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FDI Perspectives: Issues in International Investment, 2nd Edition

FDI Perspectives: Issues in International Investment, 2nd Edition

Edited by Karl P. Sauvant and Jennifer Reimer (New York: VCC, 2012).

This second edition provides an overview of important contemporary issues relating to foreign direct investment (FDI) and multinational enterprises for all those who are interested in this subject, but are not always in a position to follow diverse perspectives and what is being written in the various corners of this field. The contributions are grouped under the following headings: attracting FDI and its impact; the rise of emerging market investors; national policies; sustainable international investment; and international investment treaties and arbitration. The volume brings together all Perspectives published since the inception of this series.

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Vale Columbia Center
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FDI PERSPECTIVES

ISSUES IN INTERNATIONAL INVESTMENT

2012

Edited By

Karl P. Sauvant Jennifer Reimer

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Issues in International Investment

2nd Edition

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The Vale Columbia Center on Sustainable International Investment (VCC) is a leading forum on issues related to foreign direct investment (FDI), paying special attention to the impact of such investment on sustainable development. Its objectives are to analyze important topical policy-oriented issues related to FDI, develop and disseminate practical approaches and solutions, and provide students with a challenging learning environment.

The views expressed by the individual authors of the chapters in this ebook do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* is a peer-reviewed series.

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1. *Sjoerd Beugelsdijk, Jean-François Hennart, Arjen Slangen, and Roger Smeets*
FDI stocks are a biased measure of foreign affiliate activity

Researchers often call the value added (VA) in a host country by firms based in another country "FDI" and use FDI stocks and flows from a country's balance of payments to measure it. Because FDI stocks and flows only measure the financial flows between parents and their foreign affiliates, excluding locally raised funds, and because they omit the contribution of local labor to affiliate VA, they systematically underestimate that VA in more developed countries and thus are a biased measure of multinational activity.

2. *Mira Wilkins*
FDI stocks are a biased measure of MNE affiliate activity: A response

The term "FDI" is often used loosely. This chapter explains the historical genesis of that loose use and the relationship between FDI and MNEs. FDI stock is one of many measures of MNE activities, but has advantage over the others, since we have long, albeit imperfect, series on FDI stock. Handled with care, along with a keen recognition of the data limitations, FDI continues to serve as one excellent indicator of MNE activities.

3. *Kálmán Kalotay*
Does it matter who invests in your country?

"Indirect" FDI -- investment in which immediate investors differ from ultimate owners -- plays an increasingly important role in corporate strategies and financial management. This chapter analyses its different forms, explores its implications for development, and suggests ways to minimize the potential negative impact of such investment.

4. *Karl P. Sauvant*
The FDI recession has begun

This chapter examines the various factors that shape the impact of the financial crisis and recession of world FDI flows and discusses some policy implications.

5. *Laza Kekic*
The global economic crisis and FDI flows to emerging markets: For the first time ever, emerging markets are this year set to attract more than half of global FDI flows

> For the first time ever, emerging markets are set to attract more FDI inflows than developed countries in 2009. This chapter examines this prospect, based on an analysis of the severe downturn of investment flows worldwide.

6. *Paul Antony Barbour, Persephone Economou, Nathan M. Jensen, and Daniel Villar*
The Arab Spring: How soon will foreign investors return?

> The Arab Spring dramatically increased investors' perceptions of political risk in MENA. An examination of these perceptions indicates long-run optimism that political transitions in the region -- if democratic and coupled with political stability -- could increase FDI and contribute to MENA's economic development.

7. *Ken Davies*
Why and how least developed countries can receive more FDI to meet their development goals

> The 48 least-developed countries (LDCs), most of them in sub-Saharan Africa and a few in Asia, need FDI to help meet their development targets. The FDI they now receive, although inadequate, is enough to demonstrate that investors see potential in them. It is therefore realistic for LDCs to seek more FDI, but they need to enhance their investment environments to attract it in the much greater quantities required. Donors can help by targeting official development assistance on investment in human capital and supporting governance improvements. Meanwhile, LDCs should establish effective investment promotion agencies.

8. *Karl P. Sauvant and Jonathan Strauss*
State-controlled entities control nearly US$ 2 trillion in foreign assets

> State-controlled entities (SCEs) -- especially state-owned entities (SOEs) -- are important players in the world FDI market. Among the 100 largest MNEs from developed countries and the 100 largest from emerging markets, at least 49 are SOEs. They control nearly US$ 2 trillion in foreign assets, the bulk of them by MNEs headquartered in developed countries. Care needs to be exercised that regulatory initiatives regarding SCEs do not lead to a fragmentation of the international investment law regime.

9. *Nilgün Gökgür*
Are resurging state-owned enterprises impeding competition overseas?

> There are no up-to-date systematic data on the size, composition, ownership structure, and economic weight of SOEs, so we are unable to assess the impact of SOE performance on stakeholders in domestic and overseas markets. Yet there is

sufficient evidence of their expansion, especially following the 2008 financial crisis. Emerging markets, led by China, are now increasingly encouraging their SOEs to expand globally as MNEs.

10. *Veljko Fotak and William Megginson*
Are SWFs welcome now?

This chapter documents the change in attitudes of Western governments to FDI from sovereign wealth funds (SWFs). The authors propose an analysis of SWF investments and their impact on target firms in order for recipient governments to formulate the proper regulatory response to sovereign direct investment.

11. *Charles Kovacs*
Sovereign wealth funds: Much ado about some money

This chapter makes the point that SWFs constitute only one of the pools of anonymous capital, and for that matter, not even one of the most important ones. However, the author recognizes that issues of national security are involved and require attention.

12. *Torfinn Harding and Beata Javorcik*
Roll out the red carpet and they will come: Investment promotion and FDI inflows

Foreign direct investment flows to developing countries are hindered by many factors. Two of these factors -- the mere lack of information and red tape -- could be easily remedied through investment promotion efforts.

13. *José Guimón*
It's time for an EU Investment Promotion Agency

The author proposes an EU investment promotion agency (IPA) that coordinates FDI promotion and support for foreign investors at a regional level.

14. *Kenneth P. Thomas*
Investment incentives and the global competition for capital

Investment incentives (subsidies designed to affect the location of investment) are a pervasive feature of global competition for FDI. This chapter analyzes what is known about the extent and cost of incentives used as well as the potential efficiency, equity and environmental consequences of using incentives. Finally, it analyzes methods of controlling incentives, the most successful of which is embodied in European Union regional aid policy.

15. *Nathan M. Jensen and Edmund J. Malesky*
FDI incentives pay -- politically

> There are strong political benefits to attracting FDI at the state-level in the United States. The fiscal incentives for attracting such investment, regardless of their effectiveness, may be a strategic political tool for state politicians.

16. *Christian Bellak and Markus Leibrecht*
Improving infrastructure or lowering taxes to attract foreign direct investment?

> This chapter compares the impact of improving infrastructure versus lowering taxes on attracting and keeping FDI and discusses the policy implications for countries seeking to attract FDI, especially countries currently debating the relative merits of cutting taxes versus increased spending.

PART II THE RISE OF EMERGING MARKET INVESTORS

17. *Persephone Economou and Karl P. Sauvant*
From the FDI triad to multiple FDI poles?

> Twenty years ago, in the inaugural issue of the *World Investment Report*, the United Nations highlighted a shift in the global pattern of FDI from bipolar, dominated by the United States and the European Community, to tri-polar (the FDI Triad), dominated by the European Community, the United States and Japan.

18. *Premila Nazareth Satyanand*
How BRIC MNEs deal with international political risk

> The author analyzes the results of a survey of political risk concerns of outward-investing BRIC firms and compares the results to the concerns of global counterparts.

19. *Miguel Pérez Ludeña*
Is Chinese FDI pushing Latin America into natural resources?

> Chinese FDI into Latin America reached US$ 15 billion in 2010, 90% of which was in the extractive industries. An analysis of the figures shows that it is mainly through trade, rather than through FDI that China is influencing South America's productive structure. Moreover, there is potential for Chinese FDI to diversify into other sectors, especially in infrastructure construction and manufacturing for the Brazilian market.

20. *Ilan Alon and Aleh Cherp*
Is China's outward investment in oil a global security concern?

> The dramatic increase in investment by Chinese SOEs in overseas oil assets is primarily driven by energy security concerns. Whether such investment will benefit or harm energy security of other countries is hotly contested. On one hand, this investment can supplement the overall lack of investment in the sector, benefiting all consumers. On the other hand, it may exacerbate environmental and political problems associated with fossil fuels.

21. *Terutomo Ozawa and Christian Bellak*
Will China relocate its labor-intensive factories to Africa, flying-geese style?

> The authors explore the China-side determinants of China's industrial relocation to sub-Saharan Africa, highlighting several hurdles to substantial translocation that would jump start local economic development.

22. *Harry G. Broadman*
The backstory of China's and India's growing investment and trade with Africa: Separating the wheat from the chaff

> Common misconceptions about China's and India's increasing FDI in Africa have arisen because of a lack of systematic evidence-based analysis. Empirically-derived data, including on comparator countries, need to be rigorously analyzed within an objective and coherent framework so that policy conclusions can be drawn, which will benefit the many stakeholders involved.

23. *Karl P. Sauvant and Ken Davies*
What will an appreciation of China's currency do to inward and outward FDI?

> A revaluation of the Chinese yuan would affect the country's inward and outward FDI, not just its exports and imports. The impact on FDI inflows to China would be both positive and negative. On the other hand, revaluation is likely to provide a strong boost to overseas investments by China's multinationals, which have been rising rapidly in recent years. Suspicions that China's outward FDI is politically motivated are not so far borne out by systematic evidence. The rest of the world should learn how to benefit from this investment, not try to raise protectionist barriers against it.

24. *Karl P. Sauvant, Chen Zhao and Xiaoying Huo*
The unbalanced dragon: China's uneven provincial and regional FDI performance

> This chapter ranks all Chinese provinces in terms of their performance in attracting FDI, examines the reasons for the high unevenness of this performance and makes some policy suggestions on how to deal with it.

25. *Gert Bruche*
A new geography of innovation: China and India rising

This chapter explains the factors behind the sudden shift toward China and India for MNE R&D centers and explores how the financial crisis will affect China's and India's ability to continue to capture the R&D market.

26. *Gert Bruche*
Emerging challengers in knowledge-based industries? The case of Indian pharmaceutical multinationals

The growth of outward FDI from developing countries and of a new generation of emerging multinational enterprises has stimulated a flurry of publications. Emerging MNEs have been portrayed as on their way to adulthood, latecomers that leapfrog into advanced positions, emerging giants, and challengers of conventional MNEs from advanced economies.

27. *Michael Mortimore and Carlos Razo*
Outward investment by Trans-Latin enterprises: Reasons for optimism

Despite the global crisis, outward FDI by Latin American firms grew by more than 40% in 2008. The picture for 2009 is less clear, due to the expected regional GDP contraction, falling commodity prices, and tightening credit markets. Nonetheless, many countervailing factors make Latin American investment more resilient in the crisis than other regions may be.

PART III NATIONAL POLICIES

28. *Alice H. Amsden*
National companies or foreign affiliates: Whose contribution to growth is greater?

National firms fulfill functions that foreign affiliates are less likely to undertake. For this reason, there is a growth/efficiency justification for government programs designed to support and promote national companies (public and private) as opposed to, and in competition with, opening the doors to MNEs.

29. *Terutomo Ozawa*
The role of multinationals in sparking industrialization: From "infant industry protection" to "FDI-led industrial take-off"

Economic development has recently been time-compressed due to an ever-accelerating cross-border dissemination of industrial knowledge, especially at the hands of MNEs. And a new "open-door" strategy of industrial catch-up has come to be adopted, as best exemplified by China's FDI-led take-off, a strategy that is designed to capitalize on the profit-seeking activities of multinationals. This new approach needs to be conceptualized as such, replacing the time-honored

conventional "closed-economy" doctrine of infant-industry protection (or import substitution).

30. *Francisco Sercovich*
Knowledge, FDI and catching-up strategies

> There are policies that drive catching-up industrialization other than, but related to, those focused on FDI inflows. The shortening of catching-up periods owes much to the increasing effectiveness of policies addressing education and training, entrepreneurship development and domestic innovation and technology diffusion. FDI inflows work best when those policies are in place. Domestic absorption and innovative capability development policies are also essential.

31. *Terutomo Ozawa*
FDI, catch-up growth stages and stage-focused strategies

> For the initial stage of catch-up growth, the "FDI-led takeoff" is an expedient alternative to the traditional infant-industry protection approach. Higher stages call for more nuanced, national-interests-dictated strategies to enhance domestic knowledge capability. A stages perspective cannot be overemphasized.

32. *Thomas Jost*
Much ado about nothing? State-controlled entities and the change in German investment law

> Despite a tightening of German foreign investment law in 2009 in reaction to the growing importance of SCEs and national security concerns, Germany has remained open for FDI. So far German authorities have handled the new law carefully. But, was the change necessary?

33. *Subrata Bhattacharjee*
National security with a Canadian twist: The Investment Canada Act and the new national security review test

> This chapter discusses issues raised by the new national security test for proposed investments in Canada, including the ambiguity of the "national security" term and the possibility of politicized national security reviews. The government should be careful not to adopt an over-expansive approach to the application of the new test.

34. *Sandy Walker*
A new economic nationalism? Lessons from the PotashCorp decision in Canada

> Foreign investors must be alert to the possibility that political sensitivities may impact foreign investment review processes, hence jeopardizing a small number of deals involving perceived national champions. One example, which underlines

that politics can occasionally hijack the review of foreign investments, is the Canadian Government's rejection of BHP Billiton's takeover of Potash Corporation.

35. *Mark E. Plotkin and David N. Fagan*
The revised national security review process for FDI in the US

This chapter explains the new regulations governing the US government's national security review process for foreign mergers and acquisitions of US businesses, which became effective December 22, 2008.

36. *Mark E. Plotkin and David N. Fagan*
Foreign direct investment and US national security: CFIUS under the Obama Administration

The Committee on Foreign Investment in the United States review process slowed during the inaugural year of the Obama Administration. The authors examine the origins of this shift and suggest actions that parties can take to facilitate the process.

37. *Thilo Hanemann and Daniel Rosen*
Chinese FDI in the United States is taking off: How to maximize benefits?

