (2003: 4), for example, notes that particularly in the last WTO Ministerial Meetings (Seattle 1999, Doha 2001) “developing countries have proved first that they can modify the outcome, then that they can block a settlement, and finally that they can initiate their own issues.”
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## APPENDICES

### Appendix Table 1 – Mergers and acquisitions (million US$)

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL WORLD</td>
<td>80,713</td>
<td>186,593</td>
<td>766,044</td>
<td>1,143,816</td>
<td>593,960</td>
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<td>Developed countries</td>
<td>74,048</td>
<td>163,950</td>
<td>679,481</td>
<td>1,056,059</td>
<td>496,159</td>
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<td>Western Europe</td>
<td>38,520</td>
<td>79,114</td>
<td>370,718</td>
<td>610,647</td>
<td>228,995</td>
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<tr>
<td>European Union</td>
<td>36,676</td>
<td>75,143</td>
<td>357,311</td>
<td>586,521</td>
<td>212,960</td>
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<tr>
<td>Other Western Europe</td>
<td>1,844</td>
<td>3,971</td>
<td>13,407</td>
<td>24,126</td>
<td>16,035</td>
</tr>
<tr>
<td>North America</td>
<td>31,884</td>
<td>64,804</td>
<td>275,884</td>
<td>401,429</td>
<td>226,798</td>
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<tr>
<td>Other developed countries</td>
<td>3,644</td>
<td>20,032</td>
<td>32,879</td>
<td>43,983</td>
<td>40,365</td>
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<tr>
<td>Developing countries</td>
<td>5,786</td>
<td>16,493</td>
<td>74,003</td>
<td>70,610</td>
<td>85,813</td>
</tr>
<tr>
<td>Africa</td>
<td>47</td>
<td>840</td>
<td>3,090</td>
<td>3,199</td>
<td>15,524</td>
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<tr>
<td>Latin America and the Caribbean</td>
<td>3,529</td>
<td>8,636</td>
<td>41,964</td>
<td>452,22</td>
<td>35,837</td>
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<tr>
<td>Asia and the Pacific</td>
<td>2,210</td>
<td>7,017</td>
<td>28,949</td>
<td>22,187</td>
<td>34,452</td>
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<td>Asia</td>
<td>2,182</td>
<td>6,950</td>
<td>28,839</td>
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<td>West Asia</td>
<td>131</td>
<td>222</td>
<td>335</td>
<td>970</td>
<td>1,323</td>
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<tr>
<td>Central Asia</td>
<td>-</td>
<td>450</td>
<td>73</td>
<td>107</td>
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<td>South, East and South-East Asia</td>
<td>2,051</td>
<td>6,278</td>
<td>28,431</td>
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<td>The Pacific</td>
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### Appendix Table 2 (continued)

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**Source:** UNCTAD (2002: 303-9); UNCTAD FDI/TNC database; net figures own calculations
## Appendix Table 3
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Source: UNCTAD (2002:310-17); UNCTAD FDI/TNC database
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<td>0.9</td>
<td>2.7</td>
</tr>
</tbody>
</table>

*Source: UNCTAD (2002:328-36); UNCTAD FDI/TNC database*
### Definition of Investment

#### Narrow definition, including FDI and related transfers and payments only.

**Direct investment enterprises:** all incorporated (subsidiaries and associates) or unincorporated (branches) enterprises in which a direct investor owns 10 per cent or more of the ordinary shares or voting power or the equivalent. Should a direct investor control the company with less than 10 per cent of the ordinary shares the following criteria could be taken into account to determine whether a direct investment relationship exists: (a) representation in the Board of Directors; (b) participation in policy-making processes; (c) inter-company transactions; (d) interchange of managerial personnel; (e) provision of technical information; (f) provision of long-term loans at lower than existing market rates.

**Direct investment capital transactions:** as defined by the IMF and the OECD, it comprises both the initial transaction between the direct investor and the direct investment enterprise and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated. This includes all operations that create or liquidate direct investments as well as those that serve to maintain, expand or reduce investments, such as equity capital, long-term loans, reinvested earnings and other capital associated with various inter-company debt transactions.

**Foreign direct investors:** this concept could include all natural persons and companies of WTO Members, including public or private incorporated or unincorporated enterprises, which engage in a direct investment enterprise - such as a subsidiary, associate or branch - in a country other than the country or countries of residence of the foreign direct investor or investors.

### Non-Discrimination

#### GATS-like provisions extended to the primary and secondary sectors, but allowing for general, as well as subject- and country-specific exceptions:

- a general MFN obligation (including possible exceptions) for foreign investments across the board and on all sectors;
- a general NT obligation (including possible exceptions) for all foreign investments established in accordance with the laws and regulations of the host country (as provided for in most existing BITs);
- specific NT obligations for the establishment (i.e. admission) of foreign investments in those sectors listed in each country’s schedule of commitments. The schedule of commitments would also enumerate each member’s limitations to NT.