China's outward FDI grew rapidly in the past decade, but flows to developed economies have been limited. Now China's direct investment flows to the United States are poised to rise substantially. This new trend offers tremendous opportunities for the United States, provided policymakers take steps to keep the investment environment open and utilize China's new interest productively.

38. *Sophie Meunier et al.*
Economic patriotism: Dealing with Chinese direction investment in the United States

As Chinese FDI in the United States increases, a few investments are likely to attract negative attention. However, even though hosting Chinese FDI in the United States is not free from risk, the benefits outweigh the costs. As such, the United States should implement policy recommendations to welcome Chinese FDI, while dealing with its potential risks to limit a possible political backlash.

39. *Terutomo Ozawa*
Can the US remain an attractive host for FDI in the auto industry? New labor policy and flexible production

The proposed Employee Free Choice Act, if enacted, would decrease the attractiveness of the United States for FDI in the auto industry.

40. *Reuven S. Avi-Yonah*
President Obama's international tax proposals could go further

> The Obama Administration's 2011 international tax proposals represent a very cautious first step toward making US multinationals pay their fair share of the tax burden. Coordination with our FDI partners would allow the Administration to go even further.

41. *Geraldine McAllister and Joel H. Moser*
Beyond treasuries: A foreign direct investment program for US infrastructure

> In his jobs address to a joint session of Congress, President Obama returned to a familiar theme: a call for nontraditional infrastructure investment as a generator of economic growth and, ultimately, jobs. There is no assurance that domestic private capital investment alone is sufficient to reverse the degradation of the nation's infrastructure and as host to the largest flows of inward FDI, it is time that the United States employs this critical source of capital in tackling the nation's infrastructure deficit.

42. *Nandita Dasgupta*
FDI in retailing and inflation: The case of India

> India's food price inflation is a major driving factor behind the country's overall accelerating inflation. As demonstrated by experiences of other countries, the recent move of the Indian Government to allow FDI in multi-brand retailing is a step in the right direction, transforming the way perishable agricultural produce is acquired, stored, preserved, and marketed -- and thus helping to control India's persistent food inflation.

43. *Persephone Economou and Margo Thomas*
Greek FDI in the Balkans: How is it affected by the crisis in Greece?

> Greece accounts for only 6% of the Balkan countries' combined inward FDI stock, but Greek banking presence in the Balkans is significant. The sovereign debt crisis and recession in Greece are having a negative effect on Greek FDI into the Balkans, but it is the reduced lending by Greek bank foreign affiliates or their possible withdrawal that will have a bigger impact on the local economies.

44. *Seev Hirsch*
Nation states and nationality of MNEs

> Do nation states have an economic interest in becoming home countries to MNEs? This chapter's tentative answer to the questions is "yes." Other things being equal, extension of global reach, achieved through outgoing FDI by home country enterprises, is likely to more than make up for the tax losses and diminution of sovereignty these countries may experience.

45. *Karl P. Sauvant*
The times are a-changin' -- again -- in the relationship between governments and multinational enterprises: From control, to liberalization to rebalancing

> After a long period during which governments made the national and international frameworks for foreign investors more welcoming, a number of indicators suggest that a rebalancing is taking place toward an approach that is more protective of sovereigns, allowing governments more policy space to regulate FDI in the public interest.

PART IV SUSTAINABLE INTERNATIONAL INVESTMENT

46. *John M. Kline*
Evaluate sustainable FDI to promote sustainable development

> Prescriptions to increase the role of FDI in promoting sustainable development generally focus on the macro level -- getting policies right and otherwise improving the investment climate. These steps are necessary but not sufficient. Effective implementation processes, especially at the micro project level, are also essential to encourage FDI that matches host country development needs and priorities.

47. *Manfred Schekulin*
Shaping global business conduct: The 2011 update of the OECD Guidelines for Multinational Enterprises

> On May 25, 2011, US Secretary of State Hillary Clinton joined ministers from members of the OECD and developing economies to celebrate the Organisation's 50th anniversary and agree on an update of the OECD Guidelines for Multinational Enterprises, the fifth revision since their adoption in 1976. This marked the culmination of an intense one-year negotiating process involving a large number of stakeholders, international organizations and emerging economies.

48. *John Evans*
Responsible business conduct: Re-shaping global business

> The OECD's Guidelines for Multinational Enterprises were updated in 2011. Trade unions are calling on the OECD and the 42 adhering governments to ensure that the new Guidelines help close the global governance gaps that leave millions of workers around the world facing hardship and insecurity and denied access to their fundamental rights.

49. *Tadahiro Asami*
Toward the successful implementation of the updated OECD Guidelines for Multinational Enterprises

> The OECD's Guidelines for Multinational Enterprises have several potential impacts, including impacts on MNEs' interactions with their supply chains. Further, to be successful, it is important that the Guidelines are incorporated into MNEs' codes of conduct. It is also essential for emerging markets to adhere to the Guidelines.

50. *Perrine Toledano and Julien Topal*
A good business reason to support mandatory transparency in extractive industries

> The Cardin-Lugar Transparency Amendment is a promising step toward ending the resource curse by improving accountability and access to information for both citizens and investors. The Amendment has run into heavy corporate opposition, and its implementation has been much delayed. However, there is a business case for mandatory transparency requirements.

51. *Lorenzo Cotula*
Law at two speeds: Legal frameworks regulating foreign investment in the global South

> The global legal system regulating foreign investment in lower-income countries is more geared towards enabling secure transnational investment flows than it is towards ensuring that these flows benefit people in recipient countries. There is a need to improve national and international law safeguards for rights that may be affected by investment flows, and to strengthen local capacity to exercise those rights and get a better deal from incoming investment.

52. *Lorenzo Cotula*
Land grab or development opportunity? International farmland deals in Africa

> This chapter discusses the increasing number and size of large-scale farmland acquisitions in Africa by foreign investors over the past five years, including the opportunities and risks created by this trend.

53. *Xiaofang Shen*
Untying the land knot: Turning investment challenges into opportunities for all citizens

> Land-use conflicts also occur frequently outside the agricultural sector. In dealing with these conflicts, systematic change is necessary to lead to a fair, efficient and transparent system that both encourages investment and safeguards public interests. Diverse examples demonstrate that, although such change is difficult, it is possible and desirable.

54. *Daniel M. Firger*
The coming harmonization of climate change policy and international investment law

> The author examines recent trends in international climate finance and foreign direct investment to identify connections -- and potential areas of harmonization -- between the two regimes. On the one hand, international climate policy is emphasizing the growing role of private sector investment in clean energy and sustainable development. On the other hand, international investment law is changing to take account of social and environmental goals, including climate mitigation.

55. *Nicolás Perrone*
Responsible agricultural investment: Is there a signification role for the law in sustainability?

> Today, the world food situation remains delicate. International investment and MNE involvement could be part of the solution to this problem. However, there are many concerns regarding the effects of these activities in host countries. An adequate interpretation of the Principles for Responsible Agricultural Investment could serve to promote sustainable foreign investment in agriculture.

56. *Lise Johnson*
Absent from the discussion: The other half of investment promotion

> Investment treaties can be tools for promoting the quantity and quality of foreign investment that furthers sustainable development. But to do so, they should move beyond their current focus on simply regulating the conduct of host states, and include appropriate home-country commitments to facilitate and encourage outward investment.

57. *Kathryn Gordon and Joachim Pohl*
Environmental concerns in international investment agreements: The "new era" has commenced, but harmonization still appears far off

> The authors present findings of a large-sample survey of references to environmental concerns in international investment agreements carried out by the OECD.

PART V INTERNATIONAL INVESTMENT TREATIES AND ARBITRATION

58. *Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy*
Attracting FDI through BITs and RTAs: Does treaty content matter?

> The authors analyze empirically whether the impact of bilateral investment treaties (BITs) and regional trade agreements (RTAs) on bilateral FDI flows depends on the inclusion of two legal innovations: investor-state dispute

settlement (ISDS) and pre-establishment national treatment (NT) provisions. Indeed, they find strong evidence that liberal NT provisions promote FDI. ISDS mechanisms appear to play a minor role. Surprisingly, the impact of similar investment provisions on FDI depends on whether these provisions are contained in RTAs or BITs.

59. *Clint Peinhardt and Todd Allee*
Different investment treaties, different effects

Until recently, quantitative assessments of IIAs have tended to treat them as interchangeable. Such assessments assume that the only measure of investor protections encoded in IIAs is whether a treaty had been signed and/or entered into force. However, the actual investment effects of investment treaties depend greatly on context.

60. *Elizabeth Broomfield*
Reconciling IMF rules and international investment agreements: An innovative derogation for capital controls

In the absence of an international framework governing capital controls, a conflict has developed due to the different approaches toward such controls taken by various international organizations and IIAs. IIAs should incorporate derogations for countries when treaty obligations conflict with IMF recommendations to impose controls in response to severe economic hardship.

61. *Lauge Skovgaard Poulsen*
Political risk insurance and bilateral investment treaties: a view from below

While BITs are basically aimed at reducing the risk of investing abroad, many agencies that price the risk of foreign investments rarely take them into account, as evidenced by a survey of political risk insurance providers.

62. *Jason Webb Yackee*
How much do US corporations know (and care) about bilateral investment treaties? Some hints from new survey evidence

New evidence shows that top US corporations are surprisingly unfamiliar with -- and/or lack confidence in -- BITs that are designed to benefit their investments in other countries. To understand whether or not such treaties “work,” it is necessary to find out how and why they do, or do not, form part of firms' investment decision-making.

63. *Kevin P. Gallagher*
US BITs and financial stability

> The author, a member of the State Department subcommittee tasked with reviewing the US Model BIT, addresses the potential impact of BIT provisions on the ability of governments to prevent and mitigate financial crises and makes specific recommendations for the revised Model BIT.

64. *George Kahale, III*
The new Dutch sandwich: The issue of treaty abuse

> Years ago, international tax lawyers introduced us to the term "Dutch sandwich." A different type of Dutch sandwich has emerged over the past fifteen years, this time not related to taxes. Companies from all over the world having little if anything to do with The Netherlands seek to acquire Dutch nationality to take advantage of the protections offered by Dutch BITs. However, this type of nationality planning is giving BITs a bad name.

65. *Luke Eric Peterson*
International investment law and media disputes: A complement to WTO law

> International investment law is a potentially powerful legal tool to protect freedom of expression, at least for foreign-owned media companies.

66. *Armand de Mestral*
Is a model EU BIT possible -- or even desirable?

> The author explores whether the EU is in a position to adopt a model BIT articulating a common policy on FDI.

67. *Susan D. Franck*
International investment arbitration: winning, losing and why

> This chapter reviews recent empirical research about investment treaty arbitration in order to help create a more accurate framework for policy choices and dispute-resolution strategies.

68. *Gus Van Harten*
Thinking twice about a gold rush: *Pacific Rim v El Salvador*

> Drawing on the case brought against El Salvador by Pacific Rim, the author examines the tension in international investment law between encouraging stability and allowing adaptation to new circumstances and raises a number of resulting concerns about the international arbitration process.

69. *Alexandre de Gramont*
Mining for facts: *PacRim Cayman LLC v. El Salvador*

> The author by briefly presents Pacific Rim's case in Pacific Rim v. El Salvador and defends the international arbitration process by which this case is being adjudicated as fair, neutral and objective for both parties.

70. *Stephan W. Schill*
The public law challenge: Killing or rethinking international investment law?

> The current legitimacy crisis of international investment law results primarily from the friction investor-state arbitration creates with domestic public law values. As a response, arbitrators should enculturate public law thinking. They should draw on comparative public law when applying investment treaties and reconsider their role as public law adjudicators with concomitant responsibilities for the entire system of international investment protection.

71. *Hans Smit*
The pernicious institution of the party-appointed arbitrator

> Party-appointed arbitrators should be banned unless their role as advocates for the party that appointed them is fully disclosed and accepted. Until this is done, arbitration can never meet its aspiration of providing dispassionate adjudication by those with special skills and experience in a process designed to combine efficiency with expertise.

72. *Giorgio Sacerdoti*
Is the party-appointed arbitrator a "pernicious institution"? A reply to Professor Hans Smit

> The appointment of arbitrators by parties is an essential valuable feature of arbitration. Prof. Smit's concerns regarding party-appointed arbitrators can be met by the application of conflict-of-interest rules, obligations to disclose and oversight by arbitral institutions.

73. *M Sornarajah*
Starting anew in international investment law

> There is a crisis in international investment law brought about by rapid changes in the economic order resulting in movements of capital from erstwhile developing countries like China and India into developed ones. This is accentuated by the stances taken in investment treaty arbitration that restrict regulatory control. The reaction has been to bring about so called "balanced treaties" that neither secure investment protection nor bring about clear rules on regulatory control. There is a need for a new beginning.

74. *Gus Van Harten*
The (lack of) women arbitrators in investment treaty arbitration

> Investment treaty arbitration appears to be a boy's club. Just 4% of individuals appointed as arbitrators in known cases to May 2010 were women. This casts doubt on the system's ad hoc and partly-privatized appointments process. A roster-based model would enable a more deliberative and merit-based process of appointments and ensure public accountability and independence in the system.

75. *Michael D. Nolan and Frédéric G. Sourgens*
State-controlled entities as claimants in international investment arbitration: An early assessment

> State-controlled entities, including SOEs and SWFs, are increasingly important participants in international investment flows and international trade. As claimants in contractual arbitrations, they may face some unique issues, since it is not always clear whether such disputes may be considered "commercial." Until the status of such claims has been resolved, each case has to be examined on its merits.

76. *Mark Feldman*
The standing of state-controlled entities under the ICSID Convention: Two key considerations

> ICSID tribunals likely will need to address with greater frequency the fundamental issue of whether disputes arising from SCE investments fall within the scope of the ICSID Convention. To help preserve clear ICSID Convention boundaries -- which exclude public foreign investment disputes between states -- ICSID tribunals should consider not only the nature, but also the purpose, of SCE investments.

77. *Jo En Low*
State-controlled entities as "investors" under international investment agreements

> A review of the definition of "investor" and investor-state dispute resolution clauses in 851 IIAs reveals that, except in two cases, SCEs (including SWFs and SOEs) have equivalent standing to their purely private counterparts as "investors" under such IIAs. This article highlights the various ways in which SCEs are covered under the definition of "investor."

78. *Hermann Ferre and Kabir Duggal*
The world economic crisis as a changed circumstance

> There is little evidence that the investment treaty regime anticipated the possibility of a worldwide economic crisis like that of 2008-2010. While claims against states responding to the crisis have yet to materialize, most investment

treaties are silent with respect to a limitations period. Such claims may appear long after the crisis. States have, however, another defense: changed circumstances.

79. *Anne van Aaken and Jürgen Kurtz*
The global financial crisis: Will state emergency measures trigger international investment disputes?

It is possible that emergency measures countries are taking to mitigate the effects of the global financial crisis will give rise to liability under international investment law.

80. *Kathryn Gordon and Joachim Pohl*
The response to the global crisis and investment protection: Evidence

The authors, presenting findings of the OECD, challenge the claim that investment policy measures taken during the crisis were driven by a protectionist agenda but caution that crisis response and exit policies pose a potential threat to investment openness.

Acknowledgments

Foreign direct investment by multinational enterprises continues to be a key mechanism integrating the production systems of individual countries. Not surprisingly, this process -- which, in many ways, represents the productive core of the world economy and is more intrusive than trade -- gives rise to a range of issues. The purpose of the *Columbia FDI Perspectives* is to address these issues in a concise, easily understandable and policy-oriented manner. The *Perspectives* are distributed widely.

In January 2011, the *Perspectives* issued until then were brought together in the first edition of *FDI Perspectives: Issues in International Investment*, edited by Karl P. Sauvant, Lisa Sachs, Ken Davies, and Ruben Zandvliet, published by the Vale Columbia Center on Sustainable International Investment. Since then, nearly 50 *Perspectives* have been issued, covering a wide range of topics; they are all brought together (in addition to those contained in the first edition) in the present volume.

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We hope that our readers will find this publication of interest!

New York and Dubai, November 2012

Karl P. Sauvant, Editor-in-Chief
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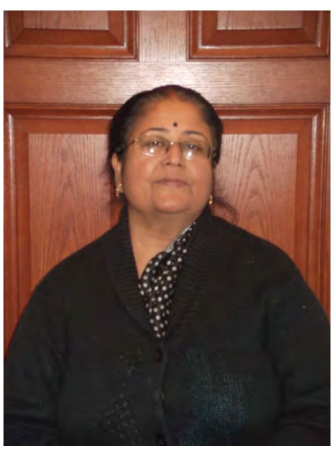

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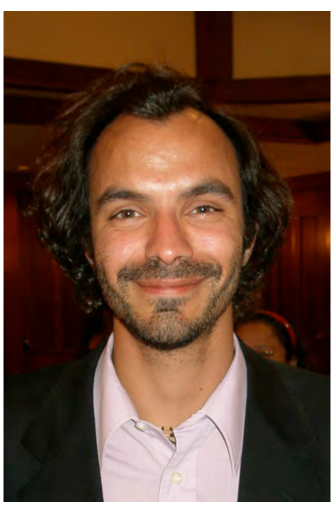

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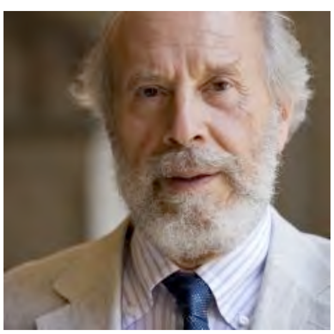

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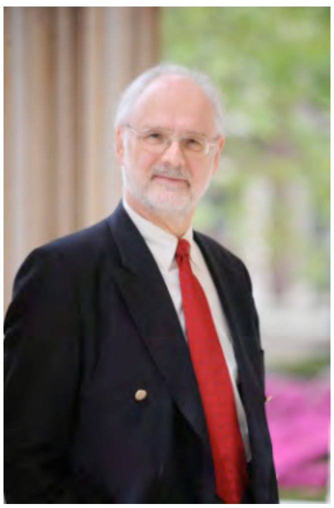

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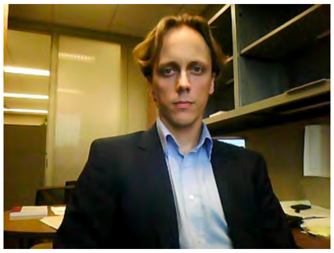

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Foreword

This volume is a welcome contribution to discussions on international business research, establishing important connections between that research and the world of policymaking and practice. Special emphasis is given to questions of the relationship between international business and national economic development and to how foreign direct investment (FDI) has affected -- and is being affected by -- recent trends and changes in the global economy. While the chosen format of brief articles concisely presents each subject, what is effectively a substantial series of executive summaries sets out key ideas on a wide variety of issues. What is more, the selection of topics draws our attention to principal areas of interest and debate in this field.

The coverage of this collection is certainly impressive. It deals with a wide range of the most topical issues under discussion today, including, for example, the global economic and financial crisis, multinational enterprises (MNEs) in and from the emerging markets, the Arab spring, sovereign wealth funds, Chinese investment in Africa and its effects, inward FDI and various countries' concerns over national security, and investment codes and regulations pertaining to corporate social responsibility. It is not only the broad coverage of issues that is noteworthy, but also that the long list of reputable authors reflects a broad spectrum of views about the major issues at hand. The brief format of each *Perspective*, as well as the large audience to which the articles are distributed, provide a platform on which members of the FDI community can challenge each other by presenting rebuttal articles. Because of this possibility of dialogue, the present volume brings out debates in the field, including different ways of addressing policy questions, apart from simply putting forward different ways of addressing a given research question.

Another attractive feature of this volume is that a number of articles revisit in a contemporary context some very long-standing questions in the field of international business and, as a result, generally add new gloss to our understanding. This applies in the case of the nature of FDI data and some of the practical difficulties in their use, whether the origins of ownership of firms matter to a host country, the networking of MNEs and their country of origin, the role of FDI in national and local economic development policy, the effectiveness of investment promotion agencies and investment incentives in attracting FDI, investment treaties viewed from the perspectives of firms and countries, and the creation of international investment law and policy. By their very nature, these are often issues worth revisiting from time to time, as the subject under investigation and the context within which it is set often change or become more complex over time.

Various articles connect topicality and revisit ongoing issues, perhaps thereby giving us a taste of familiar old wine but in new bottles, influencing the flavor we taste. Here we can refer, among other things, to discussions of the role of state-owned enterprises, which has re-emerged as a key issue for the field in an emerging market context; how what used to be described as Third World outward FDI has given way to a literature on emerging market MNEs and to a re-evaluation of the aggregate geographic patterns of world FDI, in or beyond the so-called triad of mature industrialized regions (Western Europe, North

America, Japan); and the association between currency appreciation and outward FDI from China, which recalls the discussion 40 years ago of currency overvaluation under the Bretton Woods regime and outward FDI from the United States, in the work of Aliber and others.

Finally, this volume offers us an updated refinement of some longer-standing concepts in the subject area of international business. These areas include the relationship between FDI and longer term paths of national economic development and the potential for countries catching up (most especially in the earlier work and the contributions here of Terutomo Ozawa, which are full of insight); and a re-working of the evolution of government-MNE relationships, such as in the reflections from many years of practical experience and knowledge of the co-editor of this volume, Karl P. Sauvant.

All in all, this is a valuable set of topical contributions to the field, which reflects the current state of thinking on a variety of crucial issues and concerns for researchers and policymakers.

Newark, October 2012 John Cantwell

Distinguished Professor (Professor II), Rutgers University
Editor-in-Chief, Journal of International Business Studies

Preface

The Western financial and economic crisis of 2008-2009, from which recovery has been slow and with significant risks, has taken its toll on world foreign direct investment flows: from a historic peak of US$ 2.2 trillion of outflows in 2007, they almost halved to US$ 1.2 trillion in 2009, recovering only slowly since then, to US$ 1.7 trillion in 2011.[1] Given the continuing uncertainty in the world economy, flows may well not rise much, if at all, in 2012 and 2013. Still, world investment flows have remained at a high level compared to the 1980s, when they barely averaged US$ 100 billion. This reflects, among other things, the growing internationalization of firms: by the end of 2011, more than 100,000 firms qualified as "multinational," i.e., firms that control assets abroad.

Importantly, however, as long as FDI flows remain positive, the stock of this investment continues to grow (at least as a rule). By the end of 2011, this (outward) stock had surpassed US$ 21 trillion. It represented at least 900,000 foreign affiliates, whose sales that year amounted to an estimated US$ 28 trillion -- distinctly a higher amount than world exports (of US$ 22 trillion) that year. Hence, foreign direct investment has become the most important vehicle to bring goods and services to foreign markets. This is more so the case because the actual reach of multinational enterprises is much wider than foreign direct investment data indicate, as these data do not capture the myriad of non-equity relationships (management contracts, franchising, etc.) that bring the production of firms abroad under the common governance of multinational enterprises.

As the flows and stock of foreign direct investment have grown, some of its salient features have changed. Particularly noteworthy in this respect is that emerging markets (all economies that are not members of the OECD) attract now more than half of such investment flows and (by the end of 2011) had attracted over one-third of the world's inward foreign direct investment stock. Simultaneously, firms headquartered in emerging markets have become important outward investors in their own right: at the end of 2011, there were over 30,000 multinational enterprises headquartered in these economies, investing that year US$ 460 billion abroad, for a stock of over US$ 4 trillion. A number of important emerging market multinational enterprises are state-controlled entities (although the foreign assets controlled by such entities headquartered in developed countries are much higher than those controlled by multinational enterprises headquartered in emerging markets). Emerging market firms have become important players in the world foreign direct investment market.

Given the importance of foreign direct investment, it is not surprising, therefore, that all countries, without exception, seek to attract such investment, as it can bring a range of tangible and intangible assets (including capital, technology, skills, managerial practices, access to world markets). Virtually every country has an investment promotion agency, supplemented often with similar institutions at the sub-national level. Also, countries continue to improve their investment climate for foreign direct investors. This is reflected in the fact that the majority of changes in national investment regimes have been in the

[1] Unless indicated otherwise, all data are from UNCTAD, *World Investment Report 2012: Towards a New Generation of Investment Policies* (Geneva: UNCTAD, 2012).

direction of making the investment climate more favorable for foreign investors and that countries continue to conclude international investment agreements that protect foreign investors and facilitate their operations.

Still, the attitude of a number of countries toward foreign direct investment is becoming more differentiated, as a number of them pay more attention to undesirable effects of such investment or certain types of it. After all, for governments, foreign direct investment is but a tool to promote their own national interests, especially economic growth and development. As a result, the screening of incoming mergers and acquisitions (especially when they are being undertaken by state-controlled entities) from the point of view of national security and protecting national champions is becoming more frequent. While red tape has not replaced red carpet, market entry has become somewhat more difficult in a growing number of countries. Similarly, while the international investment regime is expanding and becoming stronger (including because it is being enforced through investor-state dispute mechanisms), some governments have begun to circumscribe, at least to a certain extent, the protection of foreign investors in the interest of preserving national policy space.

Thus, a certain rebalancing of the national and international framework for foreign direct investment is underway, in order to put governments into a better position to pursue policies that maximize the positive effects of such investment and minimize its negative effects. In so doing, we may well also expect that governments will pay more attention not only to the quantity of incoming foreign direct investment, but also to its quality (or "sustainable foreign direct investment" -- defined as investment that makes a maximum contribution to a country's economic, social and environmental development and takes place in the framework of fair governance mechanisms, without jeopardizing its commercial viability).

While these developments unfold, many governments -- including now also those of a number of emerging markets -- encourage their own firms to become multinational, in order to protect, or increase, the international competitiveness of these firms. In fact, a portfolio of locational assets is increasingly becoming an important source of the international competitiveness of firms in general. Thus, the regulatory framework for outward foreign direct investment is receiving more attention. Virtually all developed countries have removed regulatory barriers to such investment, and most of them have put in place frameworks that actually encourage it. The great majority of emerging markets, on the other hand, lag considerably behind in this respect -- which puts their own firms at a competitive disadvantage vis-a-vis their competitors headquartered in developed countries. At the same time, the question of to what extent encouraging outward foreign direct investment (especially when it involves special financial and fiscal benefits for outward investors, in particular state-controlled entities) might distort the working of the world foreign direct investment market and hence might negate "competitive neutrality" is becoming an issue on the international policy agenda.

The importance that foreign direct investment has achieved, that it can have not only positive effects but also negative ones; that issues relating to such investment extend beyond economic ones (e.g., the potential compromise of national security); that foreign direct investment is more complex and intrusive than trade (involving, as it does, the entire range of issues related to the production process); and that the whole subject raises all sort of policy issues are among the reasons for which the Vale Columbia Center on Sustainable International Investment launched, in late 2008, the *Columbia FDI Perspectives*. The *Perspectives* take an interdisciplinary approach, reflecting the multi-dimensional nature of the growth and impact of foreign direct investment and its regulatory framework and implications. As a rule, the *Perspectives* seek to pay special attention to policy implications. They are deliberately short in order to present readers with a concise analysis of an issue at hand. And they can be provocative in order to promote a dialogue, stimulate further research or present policy options.

This volume brings together all *Perspectives* published since the inception of this series until November 2012. It updates the first edition of this volume, released in January 2011.[2] This second edition is intended to provide an interesting overview of important contemporary issues relating to foreign direct investment and multinational enterprises for all those who are interested in this subject, but are not always in a position to follow diverse perspectives and what is being written in the various corners of this field. And, of course, we hope that this volume will spark further interest in the field of foreign direct investment and multinational enterprises.

New York and Dubai — Karl P. Sauvant
November 2012 — Jennifer Reimer

[2] See, Karl P. Sauvant, Lisa Sachs, Ken Davies, and Ruben Zandvliet, eds., FDI Perspectives: Issues in International Investment (New York: Vale Columbia Center on Sustainable International Investment, January 2011), available at: www.vcc.columia.edu.