### Transparency

#### GATS-like provisions extended to the primary and secondary sectors, including:

**Publication:** Each member should publish, or otherwise make publicly available, all relevant measures of general application which pertain to or affect the operation of the Agreement. This should include measures affecting the establishment, expansion, withdrawal, operation of investment and international agreements pertaining to FDI.

**Notification:** A notification procedure should apply for any new or changes to, existing laws, regulations, judicial decisions, and administrative procedures which significantly and directly affect FDI. A standard proforma could be created to ensure consistency in the notifications, as in the TBT Agreement. This would make sure that all notifications cover the same important areas such as scope of measure, rationale, timing, contact for further details, etc.

**Deadline:** publication should be made promptly, and at the latest by the time of the entry into force of the relevant measures. Generally speaking transparency increases if the measures are made public earlier. Better regulation, as well as better transparency is achieved by early public awareness of a prospective measure. Transparency also implies the need to tackle the problem of uncertainty caused by policy changes. Thus, making available information on possible reforms affecting investment will increase predictability of rules.

**Enquiry:** Members should be required to respond promptly to all reasonable requests by other Members for specific information on any of its measures of general application.

**Procedural transparency:** Members shall ensure that all measures affecting FDI are administered in a reasonable, objective and impartial manner. Each member shall maintain or establish judicial, arbitral or administrative tribunals or procedures for prompt and impartial review and remedy of administrative decisions affecting FDI.
**Exemptions** may be needed in certain cases, in order to preserve confidential information and public interest. However, the potential of abusing certain exemption provisions should be taken into account and it has to be defined under which circumstances and on what grounds should exemptions be granted.

### Balance of payments Safeguards

- As a *general rule*, members should allow: all current and capital transfers related to established investments, and, as far as the making of new investments is concerned, all current and capital transfers related to those investments covered by the countries’ sectoral list of commitments.

- As an *exception*, a safeguard clause to preserve members in case of serious BOP difficulties. This provision should allow temporary restrictions on the outflows of current and capital transfers related to those investments covered in the IDF.

In any case, a BOP safeguard clause, which allows members to take restrictive measures should only be allowed under exceptional circumstances, it should be clearly defined and include strict criteria.

**Restrictions should be:**
- non-discriminatory;
- consistent with other relevant international provisions;
- limited in time and phased out progressively;
- applied in a way that does not exceed what is necessary to deal with the sudden difficulties;
- avoid unnecessary damages to the interests of other members;
- not be used to justify measures adopted to protect specific industries or sectors.

As in the GATT and in the GATS, specific procedures should be included concerning notification, review and consultations within the WTO and with other fora as appropriate.

### Development provisions

**Definition of flexibility:** flexibility is to make up for insufficient financial and human resources and, in particular, institutional weaknesses, which put heavy restraints on developing countries. Flexibility may typically involve: lower levels of commitments; asymmetrically phased implementation timetables; exceptions from obligations in certain areas; flexibility in the application of – and adherence to – disciplines.

A flexible, GATS-type structure based on positive commitments could be used for market access and NT provisions at the pre-establishment stage. This mechanism would allow some countries to take phased commitments on market access and NT which would be adapted to their level of development. The level of commitments of developing countries would be commensurate to their level of development and there would be no obligation for them to liberalise sectors. Moreover, each developing country would be able to attach to its market access and NT commitments possible conditions related to its development objectives.

**Technical assistance** should be foreseen for developing countries for all the stages, i.e. the pre-negotiation phase, the negotiation as well as for the implementation of provisions that required specific additional resources.

The right of members to regulate ‘in order to meet national policy objectives’ should be explicitly recognised, as well as possible exceptions for public interest (for example: security protection of public moral, public order and consumers, exercise of governmental authorities) and restrictions to safeguard the Balance of Payments in accordance with IMF rules.

The question of *investors’ behaviour and their responsibility* vis-à-vis host countries could also be addressed. The OECD Guidelines for multinational enterprises provide a useful example of how to ensure that MNEs conduct their activities in a responsible manner and in harmony with the policies of the countries in which they operate.

### Dispute Settlement

**DSU as in GATS**

For the sake of consistency, any possible dispute concerning a future multilateral framework on FDI to be negotiated and agreed in the WTO should also be fully covered by the WTO Dispute Settlement mechanism.

### Pre-establishment

**GATS-like positive-list approach** extended to the primary and secondary sectors.
<table>
<thead>
<tr>
<th>Issues discussed</th>
<th>Key comments/proposals</th>
</tr>
</thead>
</table>
| General concerns         | - The relationship between trade and investment is a complex one and is not susceptible to easy analysis, much less, any definitive conclusions;  
| (WT/WGTI/W/86)            | - The developmental dimension is at the heart of this educational process and in the end, for developing countries this is what counts most;  
|                           | - Flexibility for pursuing various developmental options is key to the future of any developing country; anything that reduces the flexibility currently available to countries should not be an advisable course to pursue;  
|                           | - Evidence of the putative benefits from FDI is not conclusive and what we get is a very mixed picture of the advantages and disadvantages of FDI; as with many other things, a lot depends upon the specificities of the country concerned;  
|                           | - The present regime of bilateral agreements gives flexibility to a lot of countries enabling them to channel FDI into areas of priority determined by them;  
|                           | - There is no evidence that the pattern and flow of investment will change in any significant way with multilateral rules on investment. On the other hand, the bilateral investment treaties appear quite successful in protecting existing investments;  
|                           | - On the other hand, there is evidence that should there be multilateral agreement on investment it would definitely limit flexibility currently available for developing countries;  
|                           | - FDI appears to be dependent on a host of other factors than the investment regimes per se; for example, the size of the market, skilled labour, political stability, sound legal regime and good infrastructure are some of the factors that have been mentioned by Members themselves in their various submissions.  
<p>|                           | - If the issues subject to discussion in the WGTI are not addressed from the viewpoint of the entire WTO membership, including low-income and least developed countries, then it is possible that any premature move in this regard would only widen the developmental disparities to which today’s globalisation paradigm have provided no clear solutions yet. |</p>
<table>
<thead>
<tr>
<th>Agreement and Quantity of FDI Flows (WT/WGTI/W/86)</th>
<th>Last decade or so. It is far from clear that a multilateral agreement on investment will either provide the same degree of flexibility and comfort that the bilateral instruments currently provide to developing countries or it will necessarily lead to significant increase in inward flows of investment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multilateral Investment Agreement and Efficiency (WT/WGTI/W/86)</td>
<td>The argument that multilateral rules will lead to efficiency gains, lower costs and prices which are in the interest of both home and host countries does not take into account the costs for host countries in terms of costs of adjustment and impact on social gains that could otherwise have accrued in many cases? Global welfare gains do not necessarily translate into national welfare gains for the host country. What is therefore the benefit for the host country in becoming a party to such a multilateral agreement?</td>
</tr>
<tr>
<td>Performance Requirements (WT/WGTI/W/148)</td>
<td>Host countries may find it necessary to impose performance requirements on FDI so as to assure certain domestic industries are adequately protected against the overwhelming power of MNEs. The study process within the WGTI needs to examine the positive role played by such policy instruments before arriving at any conclusion. There is a need to have a fresh look at performance requirements. Empirical studies have shown that affiliates of certain trans-national corporations buy the bulk of their inputs from parent companies and other affiliated companies leaving only a small proportion for unaffiliated suppliers within the host country or in third countries. UNCTAD’s Trade and Development Report 2002 has highlighted the poor record of generation of value added and linkages by trans-national corporations. It is also an undeniable fact that until recently performance requirements were an integral part of the growth strategy of all developed countries. It is important, therefore, that performance requirements on employment generation, transfer of technology, export performance requirements, manufacturing requirements, training and research and development requirements etc., remain available to developing countries to ensure that foreign investment contributes to the achievement of development policy goals. Another point to which attention needs to be drawn is the possible damaging effect of capital outflows on balance-of-payments. There are many recent cases of such damage to the economies of developing countries. While this calls for further policy flexibility to maintain restrictions on outflows, there is also a strong case for performance requirements such as export obligations and foreign exchange neutrality to moderate the adverse effects of capital outflows.</td>
</tr>
</tbody>
</table>
It is not appropriate to compare "investment" as defined and dealt with under GATS with "investment" as proposed for negotiation by some members under the aegis of WTO. GATS follows an "enterprise-based" definition of investment and the definition is closely linked to the mode 3 of service delivery vis-à-vis "commercial presence" which in the context of GATS has no other purpose than to facilitate service supply. One of the basic characteristics of service delivery in respect of certain categories of services is the need for the "supplier" and the "receiver" of the service to be in contact. "Commercial presence", therefore, is the only mode of service delivery in the case of certain types of services, e.g. banking and insurance. GATS deals with trade in services by its nature, not investment per se. Therefore, the "commercial presence" in a host country, even though it includes direct investment, or the establishment of a foreign company, mainly focuses on the supply of services.

Commercial presence is covered under GATS only to the extent that it facilitates the delivery of services – and that too is subject to various conditions and exemptions. What is of importance is the commitment for market access for specific service sectors undertaken by a Member. Mistaking it as a commitment to "commercial presence" is mistaking the "medium" for the "message". Therefore, inclusion of commercial presence under GATS in the WTO does not, in any way, justify the inclusion of "investment" under "goods" in the WTO.