List of abbreviations

BIT - bilateral investment treaty

BRIC - Brazil, Russia, India, China

CAFTA - Central America Free Trade Agreement

FDI - foreign direct investment

FTA - free trade agreement

GDP - gross domestic product

ICSID - International Centre for Settlement of Investment Disputes

IMF - International Monetary Fund

M&A - mergers & acquisition

MAI - Multilateral Agreement on Investment

MENA - Middle East and North Africa

MNE - multinational enterprise

NAFTA - North American Free Trade Agreement

NATO - North Atlantic Treaty Organization

NGO - nongovernmental organization

OECD - Organisation for Economic Co-operation and Development

R&D - research and development

SWF - sovereign wealth fund

TRIPS - Agreement on Trade-related Aspects of Intellectual Property Rights

UNCTAD - United Nations Conference on Trade and Development

WTO - World Trade Organization

PART I

ATTRACTING FOREIGN DIRECT INVESTMENT AND ITS IMPACT

Chapter 1

FDI stocks are a biased measure of foreign affiliate activity

Sjoerd Beugelsdijk, Jean-François Hennart, Arjen Slangen, and Roger Smeets[*]

Researchers often call the value added (VA) in a host country by firms based in another country FDI and use FDI stocks and flows from a country's balance of payments to measure it. What FDI stocks and flows actually measure, however, is narrower, since they record long term financial transactions by which domestic firms exert control over foreign firms. French FDI stocks in Australia, for example, measure the value of shares and reinvested earnings of Australian firms owned by French firms and the net indebtedness of these Australian firms to their French parents.

FDI stocks in a host country may diverge from the aggregate foreign affiliate VA in that country for three reasons. First, not all FDI in a country is used to generate VA there. Part of the flows may be sent on to other countries. Thus inward FDI stocks may overestimate affiliate VA in some countries, especially tax havens.

Second, FDI only measures part of what foreign affiliates use to finance their activities because it excludes the substantial amount they raise from external sources, for example local banks. Local and third-country financing accounts for 40% of the funds used by US majority-owned affiliates in developed countries.[1] The larger the recourse to such financing, the more FDI stocks will underestimate actual affiliate VA.

Third, FDI is a financial input, while VA is generated by both labor and capital. FDI stocks underestimate the amount of affiliate VA because they ignore the contribution of labor. The higher that contribution, the greater the underestimation.

In a recent paper we showed that these three factors make FDI stocks a *biased* measure of affiliate VA.[2] We argued that FDI stocks overestimate VA in tax-haven countries, undervalue it in most other countries and that that undervaluation is larger in countries where financial markets are more developed and labor more productive, i.e. in more developed countries. Hence the mismatch between FDI stocks and foreign affiliate VA is not random, but is systematically correlated with host country characteristics such as their level of economic development. This makes FDI stocks a biased measure of the relative level and change of the VA of foreign affiliates in a host country and suggests that studies of the determinants and consequences of affiliate VA that have used FDI stocks as their dependent or main independent variable may have reached erroneous conclusions.

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[*] The authors wish to thank Ayse Bertrand, Ned Howenstine, Robert Lipsey, and Someshwar Rao for their helpful comments on this chapter, which was first published as a *Perspective* on August 29, 2011.

[1] Alexander Lehman, Selin Sayek and Hyoung Goo Kang, "Multinational affiliates and local financial markets," International Monetary Fund Working Paper 04/107 (June 2004).

[2] Sjoerd Beugelsdijk, Jean-François Hennart, Arjen Slangen and Roger Smeets, "Why and how FDI stocks are a biased measure of MNE affiliate activity," *Journal of International Business Studies*, vol. 41 (December 2010), pp. 1444-1459.

In fact, the mismatch between FDI stocks and the actual VA of foreign affiliates in a host country is systematically correlated with specific characteristics of that country. This can be demonstrated by comparing US FDI stocks in 50 host countries and the sales and VA generated by affiliates of US MNEs in these countries over a period of 22 years in the case of sales, and 11 years in that of VA.

If one regresses the country and year-specific mismatch between US FDI stocks and US foreign affiliate sales and VA on the size of a country's stock and bond markets, the concentration of its banking sector, the level of its interest rate, its exchange rate volatility (all likely determinants of local external borrowing), whether the host country is a tax haven, and the labor productivity of its US affiliates, one finds that all these variables are statistically significant and take the right sign, supporting the view that the mismatch between FDI stocks and actual foreign affiliate activity is not random and hence that FDI stocks are a biased measure of that activity.

Hence, one cannot safely infer from FDI stocks the true level of VA by foreign affiliates in a country. Finding that FDI stocks are twice as large in country A than in country B does not necessarily mean that the actual level of affiliate VA in A is twice as large as in B, since foreign affiliates in A may obtain much of their financing from their parents while those in B may rely mostly on local external sources. Similarly, a downward trend in a country's FDI stocks can either indicate that it is becoming less attractive to foreign firms or that its financial markets are becoming more efficient and its exchange rate more stable. Because some of the hypothesized determinants of foreign affiliate activity are significantly correlated to the mismatch between FDI stocks and actual affiliate activity, studies that have used FDI stocks to measure the latter may have obtained misleading results as well.

FDI stocks and flows are perfectly appropriate measures of a country's inflows and outflows of financial capital and of their cumulative size, but they should not be used to measure host-country foreign affiliate activity.

Chapter 2

FDI stocks are a biased measure of MNE affiliate activity: A response

Mira Wilkins[*]

In a recent *Perspective,*[1] Beugelsdijk, Hennart, Slangen, and Smeets warned readers about biases in the measure of FDI stock. They are to be congratulated for pushing readers to be careful in the use of data.

They note “researchers often call the value added (VA) in a host country by firms based in another country FDI and use FDI stocks ... to measure it.”[2] They correctly insist that FDI stocks do not correspond with aggregate foreign affiliate value-added.

Their *Perspective* opens up two important topics: the frequently very loose use of the term FDI in the literature (and the genesis of that loose use); and the various measures of MNE activities.

For decades, the literature has often equated FDI and MNEs, using the words “FDI” and “MNE” interchangeably. A book on the “theory of FDI” can be expected to be on the “theory of MNEs.” So, too, if this very publication, *Columbia FDI Perspectives,* were renamed “*Columbia MNE Perspectives,”* it is doubtful that the contents would change. Virtually, every student of MNEs would agree that this is a false equation. The formulation should be, MNEs undertake FDI, but MNEs also do many other things, including transferring technology, undertaking research and development, and producing and marketing goods and services. MNEs expect a return on their investment in the business package, not merely on the FDI they undertake.

The equation of the terms “FDI” and “MNE” is a short-cut -- with an historical genesis. Early collectors of foreign investment data realized that investments by MNEs were different from foreign investments in traded securities, bonds and stock. Paish’s work on British overseas investment before World War I contained fragments of this understanding.[3] But the real understanding emerged in the late 1920s and 1930s as the US Department of Commerce began collecting balance-of-payments data. As such information was assembled in the 1920s, individuals in the Department became aware that investments by MNEs differed from capital moving through bond markets or monies arriving to fuel the rise in United States stock prices. By the late 1920s and 1930s, the Department started to measure FDI stock (as well as flows). Initially, the definition of US

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[1] Sjoerd Beugelsdijk et al., “FDI stocks are a biased measure of foreign affiliate activity,” *Columbia FDI Perspectives*, No. 45 (August 29, 2011).

[2] Ibid.

[3] Paish’s seminal articles in *The Statist* and the *Journal of the Royal Statistical Society* (1909-1914) have been republished in Mira Wilkins, ed., *British Overseas Investments 1907-1948* (New York: Arno Press, 1977).

outward FDI included all US holdings in those "foreign corporations or enterprises which are controlled by a person, or closely identified group of persons (corporate or natural), domiciled in the United States, or in the management of which such person or group has an important voice;" control was loosely defined and minority interests were included when the US entity had "an important voice."[4]

There were also studies in the 1930s of US inward FDI. Beginning in 1941, some studies defined FDI as 25% holdings in equity shares, a cutoff that would subsequently be reduced to 10%. Throughout this time there was an attempt to try to define MNE activities. FDI required the possibilities of control -- or at least influence. There were questions on what to include and exclude. Issues of the *Survey of Current Business* tell the story and the changes. Gradually, US definitions became widely accepted by many governments and by the International Monetary Fund. Since 1981, the definition of FDI has been "an investment in which a resident (in the broad legal sense, including a company) of one country obtains a lasting interest in, and a degree of influence over a business enterprise in another country."[5] The phrases "lasting interest" and a "degree of influence" show the difficulties in determining the nature of "control." The words are ambiguous, but retain the notion of FDI involving more than merely financial flows and involving the extension of the firm over borders. Over the years, other measures of MNE activities emerged, including value-added, employment, number of affiliates, size of assets, revenues, and market share. We have data on ultimate beneficial ownership, which aid in deciphering certain complexities. Each of the measures has its use, depending on the questions being asked. Each measure offers a different story line.

Yet, biases notwithstanding, unlike these other measures, we have long -- albeit imperfect -- series on FDI stock for many countries. Handled with care, these series provide *one* very useful measure. If we are aware of what is included (and excluded) in the data, that is, the data limitations, FDI stock continues to be an excellent indicator of MNE activities and one that can be used as public policies are formulated.

[4] Robert L. Sammons and Milton Abelson, *American Direct Investments in Foreign Countries – 1940* (Washington, DC: US Department of Commerce, 1942), p. 2.
[5] Jeffrey H. Lowe, "Direct investment, 2007-2009: Detailed historical-cost positions and related financial and income flows," *Survey of Current Business*, vol. 90 (September 2010), p. 57. See also US Direct Investment Abroad, 1977 (Washington, DC: US Department of Commerce, 1981), p. 2.

Chapter 3

Does it matter who invests in your country?

Kálmán Kalotay[*]

When Opel invested in car assembly operations in Gliwice in 1998, Poland registered this project as German because Opel is headquartered in, and managed from, Germany. However Opel has been owned by General Motors (United States) since 1929. Such utilization of foreign affiliates for investment in third countries is indirect FDI. At first sight the term is contradictory, although it is not so: "direct" refers to the degree of control over a foreign affiliate, while "indirect" denotes the way the *ultimate owner* arrives at such control.

Indirect FDI matters for host countries because an investor follows a distinct corporate strategy, which is influenced by the management culture of the investor's home country. If projects are transparent, host countries face few problems with indirect FDI. There are however cases in which the ultimate owners conceal their identities to circumvent sensitivities about their nationalities, such as Russian firms investing through Cyprus. A special form of indirect FDI is *round tripping*: the ultimate owners come from the same country in which the foreign affiliates are located. Round tripping is important for example between China and Hong Kong (China) and between the Russian Federation and Cyprus. Indirect FDI can be financed through *transshipment investment* by using foreign affiliates in third countries or more transient constructions such as *special purpose entities* (SPEs).[1] SPEs are concentrated in hubs, such as Luxembourg, Austria and Hungary, in that order.

Indirect FDI distorts global FDI statistics (annex table 1), although it reflects well corporate financial strategies. In part due to round tripping, host countries' statistics provide a misleading picture of the geography of FDI. For example, FDI by ultimate owners is reported by a handful of countries only. In one of them, the United States, the immediate and ultimate owners were different in at least 18% of inward FDI projects (in terms of value of investment) in 2010. UNCTAD data indicate that other countries provide less perfect proxies of the extent of indirect FDI.[2] For example, in 2008, 60% of the outward FDI stock of Brazil was registered in three Caribbean offshore centers, to be transshipped to third countries. For the Russian Federation, Cyprus accounted for 30% of the outflows and 22% of the inflows over the period 2007-2011; for Hong Kong, China accounted for 37% of the inward stock and 42% of the outward stock in 2010. Finally, the combined inward and outward FDI stocks of each Austria, Hungary and Luxembourg

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[1] An SPE is a separate legal person established to pursue temporary objectives such as the financing of an affiliate abroad. Different from ordinary projects, it allows limiting the risk of the transaction to the value of the SPE.

[2] See, UNCTAD's *World Investment Report 2012*, launched on July 5, 2012.

in SPEs topped US$ 1.7 trillion in 2010 and their ratios to global FDI stocks exceeded 8% (annex table 2).

Companies undertake indirect FDI for various reasons. The most important is corporate strategy, that is, delegating investment decisions in third countries to geographically close regional headquarters or to foreign affiliates with cultural affinity. For example, MNEs ask their Slovenian affiliates to invest in the Balkans, due to their better understanding of local business conditions. Delegation to foreign affiliates may also make sense for managing global value chains. Tax advantages are another key consideration, since lower taxes can result from transshipment through financial centers and investment through countries that have favorable double taxation treaties (DTTs) with the target host country. Taxation matters also for round tripping: a company that is registered as foreign can benefit from incentives, and can also invoke the DTT signed with the transshipment country. Some firms undertaking capital-intensive and risky projects use indirect FDI to obtain protection from the bilateral investment treaties (BITs) of transit countries. As indicated, there are also firms that wish to conceal their origins as much as possible in order to avoid scrutiny by the host country. For round tripping, escaping from potential uncertainties in the country of origin could also be a motive.

Indirect FDI has implications for development. Ultimate owners have a say in the operations of the affiliates they control indirectly. Indirect FDI influences the amount and distribution of taxes among countries. It also leverages protection for investors and can provide better access to dispute settlement. Finally, when there are sensitivities about ultimate investors, national security considerations may arise.

In principle, host countries could formulate an effective policy response because often their own regulatory systems encourage indirect FDI. They need not fully suppress indirect FDI but rather deal with its negative consequences. Tax laws encouraging indirect FDI leading to welfare losses could be revised, especially through cooperation of the jurisdictions concerned. International action on transfer pricing also needs to be strengthened. The role of BITs and DTTs needs to be revaluated. Treaty shopping is difficult to contain; but one could envisage clauses limiting the importation of protections from other BITs, following the example of exemptions to the most-favored-nation clause. Policy makers could also consider BIT clauses on transparency regarding ultimate owners.

Annex table 1. Inward FDI stock of the United States from selected economies of origin, by immediate investor and ultimate beneficial owner, 2010 (billions of US$)

Economy	By immediate investor	By ultimate beneficial owner	Difference
Bermuda	5.1	124.8	119.7
United Kingdom	432.5	497.5	65.0
Germany	212.9	257.2	44.3
Canada	206.1	238.1	31.9
United States	–	31.6	31.6
Ireland	30.6	61.7	31.1
France	184.8	209.7	24.9
Mexico	12.6	34.0	21.4
Brazil	1.1	15.5	14.4
United Arab Emirates	0.6	13.3	12.7
Israel	7.2	19.5	12.2
Belgium	43.2	52.2	9.0
Netherlands Antilles	3.7	12.4	8.7
Hong Kong (China)	4.3	11.6	7.3
Italy	15.7	23.0	7.3
Japan	257.3	263.2	6.0
Norway	10.4	14.4	4.1
India	3.3	7.1	3.8
Spain	40.7	44.2	3.5
Finland	6.6	10.0	3.5
Australia	49.5	52.9	3.4
New Zealand	0.6	3.3	2.7
China	3.2	5.8	2.7
South Africa	0.7	2.2	1.5
Korea, Republic of	15.2	16.6	1.4
Kuwait	0.3	1.5	1.1
Taiwan Province of China	5.2	6.0	0.8
Malaysia	0.4	1.0	0.6
Denmark	9.3	9.9	0.6
Venezuela, Bolivarian Republic of	2.9	3.1	0.3
Bahamas	0.1	0.2	0.1
Total difference (+)	-	-	477.7
Singapore	21.8	21.3	-0.5
Panama	1.5	0.8	-0.7
Austria	4.4	2.5	-1.8
Sweden	40.8	36.0	-4.7
United Kingdom Islands, Caribbean	31.2	0.8	-30.3
Netherlands	217.1	118.2	-98.8
Switzerland	192.2	61.6	-130.6
Luxembourg	181.2	24.4	-156.8
Total difference (-)	–	–	-424.4
All economies	2 342.8	2 342.8	–

Source: The author's calculations, based on US Bureau of Economic Analysis data.

Note: Data for various economies have been suppressed; therefore the total value of differences (+) and (-) differ.

Annex table 2. SPE and non-SPE related FDI stocks of Austria, Hungary and Luxembourg, 2010 (Stocks in billions of US$ and shares in %)

	Inward FDI			Outward FDI		
Country	Through SPEs	Excluding SPEs	Ratio of SPE to non-SPE (%)	Through SPEs	Excluding SPEs	Ratio of SPE to non-SPE (%)
Austria	170	103	166	177	98	180
Hungary	120	89	134	122	20	623
Luxembourg	1 579	287	551	1 403	499	281
Total	1 869	479	390	1 702	617	276
Memorandum item:						
Ratio to world FDI stock (%)[a]	9.77			8.34		

Source: The author's calculations, based on UNCTAD, FDI/TNC database, and national statistics.
[a] Global FDI stock data usually exclude SPEs.

Chapter 4

The FDI recession has begun

Karl P. Sauvant[*]

With US$ 1.8 trillion (according to UNCTAD), world FDI flows reached an all-time high last year. All major regions benefitted from increased flows. But that was then. What is, and will be, the impact of the financial crisis and the recession on FDI flows this year and next?

Several forces are at work, best discussed in terms of the three sets of FDI determinants: economic conditions, the regulatory framework and investment promotion. If we are lucky, as far as the first set of factors is concerned, *global* GDP will not shrink in 2009, although it is currently expected to do so a bit in developed countries offset however by expected growth in emerging markets (according to the IMF's latest forecasts). Moreover, with the present commodity boom cycle winding down, FDI in natural resources is posed to decline as well, affecting especially FDI flows into Africa, Latin America, Russia, and Central Asia.

Since economic growth is the single most important FDI determinant for attracting investment (and developed countries having received some 70% of FDI flows in 2007), this economic slowdown, further accentuated by the financial crisis, makes key markets less attractive to invest in -- and hence depresses FDI flows. Even from the narrow perspective of FDI, the proposals by Jeffrey Sachs (*Financial Times*, 27 October 2008) and George Soros (*Financial Times,* 29 October 2008) on avoiding a global recession should be heeded.

The financial crisis and the credit crunch adds to this impact as it severely restricts the ability of firms to invest abroad and finance cross-border M&As which are by far the most important form of entering foreign markets for many multinationals. Even where M&As do occur, they would involve lower values than, say, six months ago, as share prices -- and hence the values of companies -- have declined, depressing the value of FDI flows. The current economic difficulties will also entice parent companies to repatriate earnings if not to sell foreign affiliates to shore up their balance sheets, thus reducing net FDI flows. Earning downgrades and weak balance sheets make it more difficult for firms to finance deals, especially if they have to absorb other financial burdens (e.g., supporting the declining value of pension funds) and further deleveraging takes place. These considerations apply also to private equity funds, a number of which are in great difficulties. (These funds accounted for about one-quarter of the value of cross-border M&As in 2007.) The ability of firms to undertake outward FDI is therefore impaired. Not surprisingly, the value of cross-border M&As has declined by 28% during the first nine months of this year and is likely to decline further.

[*] This chapter was first published as a *Perspective* on November 22, 2008.

But the decline could be softened. In particular, if Asian countries and especially China should further stimulate domestic demand it would be even more attractive for multinationals to increase investment in those markets (although China, with US$ 84 billion of FDI inflows, was already by far the largest emerging market host country in 2007). Similarly, if Asian firms are less affected by the crisis, they may accelerate their outward FDI. Chinese outward FDI, for instance, which was US$ 23 billion in 2007, was US$ 26 billion during the first half of 2008 alone, possibly reaching US$ 50-60bn during this year. Add to that the potential FDI by sovereign wealth funds (SWFs); so far, such sovereign FDI has barely taken off (and, in the financial sector, was not very profitable). Moreover, undervalued or distressed assets in developed countries and elsewhere beckon, helped possibly by the strong currencies of some home countries and the weak currencies of some host countries. What this could mean is that important investors are sitting on the fence, waiting for the stock market to hit rock bottom, before investing abroad. If so, there is a chance that FDI outflows from emerging markets (which were US$ 300 billion in 2007) could possibly hold up, a least this year.

This possibility depends on the continuous openness of the regulatory framework for FDI, especially in developed countries. While this is, *grosso modo*, most likely assured, there are mounting signs of a reevaluation of, if not distinct uneasiness about, at least certain forms of FDI. This is reflected, among other things, in the increase of national policy changes, as well as more restrictive review processes, that make the investment environment less hospitable, especially for cross-border M&As. A good part of such protectionist attitudes is directed against sovereign FDI by state-owned enterprises and SWFs from emerging markets -- precisely those entities that, at least for the moment, still are in a position to continue, if not increase, their outward FDI. It is actually surprising how little FDI SWFs have undertaken so far; the skeptical attitude in developed countries partly explains this. Regulatory risk could exacerbate the negative economic factors.

It is here where investment promotion comes in: investment promotion agencies worldwide can be expected to make an extra effort to convince their governments to keep the investment climate welcoming. In fact, investment promotion agencies and individual firms seeking strong partners can be expected to make an extra effort to entice multinationals, private equity groups and sovereign FDI to come to their shores. How influential investment promotion agencies will be in their national decision-making processes remains to be seen.

So what does this all add up to? In the current situation of uncertainty it is impossible precisely to predict how these various factors will play out. Moreover, they need to be seen against the long-term nature of FDI, undertaken in-line with broader corporate strategies, which makes this type of investment more stable than portfolio investment (as we have seen during the Asian financial crisis) and hence could mitigate some of the immediate negative effects. In the past, a recession was typically followed in one-to-two years by a decline in FDI flows. This time, the credit crunch is accelerating the onset of the decline and it is likely to deepen it. It is quite certain that FDI flows in 2008, and especially in 2009, will decline -- the only question is by how much and for how long.

The steepness of the decline will largely be a function of how deep, long and widespread the recession will be. The decline is likely to be at least 20% this year and could well reach another 30% or more next year -- making an already difficult economic situation even more difficult. If anything, the FDI recession puts a premium on maintaining a welcoming investment climate.

Chapter 5

The global economic crisis and FDI flows to emerging markets: For the first time ever, emerging markets are this year set to attract more than half of global FDI flows

Laza Kekic[*]

The global economic and financial crisis has had a major impact on FDI flows. After declining in 2008 by 17% to US$ 1.73 trillion from US$ 2.09 trillion in 2007 -- the high point of a four-year long boom in cross-border M&As and FDI -- global FDI inflows are forecast to plunge by 44% to less than US$ 1 trillion in 2009 (annex table 1).[1] The big drop in 2009 is occurring despite the improvements in the global economy in recent months. A notable feature of trends in 2009 is that, for the first time ever, emerging markets are set to attract more FDI inflows than the developed world (annex table 2).

Global FDI plummets in first half of 2009

Global FDI inflows are estimated to have contracted by 49% in the first half of 2009 compared with the same period in 2008. The estimate is based on data for 54 countries (20 developed countries and 34 emerging markets) that accounted for just under 90% of total global FDI inflows in 2008. For 47 of the countries, FDI inflows in the first half of 2009 were lower than in the first half of 2008; only seven countries recorded growth in inflows over this period. The decline in inflows to developed countries was significantly sharper than the drop for emerging markets -- by 54% and 40%, respectively. The declines were especially marked in the US and UK, by 68% and 85% respectively. Among emerging market regions, the sharpest decline, by 55%, was to Eastern Europe. Flows to Latin America and to emerging Asia declined by one third in each case (China, the main emerging market FDI recipient, had a decline of only 18%; FDI flows to Brazil and Mexico dropped by 25%).

Only a modest improvement is expected in the second half of 2009. In particular, despite improved global economic trends in recent months, a significant recovery in M&As will not happen soon.[2] Rising confidence and a rally in equity markets have failed to boost M&As as corporations remain very cautious and bank financing is constrained. The nine-

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[*] The author wishes to thank Gary Hufbauer and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on October 8, 2009.

[1] Unless otherwise stated, all FDI estimates and forecasts are from the Economist Intelligence Unit. The data reported here for 2008 are of more recent vintage and, because of that, as well as the use of different sources in some cases, the totals differ slightly from the data reported in UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (Geneva: UNCTAD, 2009). The revised estimates for 2008 and forecasts for 2009 also differ slightly from data that appeared in the Economist Intelligence Unit, "The world economy and plunging FDI," *Viewswire*, (2009).

[2] FDI flows are dominated by trends in cross-border M&As, and the correlation between global FDI inflows and the value of completed cross-border M&A sales is very high. This is not only because cross-border M&As make up a large share of FDI, but also because even non-M&A components of FDI are affected by similar forces that affect M&As.

month 2009 data for M&As were not encouraging. According to data provider Dealogic, the value of M&A deals globally of US$ 1.62 trillion in the first nine months of 2009 was down by 37% on the same period in 2008.[3] According to Thomson Reuters data, the value of deals totaled US$ 369 billion globally in the third quarter of 2009, down by 54% on the same quarter in 2008.[4] Furthermore, the numbers would look much worse still were it not for crisis-related financial deals. Since the latter are mainly domestic deals, this means that the decline in cross-border-M&As in 2009 will be significantly sharper than the drop in total deal values.

FDI to emerging markets to surpass 50% of global total

Flows to emerging markets initially proved resilient to the impact of the global crisis. Inflows into the developed world declined by one-third in 2008, whereas flows to emerging markets increased by 11%. FDI flows to emerging markets will decline considerably in 2009, albeit by less than FDI flows to the developed world.[5] In 2009, for the first time ever, emerging markets are likely to attract more FDI than developed countries. The forecast is obviously subject to considerable uncertainty. For example, a few large cross-border deals in the final quarter of 2009 could yet tip the balance back in favor of developed countries. But even should the emerging market share in global FDI inflows fall short of 50%, the share in 2009 will almost certainly be the highest on record.[6]

Practice catches up with theory

The overall decline in global FDI flows is thus being accompanied by a distinct shift in the pattern of FDI. Economic theory tells us that capital should flow from capital-abundant rich countries to capital-scarce poor countries. In practice, that has not been the case as developed countries have consistently attracted the bulk of global FDI flows. High risk in many emerging markets, the benefits of advanced institutions and infrastructure, and a superior overall business environment in developed countries have

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[3] "M&A sector: Too early to call a return to normal," *Financial Times*, September 25, 2009.

[4] "M&A shows signs of life," *Reuters*, September 29, 2009.

[5] The Economist Intelligence Unit forecasts that FDI flows to emerging markets will decline by 35% in 2009 compared with 2008 (flows to developed countries are forecast to fall by 52%). See annex for forecasts for FDI inflows in 2009 by subregions. Although the definitions of emerging markets differ considerably, our forecast for the fall in FDI flows to emerging markets is similar to the forecasts made by the World Bank (for a 30% decline in *Global Development Finance*, June 2009, Washington, p. 38) and by the Institute of International Finance for a sample of 30 leading emerging markets (by 33%, in *Capital Flows to Emerging Market Economies*, October 2009, Washington, p. 2).

[6] The definition of what constitutes an emerging market, or the dividing line between developed countries and emerging markets, is rather arbitrary. Under Economist Intelligence Unit definitions, the developed world category is somewhat smaller than under the definition used by UNCTAD, which includes the eight new EU member states from Eastern Europe (all these are considered as emerging markets under most definitions). The emerging market share in global FDI inflows is set to surpass 50% in 2009 on both definitions, although by a narrower margin on the UNCTAD definition. The Economist Intelligence Unit classification is given in Laza Kekic and Karl P. Sauvant, eds., *World Investment Prospects to 2011: Foreign Direct Investment and the Challenge of Political Risk* (London and New York: Economist Intelligence Unit and the Columbia Program on International Investment, 2007), p. 195.

tended to outweigh the attractions of greater market dynamism and lower costs in emerging markets.

This time, practice may be catching up to theory. FDI has tended to rise during recessions as slumps in M&As have hit the developed world disproportionately (and some 80% of cross-border M&A sales are still in developed states). However, other factors are also pushing up the share of emerging markets in global FDI inflows.

FDI flows to emerging markets have held up better because their overall economic performance has been much better than that of the developed world, which has experienced its worst recession since the Second World War. Much of the superior performance of emerging markets is, of course, due to the continued fast growth of China and India. However, even if China and India are taken out of the equation, most emerging markets will have outperformed the developed world in 2009. Emerging markets have thus to some extent "decoupled" from the developed economies.[7]

Globalization and increasing competitive pressure on companies have increased the opportunity cost of not investing in emerging markets.[8] A recent Economist Unit survey provides evidence of a link between investing in emerging markets and corporate financial success. Among surveyed companies from developed countries that derive less than 5% of their revenue from activities in emerging markets, only 24% reported their financial performance as being better than their peers. By contrast, for developed country companies that derived more than 5% of their revenue from emerging markets, the share reporting better performance than their peers was just under 40%.