It was to bring services under the umbrella of the WTO that it was found necessary to devise a specific architecture involving, inter alia, mode based definitions. It would be erroneous logic to now reaply the GATS architecture to the goods sector. GATS is a complex Agreement. Safeguard measures in respect of services have eluded evolution. Protection in respect of goods is possible through tariff and other border measures, while certain modes of services are not amenable to such measures. Given the complex nature of capital flows/investments, application of non-discrimination principle as it exists in goods and services to investment cannot be automatic. Developing countries need to retain the ability to screen and channel foreign direct investment.
consistent with their domestic interests and priorities. This is the reason why bilateral investment treaties are preferred the world over.

| Pre-establishment in a GATS-type positive list approach (WT/WGTI/W/150) | - The concept of pre-establishment national treatment as such does not exist under the GATS. National treatment is available only to the extent that commitments have been taken by Members.  
- With the exception of regional trading agreements, BITs involving the United States or Canada, and a recently negotiated between Japan and Korea, all international investment agreements provide for national treatment only at the post-establishment stage. BITs leave host countries the right to make or modify their rules and regulations on foreign investment. Availability of this policy space is the most important development dimension.  
- Other factors, such as size of host-country market, macro-economic conditions, availability of skilled personnel and inputs, have attracted substantial investment flows to certain countries without national treatment being guaranteed to investment or investors.  
- Most BITs grant national treatment to investment, while investors are accorded MFN treatment only. When certain international instruments envisage national treatment at the pre-establishment stage, such instruments are non-binding and cover only investments and investors. Binding national treatment and MFN provisions are available in some regional trading arrangements, such as NAFTA, covering advanced stages of integration. However, it is not clear for why this should be emulated by an investment agreement in WTO, where the membership is predominantly low-income developing countries and LDCs, with diverse economic backgrounds and at different stages of development.  
- National treatment at the sub-central level: it is not clear what should be the modalities for treatment of sub-national authorities with constitutional powers to make rules and regulations related to foreign investment.  
- Unlike goods and services, investment essentially involves movement of capital, which tends to move in various ways from home country to third countries and then to host countries. Given the complex nature of capital flows/investments, binding rules on "pre-establishment commitments" will neither be feasible nor necessary. Developing countries need to retain the ability to screen and channel FDI in tune with their domestic interests and priorities. Bilateral investment treaties have been favoured the world over for precisely the flexibility they provide to the host country while at the same time extending necessary protection to foreign investors. |

| Development provisions (WT/WGTI/W/148) | - Development is a complex process, and no single formula can fit into every economic situation in such a manner that it inevitably leads to growth. Developing countries, therefore, need policy space so that they can determine for themselves how the process of economic development can be speeded up and the welfare of their citizens enhanced. This also includes the policy space to determine the manner in which investment shall be regulated and channelled. Any multilateral discipline that seeks to limit this policy space, by its very definition, would reduce the policy options available to developing countries to use foreign investment for promoting development.  
- The basic assumption underlying the proposal for multilateral disciplines on investment is that the principle of free trade, which permeates WTO rules in respect of goods and services, would apply equally to movement of capital. If conditions of a perfect market prevail, then freedom of international capital movement could possibly lead to benefits both for home and host countries and for investors. This is not a realistic situation, as the efficient markets paradigm is fundamentally misleading when applied to capital flows. In the case of domestic distortions and/or market failures, which are endemic particularly in developing economies, then there is no reason to assume that financial liberalisation will be welfare improving. Several studies have highlighted cases where foreign investment may have lowered host-country welfare.  
- Developing countries need policy flexibility to determine the form of investment leading to highest growth. The definition of investment would have important implications for the development dimension. Greenfield investment is generally preferable to mergers and acquisitions. Any movement of capital that could cause serious damage to the host economy would need to be carefully regulated. Existing BITs provide such necessary flexibility.  
- Money falls in the category of neither goods nor services. WTO is a trade-negotiating forum: it is neither a forum of bankers, nor of monetary economists. The less-developed countries in the WTO do not have the skills and the expertise of the richer countries have. Perhaps the best contribution that can be made to the cause of development is to understand the limitations of developing countries and focus only on trade issues within the WTO. |

| Investor obligations (WT/WGTI/W/148) (WT/WGTI/W/152) | - While foreign investment could generate positive changes in the economy through the induction of capital, technology, managerial and marketing skills, it could also have various negative effects. It need not necessarily bring in any significant new technology as empirical evidence presently indicates, generate little value added for employment or develop linkages with domestic industry |
| Note: submission no.152 on investors' obligations is co-sponsored by China, Cuba, India, Kenya, Pakistan and Zimbabwe | in the host country. The objective of global profit maximisation by trans-national corporations rather than by each new subsidiary may sometimes result in conflict of interests with the developing host country being the loser in many cases. It is important, therefore, that the Working Group discusses also a binding code of conduct on investors with a further stipulation that it shall be enforced by home countries through a set of precise domestic laws that can be activated by any host country.

- Some possible general principles that would need to be kept in view while drawing up any investor obligations could be as follows.

a) General principles, to cover the following broad principles:

- foreign investors would respect the national sovereignty of host member and the right of each member government to regulate and monitor their activities;
- non-interference in internal affairs of the host member and in its determination of its economic and other priorities;
- adherence to economic goals and development objectives, policies and priorities of host members, and working seriously towards making a positive contribution to the achievement of the host members' economic goals, developmental policies and objectives;
- adherence to socio-cultural objectives and values, and avoiding practices, products or services that may have detrimental effects.

b) Restrictive business practices (RBP):

The provisions of the UNCTAD's Set of Multilaterally Agreed Principles on RBPs could be incorporated, making them legally binding and thus enforceable.

c) Obligations of technology transfer should include:

- Contribution to technical and managerial training of citizens of host members
- Prohibition to impose restrictive clauses in technology transfer contracts with their affiliates and licensees that prevent absorption and assimilation of technology transferred.
- Providing information on various aspects of the technologies to be transferred.

d) Balance of payments

Foreign investors should be obliged to follow and contribute towards the goal of host countries' policies implemented to counter adverse, or to improve positive BOP effects from FDI. Such obligations should include:

- adhere to policies and measures instituted by the host member governments aimed at safeguarding the balance-of-payments and at strengthening the balance-of-payments position;
- contribute to promotion and diversification of exports and to increased utilization of goods, services and other resources available locally;
- cooperate with the host governments in periods of balance-of-payments crisis by delaying remittances of profits and by phasing out divestment proceeds;
- desist from engaging in short-term financial operations or intra-corporate transfers in a manner that would increase currency instability and balance-of-payments difficulties
- apply fair pricing policies in intra-corporate trade and curb transfer pricing manipulations.

e) Ownership and control:

MNE’s should be required to:

- delegate as much as possible the power of decision making to their entities, so that the latter can contribute positively to the economic and social development of the host members;
- should work together with the governments and citizens of host members to realize the national objectives of local equity participation and effective exercise of control by local partners in accordance with contractual terms of equity or non-equity arrangements or with the terms of control as established by the laws of those members concerned;
- exercise their personnel policies in light of host member national polices, laws and regulations to the effect that priority is given to local nationals in recruitment, training and promotion to posts of managerial and leading nature so as to enhance the effective participation of local citizens in the process of decision-making.

f) Consumer protection and environmental protection |
MNEs should be required to:

- respect the rights of consumers in host members and pay due regard to effective consumer protection and ensure the safety and quality of the goods and services they provide and not to produce, market or advertise potentially harmful products;
- adhere to environmental and safety practices and requirements to ensure that the health, safety and environment of people in the host members are properly protected;
- take steps to protect the environment and to rehabilitate the environment when there is damage caused by the investor;
- respect the right of the host member population to know the names and types of dangerous chemicals used in the production process and size of their inventory, the undesirable effects resulting from their use and their accidental consumption and possible remedial measures to be taken in the event of an accident.

g) Disclosure and accounting

- acceptance to provide a disclosure on the financial as well as non-financial information on the structure, policies and activities of MNE as a whole, as well as that of the local affiliate;
- providing details of transactions with the affiliated parties such as parent or other group companies outside or inside the host member;
- transparency with regard to transactions in financial markets that have a speculative effect on the currency or financial markets of the host member.

Source: Indicated submissions to the WGTI
## Appendix Table 7: A comparison between bilateral, regional, and multilateral investment agreements in terms of provisions affecting the entry and operations of foreign investors

<table>
<thead>
<tr>
<th>Bilateral Investment Treaties</th>
<th>Regional and Interregional Agreements</th>
<th>Multilateral Agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN</td>
<td>MERCOSUR</td>
<td>OECD Codes of Liberalisation of Capital Movements and Current Invisible Transactions</td>
</tr>
<tr>
<td>APEC (non-binding investment principles)</td>
<td>Islamic Confederation Agreement on Investment</td>
<td>Arab League: Unified Agreement for Investment of Arab Capital among Arab States</td>
</tr>
<tr>
<td>CoMESA</td>
<td>Energy Charter Treaty</td>
<td>OECD Declaration on International Investment and Multinational Enterprises and related Decisions</td>
</tr>
<tr>
<td>NAFTA</td>
<td>GATS</td>
<td>World Bank (*)</td>
</tr>
<tr>
<td>GATS</td>
<td>TRIMS</td>
<td>United Nations (+)</td>
</tr>
</tbody>
</table>

### 1. Restrictions

| (a) Entry and establishment | Y (some) | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |
| (b) Ownership and control |           |   |   |   |   |   |   |   |   |   |   | GUIDE |
| (c) Operational conditions | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |
| (d) Authorisation and reporting | Y (some) | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |

### 2. Incentives

| (a) National Treatment | Y | Y | Y | Y | Y (in part) | Y | Y | Y | Y | Y | Y | GUIDE |
| (b) MFN Treatment | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |
| (c) Fair and Equitable Treatment | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |

### 3. Standards of treatment

| (a) Minimum international standard of protection | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |
| (b) Expropriation | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |
| (c) Recourse to international means for settlement of investment disputes | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |

### 5. Protection Standards

| (d) Restrictive business practices | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | RBP, GCP |
| (e) Consumer protection and health safety standards | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | RBP, GCP |
| (f) Labour standards | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | ILO |
| (g) Corporate behaviour | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | Y | GUIDE |

### Notes:

1. (*) Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID); Convention establishing the Multilateral Investment Guarantee Agency (MIGA); Guidelines on the Treatment of Foreign Direct Investment (GL). (+) ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (ILO); UNCTAD Multilaterally Agreed Set of Principles and Rules for the Control of Restrictive Business Practices (RBP); Guidelines for Consumer Protection (GCP). Source: UNCTAD (1996: 140-3, Table V.3)
### Table Appendix 8: Main findings by empirical studies on the determinants of FDI

<table>
<thead>
<tr>
<th>Determinants of FDI</th>
<th>Positive effect on FDI</th>
<th>Negative effect on FDI</th>
<th>Insignificant/inconclusive effect on FDI</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market size</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Infrastructure quality</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Labour cost</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Labour quality/ Human capital</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Openness/Export orientation/Trade liberalisation</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Taxes, tariffs, NTBs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Country risk/ Political instability</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Corruption/lack of transparency</strong></td>
<td></td>
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</tbody>
</table>

Notes: (*) Find that real GDP per capita is inversely related to FDI/GDP. Almost all empirical work on FDI is seriously flawed: relevant variables are either difficult to measure or to proxy (e.g., transparency, infrastructure, etc.), and trade-related variables (e.g. openness) are notoriously biased. Results from cross-section studies are likely to be biased by non-measured, country-specific variables. Time-series analyses are usually limited by the insufficient length and variation on the relevant policy variables. Panel data analyses lead to contrasting results, depending on specification and proxies used. Outcomes generally lack robustness.
The following communication, dated 12 September 2002, has been received from the Permanent Mission of the United States.

Covering FDI and Portfolio Investment in a WTO Investment Agreement

INTRODUCTION

For a number of reasons, investment agreements must have a broad, open-ended definition that includes all types of investment, including portfolio investment. Long-standing U.S. practice is to have the broadest definition of investment, covering both direct and portfolio investment. European bilateral investment treaties also cover all types of investment.

In UNCTAD’s recent study of investment treaties, the number of bilateral investment treaties grew fivefold during the 1990’s, from 385 to 1,857, with 173 countries concluding these instruments. Moreover, the number of treaties signed by developing and emerging market countries increased dramatically, rising from 63 at the end of the 1980s to 833 at the end of the 1990s. Many of these treaties were with the US and Europe, and the preponderance cover both direct and portfolio investment. This growth indicates increasing acceptance by developing and emerging market countries of the need to cover both direct and portfolio investment in order to maximize the gains from investment liberalization and protection.

A. WHAT IS PORTFOLIO INVESTMENT?

The principal difference between FDI and portfolio investment is the extent of control. A direct investment is one in which the investor obtains a lasting influence in, and a degree of influence over the management of, a business enterprise. Portfolio investment is all other investment, including investments in financial assets without the expectation of significant management control of the real assets on which the financial assets are based. Other examples of portfolio investment include, interests in concessions agreements, contractual rights, (such as rights embodied in intellectual property interests), debt interests in business enterprise, and ownership interests in tangible and intangible property, such as leases, mortgages, and liens.

For statistical purposes, governments and international organizations may require a minimum level of ownership for an investment to be treated as FDI. The OECD and IMF, in compiling FDI statistics, consider a direct investment to be one in which ownership is at least ten per cent of the voting securities of an incorporated business enterprise, or the equivalent interest in an unincorporated business enterprise.

While useful for statistical categorization, the "ten per cent" rule may be too rigid for practical use in a legal agreement. For example, an investor might own only nine per cent of an investment but still exercise effective control over the investment because other shareholders have extremely limited holdings. The extent to which an investment confers control is the most reliable indicator of whether it represents direct or portfolio investment.

B. WHY INVESTMENT AGREEMENTS SHOULD COVER PORTFOLIO INVESTMENT AS WELL AS FDI

Portfolio investment is vital for economic growth and development.

1. Developing and emerging market countries benefit from portfolio capital inflows. Portfolio investment adds to national savings, helps broaden and deepen financial markets in developing countries to mobilize capital more efficiently, broadens the array of lending available to domestic businesses, promotes large-scale investments that capture economies of scale, and stabilizes the local economy by spreading credit risk. The investment and financial development impact of capital account liberalization, which reflects increased FDI and portfolio investment, has been shown to increase economic growth in developing countries by 0.5 per cent annually. Excluding portfolio investment from the definition of investment would be counter productive for countries that hope to use foreign investment to bolster their own growth.

133 "International Financial Integration and Developing Countries," World Economic Outlook, IMF, October 2001, p. 143.
Portfolio investment is key to financial market deepening. Relegating portfolio investment to second-class status discourages the creation of sound financial markets.