The trend of improving business environments and liberalization in many emerging markets in recent years has also helped limit the recession-induced fall in FDI inflows. Finally, the increased share of emerging markets in outward investment is increasing the share of emerging markets in inward flows because a disproportionate share of outward investment by emerging markets goes to other emerging markets.

The outlook for 2010 and beyond

Although the global economy is still weak, conditions are now improving in many countries. Global growth resumed in the second half of this year, creating momentum that will carry into 2010. The recovery in 2010 will, however, be sluggish and fragile. Global growth is unlikely to return any time soon to the trend rate of recent years, as it will be constrained by the after-effects of the crisis in 2008-2009. As a result, although global FDI inflows are likely to grow in 2010, the recovery will be modest. The growth rates of

[7] The notable exception is Eastern Europe, which has suffered very badly and its average output is forecast to contract by 6% in 2009.

[8] Economist Intelligence Unit and UK Trade and Investment, *Survive and Prosper: Emerging Markets in the Global Recession* (London: Economic Intelligence Unit, 2009). The Economist intelligence Unit carried out a survey of 548 companies from 19 business sectors around the world in July and August 2009. Two-fifths of the sample was made up of companies headquartered in emerging markets; the remainder were companies headquartered in developed countries.

FDI into the developed world and emerging markets are expected to be similar so that their shares in global FDI are unlikely to change significantly from 2009.

Companies' plans for the next five years, as reflected in the aforementioned Economist Intelligence Unit survey, *Survive and Prosper,* imply that emerging markets will attract considerable FDI and probably more than developed countries. Just under 60% of companies expect to derive more than 20% of their total revenue in emerging markets in five years' time – almost double the present proportion of 31%. This would suggest that the shift in the distribution of global FDI flows in 2009 is a longer-term development and not just a transitory phenomenon.

Annex table 1. FDI inflows (billions of US$)

	2007	2008	2009
World total	**2,092.4**	**1,730.9**	**975.2**
% change	44.8	-17.3	-43.7
Developed countries	**1,355.0**	**914.7**	**441.3**
% change	52.3	-32.5	-51.8
Emerging markets	**737.4**	**816.3**	**533.9**
% change	32.9	10.7	-34.6
of which:			
Sub-Saharan Africa	38.0	49.7	30.3
% change	14.2	30.7	-39.1
Middle East & North Africa	81.9	98.1	73.4
% change	13.6	19.8	-25.2
Developing Asia	298.1	323.2	235.5
% change	38.9	8.4	-27.1
Latin America & Caribbean	128.1	140.5	93.8
% change	37.1	9.7	-33.3
Eastern Europe	165.7	183.3	90.4
% change	40.8	10.7	-50.7
% share developed countries	**64.8**	**52.8**	**45.3**
% share emerging markets	**35.2**	**47.2**	**54.7**

Note: Emerging markets according to Economist Intelligence Unit definitions; see text.
Source: IMF; national statistics; UNCTAD; Economist Intelligence Unit forecast for 2009.

Annex table 2: FDI inflows (% of global FDI inflows)

	UNCTAD definitions		Economist Intelligence Unit definitions	
Year	**Developed countries**	**Emerging markets**	**Developed countries**	**Emerging markets**
1992	69.4	30.6	67.3	32.7
1993	66.7	33.3	64.3	35.7
1994	59.7	40.3	57.7	42.3
1995	65.5	34.5	61.8	38.2
1996	61.0	39.0	58.3	41.7
1997	59.9	40.1	57.1	42.9
1998	72.0	28.0	69.4	30.6
1999	78.7	21.3	76.9	23.1
2000	81.5	18.5	79.9	20.1
2001	69.7	30.3	67.3	32.7
2002	71.9	28.1	68.0	32.0
2003	66.3	33.7	63.4	36.6
2004	57.8	42.2	52.5	47.5
2005	66.2	33.8	61.6	38.4
2006	65.9	34.1	61.6	38.4
2007	68.3	31.7	64.8	35.2
2008	56.7	43.3	52.8	47.2
2009	48.4	51.6	45.3	54.7

Source: IMF; national statistics; UNCTAD; Economist Intelligence Unit forecast for 2009.

Chapter 6

The Arab Spring: How soon will foreign investors return?

Paul Antony Barbour, Persephone Economou, Nathan M. Jensen, and Daniel Villar[*]

The events of the Arab Spring have dramatically increased the risk perceptions of foreign investors. In directly affected countries, these events led to disruptions in economic activity including plummeting tourism and FDI flows, all of which negatively impacted economic growth. While the economic impact was uneven across the MENA region, for the region's developing countries the growth rate assumption underpinning survey analysis in the Multilateral Investment Guarantee Agency's (MIGA's) World Investment and Political Risk Report for 2011 was 1.7%.[1] How much will these developments affect future FDI?

The financial crisis in 2008 led to declines in aggregate FDI flows into MENA. As events unfolded in 2011, FDI flows into MENA plummeted further in the directly affected countries; for example, in the first quarter of 2011, FDI inflows turned negative in both Egypt and Tunisia, which were two of the most affected countries.[2] The World Bank has forecasted FDI flows into MENA to decline in 2012, but to grow again in 2013. Over the medium and longer term, the region's economic and demographic factors will continue to attract market-seeking foreign investors, more so under conditions of improved governance.

The findings of a foreign investor survey jointly undertaken in 2011 by the World Bank's MIGA and the Economist Intelligence Unit[3] found that the turmoil did have a significant impact on corporate investors' investment intentions concerning MENA: a quarter of investors put their plans on hold, while others reconsidered (18%), canceled (11%) or withdrew investments (6%). Only just below a third did not alter their investment plans (see the supporting data below). Despite heterogeneity among the different countries in MENA, on balance, the turmoil has stressed existing investments and dampened plans for expansions and new investments. While there are differences between investors in extractive industries, these differences do not affect the overall results from a

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[1] The developing economies in MENA are Algeria, Egypt, Iran, Iraq, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia, West Bank and Gaza, and Yemen. MIGA.

[2] Central Bank of Egypt, "Monthly statistical bulletin," August 2011; Central Bank of Tunisia, "Development of main flows and balance of external payments receipts," available at: http://www.bct.gov.tn/bct/siteprod/english/indicateurs/paiements.jsp#qqind.

[3] The survey covered a representative sample of 316 senior executives from MNEs investing in developing countries. The survey was conducted in June-August of 2011. Therefore, the particular questions on MENA involved a self-selection of firms active or intending to invest in MENA; however, these were compared with the global questionnaire for consistency of overall findings.

representative sample of investors worldwide. Thus, the findings are probably less negative than they would be if the oil sector was excluded.[4]

Some investors in the countries directly affected by the civil disturbances, especially investors in the energy and service sectors, have reported suspending operations.[5] All of this has been amplified by the worsening state of domestic economies, as current account deficits and budget deficits have widened, private capital flows have weakened, inflation has risen, and production and investment have declined. Political violence -- especially civil disturbance and to a lesser extent war and terrorism -- ranked particularly high as the risk of most concern as did governments' abilities to honor their sovereign financial obligations.

The survey found greater confidence from MNEs investing in stable democracies relative to stable authoritarian regimes. This pattern has also emerged in the region: just over half of the firms surveyed would invest in MENA, assuming that there is at least a year of stability under a democratic government. Nearly half of the firms in the survey said they would decrease investments should there be significant and persistent instability, even in the presence of democracy. Only 8% of firms would increase their investments under such circumstances. The worst-case scenario would be a period of prolonged and significant instability, where nearly half of the firms surveyed would substantially decrease investments. In the event of a non-democratic regime that nevertheless succeeds in stabilizing the country for at least a year, 44% of the firms surveyed claimed that they would not change their plans for investment, essentially adopting a "wait and see" approach. This lesson is also supported by evidence from the private political risk insurance market, which stressed the difficulty in selling coverage in seemingly stable authoritarian regimes, but saw the demand for coverage in such countries (both in MENA and worldwide) rise as a result of the events in MENA.

The findings of the survey provide evidence of both pitfalls and possibilities arising from the Arab Spring. Investors will return fairly quickly once stability returns given the vast opportunities in the region. Most investors would prefer this stability to be under a democratic regime. Thus there is long-run optimism that, if political transitions in the region are democratic and coupled with political stability, the Arab Spring could increase FDI and help contribute to economic development in the region.

[4] Due to sampling size of the MENA specific investors, the survey is not able to clearly draw this distinction.
[5] "Arab Spring cleaning: What regional turmoil has meant for Western investment," *Business Law Currents*, August 25, 2011.

Chapter 7

Why and how least developed countries can receive more FDI to meet their development goals

Ken Davies[*]

The 48 least-developed countries[1] (LDCs), most of them in sub-Saharan Africa and a few in Asia, need FDI to help meet their development targets. The FDI they now receive, although inadequate, is enough to demonstrate that investors see potential in them. It is therefore realistic for LDCs to seek more FDI, but they need to enhance their investment environments to attract it in the much greater quantities required. Donors can help by targeting official development assistance (ODA) on investment in human capital and supporting governance improvements. Meanwhile, LDCs should establish effective investment promotion agencies (IPAs).

Have MNEs shown any interest in investing in LDCs? Perhaps surprisingly, LDCs have recently been punching above their weight in bringing in FDI, despite their reputation for inadequate infrastructure and governance. In 2006-2009, average FDI inflows to LDCs were 1.7% of the global total -- over twice these countries' share of world GDP and capital formation.[2] The LDCs' share in the world's FDI stocks was 0.6%. FDI inflows to LDCs have increased sharply, averaging US$ 27 billion per year in 2006-2009 compared to US$ 10 billion in 2000-2005, US$ 2.5 billion in the 1990s, and US$ 506 million in the 1980s. FDI inflows to LDCs in 2001-2010 exceeded portfolio and other private capital inflows and also exceeded bilateral aid inflows.[3] FDI flows for the world as a whole in 2006-2009 averaged 2.9% of GDP, while they were 6.3% of GDP in LDCs (compared to 2.6% in developed economies, 4.6% in transition economies and 3.6% in developing economies). FDI flows were 13% of gross fixed capital formation globally in 2006-2009 but 48.5% in LDCs; world FDI stocks were 131.7% of gross fixed capital formation, LDC FDI stocks 117.7%, not far behind, similarly indicating an upward trend.

A major example of this trend is Africa, where most LDCs are situated. Africa is becoming increasingly attractive to international investors, particularly from emerging markets. FDI from emerging markets into Africa grew at a compound annual rate of 13% a year from 2003 to 2010. While investors from developed countries tend to be more cautious in their African investments, they still account for the largest share of FDI in the continent and are investing in a diverse range of sectors -- not just mineral resources -- including telecommunications, food, beverages and tobacco, transport, storage and hotels.

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[1] LDCs are defined by three criteria: low GNI per capita, weak human assets and economic vulnerability.

[2] Unless otherwise cited, the statistics in this *Perspective* are taken, or calculated, from the online UNCTAD statistical database, UNCTADstat, at http://unctadstat.unctad.org/

[3] UNCTAD, *Foreign Direct Investment in LDCs: Lessons Learned from the Decade 2001-2010 and the Way Forward* (New York and Geneva: United Nations, 2011).

But the most rapid FDI growth in Africa (a 21% compound growth rate from 2003 to 2010) is being achieved by Africans investing in other African countries.[4]

While the picture is improving, current FDI inflows to LDCs are still nowhere near enough to meet Africa's needs. Total fixed investment in LDCs is now approximately 20% of GDP, insufficient to support the sustained growth needed to meet the Millennium Development Goal (MDG) of halving the proportion of the world's population with incomes below a dollar a day and other MDGs such as universal primary education and basic health targets.[5]

FDI is also distributed unevenly among LDCs: in recent years, over 80% has gone to resource-rich countries in Africa like Angola and Sudan, while inflows have stagnated or declined in some other LDCs, including Burkina Faso, Djibouti and Mauretania. Those LDCs that received FDI inflows in their extractive sectors tend not to have benefited from similar levels of FDI in services and manufacturing, where job creation, linkages and skills transfers are greater.[6]

What can LDCs do to promote stronger FDI inflows to all sectors of their economies, especially those that have a strong positive impact on development, such as manufacturing and services? In the short term, LDCs should establish effective investment promotion agencies at national and subnational levels to ensure their visibility as investment destinations. Long-term actions, which should be initiated as soon as possible because of the long gestation period, include building physical infrastructure and investing heavily in human capital. Necessary governance improvements, which also take time, include building a transparent and rules-based regulatory framework to provide predictability in areas such as property rights, competition and anti-corruption.

ODA still exceeds FDI inflows to LDCs, but is not easy to expand when there are other demands on the funds of donor countries and international bodies. On the other hand, MNEs have investment funds looking for a good home, so FDI is well placed to fill the gap between domestic savings and LDCs' investment requirements and also find opportunities for investment in activities that might not attract less-experienced domestic LDC investors. It can also bring benefits like increased employment and improvements in technology, including via spillovers to local industry. LDC governments' limited development funds can be supplemented by well-targeted ODA and by FDI, for example through public-private partnerships in infrastructure. If effectively and efficiently utilized to build a business environment that will attract and promote sustainable FDI, such funding will eventually facilitate self-sustaining growth.

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[4] Ernst & Young, "It's time for Africa: Ernst & Young's 2011 Africa Attractiveness Survey," (Johannesburg and London: Ernst & Young, 2011).

[5] UNCTAD, op.cit.

[6] Ibid.

Chapter 8

State-controlled entities control nearly US$ 2 trillion in foreign assets

Karl P. Sauvant and Jonathan Strauss[*]

Developing country sovereign wealth funds (SWFs) as players in the world FDI market have received considerable attention. While outward FDI from emerging markets has indeed risen dramatically,[1] that by SWFs has been negligible: their outward FDI stock is around US$ 100 billion (compared to a world FDI stock of US$ 20 trillion in 2010).[2]

On the other hand, state-owned enterprises (SOEs)[3] -- another class of state-controlled entities (SCEs) -- are serious players in the world FDI market. UNCTAD identified more than 650 SOEs that are MNEs.[4] They hail from both emerging markets and developed countries.[5] (There are also many important financial SOEs that are MNEs.)

More specifically, research on the 200 largest non-financial MNEs identified by UNCTAD for 2010[6] yields 49 SOEs that are MNEs (annex table). The 2010 foreign assets[7] of these 49 together account for US$ 1.8 trillion, with US$ 1.1 trillion in aggregate foreign revenue. Of these 49:

- 23 were at least 50% owned directly or indirectly by states; their foreign assets were US$ 570 billion.
- If the state ownership threshold is lowered to 10%, 26 more firms are added; their foreign assets were US$ 1.16 trillion.