2. A well-developed financial market is able to match willing sellers of capital with willing buyers in such a way that both parties can expect to benefit from the transaction. To meet the various needs of its customers, the financial market ideally has a range of instruments on offer, including equity, debt, and the many variations on these concepts that are found in modern financial centers. Granting fewer rights to the holders of portfolio capital than to direct investors would only create a bias against portfolio investment and stall the development of an efficient, diversified capital market.

The definition of “portfolio investment” covers a broad range of investments that are in common use worldwide.

3. Denying the benefits of an investment treaty to portfolio investments means leaving out such standard types of investments as minority equity holdings, such as of shares and stocks; bonds, debentures, and other forms of debt interests in a company; contractual rights, such as under turnkey contracts, production or revenue-sharing contracts, and concessions; rights conferred pursuant to law, such as licenses and permits; and other investments such as leases, mortgages, liens, and pledges.

4. One could ask whether it is worth negotiating an investment treaty that leaves such a wide array of investments without coverage. Certainly such a treaty could not be called “comprehensive.”

Offering fewer protections to portfolio investors than direct investors increases the risks associated with portfolio investment, raising the cost of borrowing foreign capital, which is a drag on the economy.

5. Developing countries, already contending with scarce economic resources, can little afford to worsen the terms facing domestic borrowers who wish to raise capital abroad. Recent research shows that increased openness to portfolio investment benefits the liberalizing country by decreasing the cost of capital in that country and giving domestic investors access to global financial markets, which enables them to share risk with other investors. An IMF study of 38 developing countries over the period 1980–1999 found that capital account liberalization generally leads to greater capital inflows and, with good management of these inflows, more domestic investment and higher growth. The growth effects of liberalization on developing countries came from both FDI and portfolio investment.

It is not always possible to decide what constitutes a portfolio investment.

There is no easy way to distinguish between direct and portfolio investment in many cases. For example, a venture capitalist might loan a foreign start-up company a large amount of money, underlying a large share of the start-up’s assets. The venture capitalist may not hold any evidence of ownership because no shares have been issued, only debt or have measurable control over the start-up. This type of start-up capital is critical to many successful businesses.

Because portfolio and direct investment are not always easily distinguished, removing portfolio investment from the definition of investment would require case-by-case analysis to determine which kind of investment a given investor had made, or intended to make, and whether it was covered by the investment agreement. At best, this would complicate the investment process considerably; at worst, it could lead to disputes between treaty partners and weaken the treaty’s ability to promote overseas investment in general.

Portfolio investment is a concomitant of direct investment.

It is not possible to isolate foreign direct investment from portfolio flows, because direct investors will be engaged in portfolio investment as they manage their cash flows. For example, the treasurer of Ford’s operations in Europe will be in and out of the “portfolio” markets as he manages the cash and other financial assets involved in the business. Any classic direct investment of any size and autonomy will have a similar treasurer’s function, and be an active portfolio investor. Portfolio investment characteristically accompanies direct investment across borders. An agreement limited to FDI denies the benefit of the agreement to portfolio investor partners and to the portfolio operations within a direct investment and thus will act to discourage FDI.


135 “International Financial Integration and Developing Countries”, World Economic Outlook, IMF, October 2001, pp. 152-159.
Restrictions on portfolio capital flows to capital-starved countries is not a long-term solution to financial instability.

In the aftermath of the financial crises of the 1990’s, there has been criticism of capital market liberalization for promoting short term capital inflows – sometimes referred to as "speculative capital" – into emerging market economies. The problem is not with capital market liberalization, or with short term capital flows per se. Empirical research by the World Bank demonstrates that in the long run, volatility tends to decrease following liberalization and integration with world financial markets. One study, which examined a sample of 103 countries from 1980 to 1996, found that portfolio investment was only slightly more volatile than FDI. Among 85 emerging market countries over the same interval, the levels of volatility of FDI and portfolio investment were actually equal. However, the process of capital account opening has been shown to raise, temporarily, the danger of volatility. This argues for a careful approach to financial liberalization itself, mostly through the establishment of supportive macroeconomic and structural policies, in particular, improved bank regulation, prudential standards, and other safeguards.

In the Asian financial crisis, certain countries were vulnerable to sudden capital outflows in part because their domestic banks had too much exposure in short-term foreign currency-denominated borrowing. In some cases, bank customers were permitted to borrow short-term in hard currency even though proper credit analysis would have shown they were not good risks for such lending. The solution is not to restrict portfolio investment per se, but to improve financial supervision, surveillance, and risk analysis, such as through standards developed by the Financial Stability Forum, which was established shortly after the Asian financial crisis to strengthen international financial cooperation and stability.

Excluding portfolio investment defeats the purpose of an international investment agreement.

6. Governments should be as open to portfolio investment as they are to direct investment. There is general agreement on the positive role of investment in promoting sustainable growth in developing economies. This is true of both direct and portfolio investment flows. Potential investors would have to question the commitment to liberalization and investment protection of a country that would not agree to extend treaty rights to portfolio investment.