20 of the 49 SOEs are headquartered in developed countries and 29 in emerging markets, with foreign assets of US$ 1.4 trillion and US$ 0.4 trillion, respectively. They operate in

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[1] See e.g., Karl P. Sauvant et al., eds., *Foreign Direct Investment from Emerging Markets* (New York: Macmillan, 2010).

[2] UNCTAD, *World Investment Report 2011* (Geneva: UNCTAD, 2011).

[3] Following UNCTAD, ibid., p. 28, "SOEs" are defined as enterprises in which the government has a controlling interest, with "control" defined as a stake of 10% or more of voting power. Ownership can be direct or indirect (including through e. g. government-controlled pension funds, other government-owned firms) or involve special circumstances (e.g. golden shares). It can be passive, even if a government holds (directly or indirectly) more than half of the shares. "SOE" should therefore be read accordingly -- and it draws attention to the need for research on this matter.

[4] Ibid.

[5] The country classification follows UNCTAD, ibid.

[6] Ibid. The firms researched were the 100 largest non-financial MNEs globally and the 100 largest non-financial MNEs headquartered in emerging markets, ranked by foreign assets.

[7] "Foreign assets" of MNEs are the current and fixed assets abroad that they control. They are usually much larger than their outward FDI.

many sectors.[8]

Thus, SOEs are among leading players in the world FDI market. They are more numerous among the leading MNEs headquartered in emerging markets, but the foreign assets of those headquartered in developed countries are considerably higher than those of the SOEs from emerging markets.

FDI by SOEs is likely to grow further. For example, in the case of China -- in 2010 the world's fourth largest outward investor in terms of flows (not counting Hong Kong) -- SOEs control the bulk of the country's growing outward FDI; one prediction is that Chinese firms will invest US$ 1-2 trillion abroad over the coming decade.[9] To that, one would have to add the likely growth of FDI by SWFs.

Not surprisingly, regulatory attention has begun to focus on FDI by SCEs. It is fueled by the concern that SCEs may pursue objectives other than commercial interests[10] (and therefore might constitute a national security risk for host countries) and that they receive benefits from their governments that put them into a competitive advantage vis-à-vis their private counterparts.[11] To address the first concern, especially developed countries have passed laws or clarified regulations that foresee special treatment for SCEs, creating a separate class of foreign investors. An example is the Foreign Investment and National Security Act of the United States: it establishes a presumption that an investigation needs to be undertaken by the Committee on Foreign Investment in the United States if a merger or acquisition in the United States is undertaken by a SCE. (It remains to be seen to what extent this kind of distinction is permitted in light of international investment law.) The second concern has given rise to a discussion of "competitive neutrality."

FDI can make an important contribution to economic growth and development. There is no systematic evidence that such investment by SCEs cannot make the same contribution that private firms can make. The special treatment that seems to be emerging for these entities needs to be watched carefully, including from the perspective as to what extent such a fragmentation in the treatment of a certain class of foreign investors serves the broader and longer-term purposes of a non-discriminatory international investment law regime.

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[8] The three most important are: natural resources (12); telecommunications (10); utilities (6).

[9] Thilo Hanemann and Daniel Rosen, "Chinese FDI in the United States is taking off: How to maximize its benefits?," *Columbia FDI Perspective*, No. 49 (October 24, 2011), p. 2.

[10] See Karl P. Sauvant, Lisa E. Sachs and Wouter P.F. Schmit Jongbloed, eds., *Sovereign Investment: Concerns and Policy Reactions* (New York: OUP, 2012).

[11] However, non-SCE MNEs also receive a range of benefits.

Annex table. Non-financial MNEs with 50% or more government ownership stake, 2010[1]

SOE	Economy	Industry	Total assets (m)	Foreign assets (Millions)	Total revenues (Millions)	Foreign revenues (Millions)	Total employment (Number)	Foreign employment (Number)	Govt. stake
Électricité de France	France	Utilities	321,431	165,413	86,311	33,737	158,842	54,924	84.51% French State
Vattenfall AB	Sweden	Electricity, gas and water	80,694	54,013	29,632	22,606	40,363	30,994	100% Swedish State
Statoil ASA	Norway	Natural resources	109,728	50,927	87,144	19,315	30,344	11,506	67% Norwegian State
CITIC	China	Diversified	315,433	43,814	30,605	10,878	125,215	25,285	100% Chinese State
Petroliam Nasional Berhad (Petronas)	Malaysia	Natural resources	145,099	38,787	76,822	34,817	40,992	8,198	100% Malaysian State
Japan Tobacco Inc.	Japan	Food/ processing	43,108	31,475	72,273	30,943	48,472	23,902	50% Japanese State
China Ocean Shipping	China	Transport, shipping and storage	36,287	28,092	27,908	18,354	71,584	4,207	100% Chinese State
Singapore Telecom-munications Ltd	Singapore	Telecom-munications	27,151	22,557	11,814	7,616	23,000	10,417	54.46% Singaporean State
Qatar Telecom	Qatar	Telecom-munications	23,335	18,355	6,600	5,054	1,900	1,495	55% Qatar State
Petroleo Brasileiro SA	Brazil	Natural resources	200,270	14,914	115,892	28,709	76,919	7,967	66% Brazilian State
Abu Dhabi National Energy Company	United Arab Emirates	Utilities	25,009	14,282	4,590	3,086	3,654	2,819	100% UAE
Petróleos de Venezuela SA	Venezuela	Natural resources	149,601	11,983	74,996	32,576	91,949	5,159	100% Venezuelan State
China National Petroleum	China	Natural resources	325,327	11,594	178,343	4,732	1,585,000	29,877	100% Chinese State
Oil and Natural Gas Corporation	India	Natural resources	37,223	10,447	21,445	2,912	32,826	3,896	74.14% Indian State
DP World Limited	United Arab Emirates	Transport and storage	18,961	9,238	2,929	1,181	30,000	14,617	80.45% Government of Dubai
Axiata	Malaysia	Telecom-munications	10,847	8,958	3,719	1,936	25,000	21,250	97.72% Malaysian State
Sinochem Group	China	Natural resources	25,132	8,124	35,577	27,492	42,282	225	100% Chinese State
China Resources Enterprises	Hong Kong, China	Natural resources	9,731	7,805	8,273	7,387	152,000	144,400	51.38% Chinese State

China National Offshore Oil Corp.	China	Natural resources	75,913	6,648	30,680	4,898	51,000	1,739	100% Chinese State
Sime Darby Berhad	Malaysia	Diversified	10,061	4,307	8,827	6,065	100,000	25,432	51.93% Malaysian State
China Railway Construction Corporation	China	Construction	41,444	3,580	50,501	3,265	209,103	20,426	100% Chinese State
China Minmetals Corp.	China	Natural resources	18,889	2,352	24,956	3,994	100,656	12,535	100% Chinese State
Neptune Orient Lines Ltd.	Singapore	Transport and storage	5,341	2,192	6,516	4,915	11,498	3,608	68% Singaporean State
TOTAL			2,056,015	569,857	996,353	316,468	3,052,599	464,878	

Source: The authors, based on UNCTAD, *World Investment Report 2011: Non-Equity Modes of International Production and Development* (Geneva: UNCTAD, 2011), annual reports, financial registration documents, company corporate websites, and Thomson Worldscope database.

[1] Whenever available, the table reflects the government's share of voting rights. However, due to lack of information, the table uses in some cases shares in capital or other variables as reported by the companies (sometimes, however, it is unclear what variables are being used). Note, moreover, that recent information (especially on MNEs based in emerging markets) could not be obtained for all of the 200 firms contained in the sample, particularly as far as indirect ownership is concerned. Thus, there may be additional firms among the 200 that should be included in table 1 and/or table 2. Moreover, as a rule only state ownership stakes by the government of the country in which a MNE is based are reported here (and not ownership shares of foreign government entities, e. g. via SWFs). In some cases, government ownership may be temporary, and in some cases, the data refer to earlier or later years.

Chapter 9

Are resurging state-owned enterprises impeding competition overseas?

Nilgün Gökgür[*]

There are no up-to-date systematic data on the size, composition, ownership structure, and economic weight of state-owned enterprises (SOEs),[1] so we are unable to assess the impact of SOE performance on stakeholders in domestic and overseas markets. Yet there is sufficient evidence of their expansion, especially following the 2008 financial crisis. Emerging markets, led by China, are now increasingly encouraging their SOEs to expand globally as MNEs.[2]

The competitive advantage of SOEs is enhanced by Treasury guarantees for financing from state-owned financial institutions. Governments as majority or full owners of state-owned banks accept a lower rate of return on their invested capital than private investors and so can offer favorable borrowing terms. For example, Chinese state ownership and control over the entire banking sector, except for Minsheng Bank, is well documented.[3] Sixteen of eighteen Chinese MNEs–most or all state-owned–have apparently taken the lead in the country's international expansion with "easier access to bank loans and financial markets."[4] Chinese SOEs in African markets are supported by other Chinese SOEs in banking and logistics.[5] Chinese state-owned MNEs deter private competitors in African markets as they tilt the playing field to their advantage. Non-transparent government-to-government deal-making reduces the welfare of stakeholders.[6]

Backing from state-controlled financial institutions is not confined to state-owned MNEs, but is provided to privately owned MNEs as well as they enter international infrastructure markets in the form of public-private partnerships (PPPs). Recently, for example, a consortium led by a privately-owned Turkish construction conglomerate won a competitive tender to build a € 100 million airport in Kosovo -- raising 80% of the

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[1] The single document that assembled and analyzed the latest data on SOEs in developing countries is a World Bank publication, *Bureaucrats in Business: The Economics and Politics of Government Ownership* (New York: OUP, 1995), with no subsequent follow-up thereafter. The OECD has recently been trying to measure the dimensions of the state-enterprise sectors of its members. There are hardly any systematic data worldwide on the dimensions of enterprises owned by sub-national governments and municipalities.

[2] Ian Bremmer, *The End of Free market: Who Wins the War Between State and Corporations?* (New York: Portfolio, 2010), pp. 85-145.

[3] Working Group on Privatization and Corporate Governance of State-Owned Assets, "State enterprises in China: reviewing the evidence," OECD, *Occasional Paper*, January 2009, pp. 6-7.

[4] Fudan University and Vale Columbia Center on Sustainable International Investment (VCC), "Second ranking survey finds strong growth in the foreign assets of Chinese multinationals," December 17, 2009, p. 3, available at: www.vcc.columbia.edu.

[5] Keith Campbell, "800 Chinese state-owned enterprises active in Africa, covering every country," *Mining Weekly*, September 28, 2007, pp. 2-3.

[6] Harry G. Broadman, "China and India go to Africa," *Foreign Affairs*, vol. 87 (March/April 2008), pp. 95-109.

financing from a state-controlled Turkish bank and 20% from the consortium.[7] Other bidders may not have enjoyed similar access to such bank loans.

The international development community has begun to promote PPPs in infrastructure sectors, expecting the private sector to bring private investments and technical know-how, with competitive tenders delivering the intended development outcomes. This is doubtful if state-owned and controlled banks back privately-owned MNEs, hinder competition overseas and unintentionally reduce the intended benefits to domestic entrepreneurs as they fail to enter and win PPP concessions.

We can only know how much SOEs impede competition if there is a single entity worldwide collecting and analyzing consistent cross-country and cross-sectoral data on all SOEs. Only with proper data *and* analysis we can measure the size, magnitude, economic weight, and performance of SOEs, including state-owned banks, worldwide. The World Bank does not engage in such data collection, but the IMF might. With such data, we can assess SOEs' impact on consumers, labor, enterprise performance, owners and operators, taxpayers, competitors, communities, and the environment. We could then draw policy conclusions, maximize the development impact of the SOEs at home *and* overseas, and ensure that PPPs produce desired outcomes.

[7] Vakif Bank, majority owned by the Directorate of Public Foundations and managed by the Prime Minister, can afford to seek a lower rate of return on invested capital compared to private banks; the details of this transaction are available at: http://www.invest-ks.org.

Chapter 10

Are SWFs welcome now?

Veljko Fotak and William Megginson[*]

Until the end of 2007, western media, governments and regulators often seemed more concerned about protecting domestic firms from investments by SWFs than about attracting capital inflows. Politicians in many countries called for the regulation of sovereign foreign investments at that time, when SWF investments were growing rapidly. In fact, during 2006 and 2007, countries that introduced at least one regulatory change (many of them related to such investments) making the investment climate less welcoming for MNEs accounted for 40% of all FDI inflows.[1]

In early 2008, attitudes began to change, as SWFs temporarily rescued the western banking system by purchasing approximately US$ 60 billion of new equity issued by US and European banks. As the financial crisis deepened, western financial firms displayed an ever-increasing appetite for foreign capital. At the same time, sources of the latter dried up rapidly, with a decrease in total FDI in 2008 of around 15%. Investment in OECD countries by SWFs declined throughout 2008, totaling US$ 37 billion during the first quarter, US$ 9 billion during the second and US$ 8 billion during the third.[2] A handful of factors brought about this decline. Low commodity prices and the underperformance of previous investments led to a shrinking asset and funding base even as a renewed emphasis on more conservative asset classes and domestic investments dramatically reduced the proportion of assets invested in foreign equity.

The ongoing need for capital by the western financial system, coupled with the sudden drop in foreign investments by SWFs, is leading to a dramatic shift in attitudes. Rather than discouraging SWF capital inflows, Western governments and firms are actively seeking sovereign direct investment, and public calls for opening financial markets to SWFs now abound.[3] Whereas observers once feared an excessive push toward the regulation of foreign investment and a consequent stifling of FDI inflows into OECD countries, these fears have been allayed in part by the adoption of the Santiago Principles by both the major SWFs and the principal Western countries that now seek SWF capital.

Today, we are again facing the risk of overreaction, but in the opposite direction: security concerns, certainly overplayed in the past, are being sidelined. Yet, previous calls for

[*] The authors are grateful to José María Serena Garralda and April Knill for their helpful comments on this chapter, which was first published as a *Perspective* on July 21, 2009.

[1] Karl P. Sauvant, "Driving and countervailing forces: a rebalancing of national FDI policies," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2008-2009* (New York: OUP, 2009), pp. 239-240.