7. Including portfolio investment in the definition of investment does not mean that host governments will not be able to treat portfolio investment differently from direct investment. Most regulations of the financial markets need not violate the agreement, as they need not discriminate between foreign and domestic investors. In a U.S. Bilateral Investment Treaty (BIT), for example, the transfers provision permits financial market regulators to prevent or delay a transfer if necessary for the proper functioning of the market, and allows for the mandatory reporting of transactions that may be required by financial regulations.

CONCLUSION

The United States favours a broad definition of investment that includes both direct and portfolio investment. Our experience, based on negotiation of more than forty BITs, the NAFTA, and the ongoing FTAA and bilateral FTAs with Chile and Singapore, is that a broad, open-ended definition is necessary to maximize the benefits of investment liberalization and protection. We believe that covering portfolio investment can contribute to the development agenda of this round by making developing and emerging market countries more attractive hosts to foreign capital, deepening local financial markets, and furthering global economic integration. We would be interested in exploring with our colleagues how best to realize the advantages of portfolio investment coverage while responding to the challenges, for example, through technical assistance and capacity building in the areas of bank supervision and regulation. The task ahead is to build on our shared experience of covering portfolio investment in our bilateral treaties, and to internationalize it in a high-standards investment agreement from which all WTO members may benefit.

Source: WTO (http://docsonline.wto.org)


Appendix Box 2

Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose

Effects of Financial Globalization on Developing Countries: Some Empirical Evidence
International Monetary Fund - (March 17, 2003)

"SUMMARY"

“This paper provides a review of recent empirical evidence, including some new research, on the effects of financial globalization for developing economies. The paper focuses on three questions:

(i) Does financial globalization promote economic growth in developing countries?
(ii) What is its impact on macroeconomic volatility in these countries?
(iii) What factors can help to harness the benefits of financial globalization?

‘Developing economies’ financial linkages with the global economy have risen significantly in recent decades. However, a relatively small group of these countries has garnered a lion’s share of private capital flows from industrial to developing countries, which surged in the 1990s. Despite the recent sharp reversals in such “North-South” capital flows, various structural forces are likely to lead to a revival of these flows, and to continued financial globalization, over the medium and long term.

Theoretical models have identified a number of channels through which international financial integration can promote economic growth in developing countries. However, a systematic examination of the evidence suggests that it is difficult to establish a strong causal relationship. In other words, if financial integration has a positive effect on growth, there is as yet no clear and robust empirical proof that the effect is quantitatively significant.

There is some evidence of a “threshold effect” in the relationship between financial globalization and economic growth. The beneficial effects of financial globalization are more likely to be detected when the developing countries have a certain amount of absorptive capacity. Preliminary evidence also supports the view that, in addition to sound macroeconomic policies, improved governance and institutions have an important impact on a country’s ability to attract less volatile capital inflows, and on its vulnerability to crises.

International financial integration should, in principle, also help countries to reduce macroeconomic volatility. The available evidence suggests that developing countries have not fully attained this potential benefit. Indeed, the process of capital account liberalization appears to have been accompanied in some cases by increased vulnerability to crises. Globalization has heightened these risks since cross-country financial linkages amplify the effects of various shocks and transmit them more quickly across national borders. A type of threshold effect appears here as well—reductions in volatility are observed only after countries have attained a particular level of financial integration.

The evidence presented in this paper suggests that financial integration should be approached cautiously, with good institutions and macroeconomic frameworks viewed as important. The review of the available evidence does not, however, provide a clear road map for the optimal pace and sequencing of integration. For instance, there is an unresolved tension between having good institutions in place before undertaking capital market liberalization and the notion that such liberalization can itself help import best practices and provide an impetus to improve domestic institutions. Such questions can best be addressed only in the context of country-specific circumstances and institutional features.”

Figure A.1 - M&A Purchases by Industry
(percentage shares of total purchases)

Source: UNCTAD FDI/TNC database

Figure A.2 - Inward FDI stock as share of GDP
(per cent, year 2000)

Source: OECD 2002: 54 - UNCTAD data

Appendix Figure 3 - Total resource flows to developing countries, by type of flow, 1990-2001 (billion US$)

Source: UNCTAD (2002: 12 – Figure I.7)
Figure A.4 - BITs concluded in 2001, by country group

- 42% Between developed and developing countries
- 33% Between developed countries and countries of CEE
- 11% Between countries of CEE and developing countries
- 8% Between countries of CEE
- 6% Between developing countries

Source: UNCTAD (2002: 8 – Box Figure I.3.1)

Figure A.5 - Participation of countries in BITs, by region and decade, 1960-1999

Source: UNCTAD (2000: 15 - Figure 4)
Figure A.6 - World FDI inflows, top 10 economies (billion US$)

Source: UNCTAD (2002 – Overview, p.6 – Figure 2)

Figure A.7 - World FDI outflows, top 10 economies (billion US$)

Source: UNCTAD (2002 – Overview, p.7 – Figure 3)