[2] William Miracky et al., "Sovereign wealth fund investment behavior: analysis of sovereign wealth fund transactions during Q3 2008," Monitor Company Group Publications (2008).

[3] For example, Organisation for Economic Co-operation and Development, "Sovereign wealth funds and recipient country policies," OECD Investment Committee Report (2008) and Warren Buffet, "Letter to the shareholders of Berkshire Hathaway Inc." (2008).

protectionism and current appeals to open markets completely both lack the support of empirical evidence, as very little is known about the impact of SWF investments on target firms and recipient economies. Accordingly, we believe that the most important step for governments is to promote the analysis of SWF investments and their impact on target firms, with the goal of developing the body of knowledge necessary for the formulation of the proper regulatory response. In doing so, we recommend the following guiding principles:

- *The burden of proof should fall on those calling for restricting access to national markets*. While we recognize the need for further investigation, we note that, despite over a half-century of SWF activity, there are no examples of politically charged or otherwise detrimental (to recipient economies) SWF investments. At the same time, the benefits associated with long-term, stable investments are obvious.
- *Beware of excessive transparency*. Regulators have singled out SWFs for their lack of transparency. Yet, many other investment vehicles, such as hedge funds, are just as opaque. While transparency is, in general terms, desirable, transparency imposed on select market participants can put those at a serious disadvantage and lead to unprofitable trading; in fact, evidence indicates that SWF profitability is inversely related to their transparency.[4] Any measure aimed at increasing transparency should not be targeted at any specific class of investors. SWFs need to provide information to regulators, but should not be subject to any further transparency requirements in respect to other market participants.
- *Act multilaterally -- involve the World Trade Organization along with the IMF.* Past experience with FDI regulation suggests that multilateral action is more effective than bilateral agreements. Accordingly, we urge regulators to act in concert. The IMF brokered the Santiago Principles last year, and should remain involved in negotiations between SWFs and investee countries. Another international body that naturally emerges as a candidate for assuming a true regulatory role is the WTO, as it already enforces the General Agreement on Trades in Services which covers most SWF investments.
- *Remember that SWFs are not all equal*. Governments must realize that SWFs are a heterogeneous group. They vary dramatically in respect to size, funding, objectives, investment style and sophistication. Accordingly, regulators should resist the temptation to restrict SWFs unduly in the event of a fund "misbehaving." Regulation should, *a priori*, treat all SWFs equally, but any ad-hoc response should affect the offending fund, rather than the entire category.

Formulating the proper regulatory response requires striking a fine balance between the need for foreign capital and the danger of foreign governments interfering in sensitive sectors of the economy. Yet, while the benefits are clear, the risks are not yet understood. Unfortunately, a global financial crisis and recession is not the best time for the development of a cool-headed, rational, regulatory response, but the actions of western governments during this period are likely to shape the landscape of FDI for years to

[4] Bernardo Bortolotti, Veljko Fotak, William Megginson, and William Miracky, "Sovereign wealth fund investment patterns and performance," Fondazione Eni Enrico Mattei Working Paper, mimeo (2009).

come. In the short term, we urge regulators to rely on existing FDI restrictions, already ensuring the avoidance of the most pernicious scenarios, and on SWF self-regulation, while encouraging the study of SWF investments.

Chapter 11

Sovereign wealth funds: Much ado about some money

Charles Kovacs[*]

The first sovereign wealth fund was established by Kuwait in 1953,[1] and was followed by many others from 1973-1974, after the first oil crisis.[2] Since then, each major jump in oil and gas prices increased the number and size of SWFs; after 2000, countries with large trade surpluses also began to establish SWFs. By April 2009, SWFs had grown to US$ 3-5 trillion of assets under management,[3] invested mostly in high quality bonds. Equity investments have been a much smaller part of their portfolio and began to grow only in the 1990s. This trend has since accelerated with at least 698 documented equity investments between June 2005 and March 2009.[4]

These investments brought SWFs not only increased attention, but also their name, adopted by the *Financial Times* in May 2007.[5] This has been unfortunate and misleading. The term has endowed SWFs with a special and even threatening aura, even though, under international law, they do not enjoy sovereign immunity, as they are just state-owned entities, along with government-owned airlines, banks, shipping companies, etc. We have a long history of national and international jurisprudence for dealing with these, but, since reality is rarely a bar to fashion, the term is here to stay.

The recent large investments by SWFs in troubled financial institutions brought these funds unprecedented publicity, and the increased attention of the governments of host countries and of International Financial Institutions. The former were interested mainly in the economic and security implications of SWFs' investments, while the latter, and the OECD in particular, seem concerned that SWFs might face restrictions by host countries of the kind that many of the SWFs' home countries have been applying against foreign investors.[6]

How important in fact are the SWFs? Of course, 3-5 trillion dollars is a lot of money, but it is only a small part of the investment universe. This universe includes external

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[1] Bernardo Bortoletti, Veljko Fotak, William L. Meggison, William F. Miracky, "Sovereign wealth fund investment patterns and performance," MSS Draft, 13 July 2009, pp. 39 and 49. (Hereafter: BFMM).

[2] Singapore was the exception to this rule; it established in Temasek Holdings in 1974, and the Government of Singapore Investment Corporation in 1981.

[3] BFMM, op. cit., p. 37, listing 32 funds that meet Monitor-FEEM standards, with US$ 1,831 million in assets, while UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008), p. 20 reported US$ 5 billion as a headline number, but also noted US$ 3 billion+ as a credible estimate.

[4] BFMM, op. cit., p. 1.

[5] BFMM, op. cit., p. 50.

[6] See e.g., OECD, "Sovereign wealth funds and recipient country policies: report by the OECD Investment Committee," (Paris: Organisation of Economic Co-operation and Development, 2008).

sovereign debt of US$ 55 trillion, equities of at least US$ 40 trillion, plus even more in real estate, artificial financial instruments, precious metals, commodity trading instruments, and so on and on. SWFs are actually one of the smaller players, just above hedge funds. By way of comparison, pension funds, mutual funds and insurance funds *each* have approximately US$ 20-23 trillion of assets.

Paradoxically, SWFs are least important with regards to FDI, defined by the IMF as equity investments that exceed 10% of the target company's voting shares. Annual FDI flows in the past 10 years have ranged between US$ 600 billion to a record US$ 2 trillion in 2007. Meanwhile, the FDI from SWFs amounted to only US$ 10 billion in 2007: 0.2% of their total assets, and 0.6% of the FDI flows that year.[7]

Clearly, the attention and concern generated by SWFs has been disproportionate to their systemic importance, and especially so regarding FDI. The reasons? SWFs are good copy for the media because most are from distant countries with dictatorial or authoritarian regimes, they are at least vaguely mysterious, and many of their transactions are genuinely newsworthy. The media's focus has in turn generated hype and political attention, and much of what we are witnessing now is similar to the spectacles of the late 1970s about Arab equity investments in the United States and Western Europe.

The attention by governments has been partly a response to public and political pressures, but their concern about national security should not be underestimated. All foreign investment has been subject to national security considerations for a long time. SWFs are instruments of state, mostly of states with at best delicate relations with NATO member countries, and several belong to potential adversaries with a long history of extensive and effective espionage. SWFs are not the best vehicle for information gathering, influencing host countries, and for various economic and commercial mischiefs, and this is why national security related reviews cover all foreign investments.

In the coming years, SWFs will grow in number and size, probably in an international arena more turbulent than now, and SWFs will continue to favor the major advanced economies. Although SWFs are unlikely to become a significant source of FDI, their importance in other equity investments may well increase along the lines of their recent acquisitions of up to 9.99% of several major financial institutions. Consequently, host governments will continue to be obliged to follow a fine line between the demands of national security, balanced against the desirability of increased capital inflows, and the goodwill of countries needed for the attainment of foreign policy objectives.

This may well require a review process for SWFs that goes beyond the existing review mechanisms, and may even have informal aspects. Host countries will need to differentiate SWFs by their nationality and by their relationship with the host countries. Therefore, decision-making will need the direct involvement of the diplomatic, military and intelligence communities while still acting within the time frame required by investors. All this may seem daunting, but the United States and the United Kingdom in

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[7] UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008), p. 20.

particular have immense experience in dealing with foreign investment since the First World War. These experiences and *modus operandi* are readily transferable to existing or new monitoring entities. It remains to be seen whether SWFs will become a source of conflict or of responsible capital, but judging from past experience, a sensible and sensitive review process should serve well both the SWFs and the host countries as long as they are both aiming at a seamless and quiet settlement of actual and potential disagreements. After all, business is business, and host countries and SWFs have already established an agreeable symbiotic relationship.

Chapter 12

Roll out the red carpet and they will come: Investment promotion and FDI inflows

Torfinn Harding and Beata Javorcik [*]

Foreign direct investment (FDI) flows to developing countries are hindered by many factors. Two of these factors -- the mere lack of information and red tape -- could be easily remedied through investment promotion efforts.

Prior to undertaking FDI in a foreign country, investors need to familiarize themselves with the rules and regulations prevailing in the host country. They need to analyze its growth prospects and obtain detailed information on labor costs. They may want to know about the availability of potential joint venture partners or suppliers of inputs. While information on developed countries is readily available and consulting firms can assist in this process, obtaining information on business conditions in developing countries is often tricky.

Once an investment decision is made, investors need to comply with a series of bureaucratic procedures. As illustrated by the *Doing Business Indicators* produced by the World Bank, such procedures may be quite burdensome. For instance, the number of procedures required to start a business varies from 2 in Georgia to 21 in Equatorial Guinea. The number of days required to complete a registration process ranges from 2 in Georgia to 649 in Suriname.

Investment promotion efforts can reduce the negative effect of the lack of information and the burden of bureaucratic procedures and in this way stimulate inflows of FDI.[1] Sectors targeted by investment promotion agencies receive twice as much FDI in the post-targeting period relative to the pre-targeting period and non-targeted sectors. Importantly, the effect is not driven by promising industries being targeted.[2] The magnitude of the effect is plausible, since the median sector-level investment (in country-

[*] The authors wish to thank Henry Loewendahl, Karin Millett and Stephen Young for their helpful comments on an earlier text on this chapter, which was first published as a *Perspective* on June 18, 2012.

[1] For details, see our "Roll out the red carpet and they will come: Investment promotion and FDI inflows," *Economic Journal*, vol. 121 (December 2011), pp. 1445-1476. Our study took advantage of differences in investment promotion efforts across countries, sectors and time and the fact that most investment promotion agencies (IPAs) target particular sectors to attract FDI. It used information on sector-specific investment promotion efforts and detailed figures on flows of US FDI into 95 developing countries during 1990-2004 to conduct a difference-in-differences analysis.

[2] The results hold when the sample excludes countries whose targeting decision was based on the past success or failure in attracting FDI to the sector. There is no evidence suggesting that targeting took place in sectors with relatively high or low inflows in the years preceding targeting. Finally, a strict exogeneity test does not reject the validity of the empirical strategy used. The analysis controls for changes in host country business environment by including country-year fixed effects, heterogeneity of sectors in different locations by including country-sector fixed effects and shocks to supply of FDI in particular sectors by adding sector-time fixed effects.

sector combinations with positive FDI flows) reached US$ 11 million in 2004. The estimated effect of investment promotion, therefore, translates into an additional annual inflow of US$ 17 million.

How exactly does investment promotion increase FDI inflows? The process of selecting an FDI site typically involves four stages. First, a long list of 8-20 potential host countries encompassing popular FDI destinations, countries close to existing operations and emerging FDI destinations is created. The third group represents an opportunity for an IPA that, by advertising in the business press and participating in industry fairs, can draw attention to its country. In the second stage, about five sites are selected from the long list, based on the trade-off between costs and the quality of the business environment. The accessibility of the information about potential host countries plays a crucial role, as sites under consideration are rarely visited during this stage. IPAs that have up-to-date, detailed and accurate data on their websites and are willing to prepare detailed answers to investors' inquiries can increase the chances of their countries being included in the short list. In the third step, the investor typically visits the host country, giving the IPA an opportunity to emphasize the advantages of locating there, present potential investment sites and facilitate contacts with the local business community. IPAs can also play a role in the fourth and final stage by providing information on investment incentives and offering help with the registration process.

IPAs stimulate FDI inflows by facilitating access to information and reducing the burden of red tape. More specifically, investment promotion is more effective in countries where English is not an official language and in countries that are more culturally distant from the United States. These two findings are consistent with investment promotion reducing information and communication barriers between US investors and host countries. Also, investment promotion works better in countries with less effective governments, higher corruption and a longer time period required to start a business or obtain a construction permit, which is consistent with investment promotion alleviating problems of red tape.

Chapter 13

It's time for an EU Investment Promotion Agency

José Guimón[*]

One important novelty of the Lisbon Treaty, ratified by the EU in December 2009, is the inclusion of FDI within the scope of Common Commercial Policy, implying a transfer of certain FDI competences from the member states to the EU, which now has the ability to conclude international investment treaties.[1] Until now, member states had full competence over FDI, and the role of EU institutions was very limited. It remains to be seen how the new Treaty will be interpreted and implemented in light of the difficult legal and political questions that this development raises.

While the Treaty does not propose any change regarding FDI promotion competences, perhaps this is also the opportunity to take a more active, coordinated approach to FDI promotion at the EU level. Within the European Single Market, member states fiercely compete against each other and have steadily increased the scale and scope of resources devoted to national and sub-national investment promotion agencies (IPAs). While competitive FDI promotion will remain, a critical challenge now is to increase cooperation among member states to attract more FDI into the EU as a whole.

There are several reasons for this suggestion. There might be information failures to be addressed at the EU level: for example, the potential for cross-border activities by foreign MNEs across the EU, the incentive schemes available at the EU level or the mechanisms to engage in European research networks and to benefit from European R&D funding. The sharp decline in FDI inflows in recent years also supports a coordinated EU approach to FDI promotion: according to UNCTAD, in 2009, FDI into the EU fell by 28%, following a deeper 40% decrease in 2008. This does not necessarily mean that the EU is losing FDI competitiveness -- for example the US experienced a similar decline -- but it is still reason for concern. What's clear is that the share of developed countries in FDI inflows has fallen significantly relative to the share of developing economies, within a context of shrinking global FDI flows.[2] Moreover, the prospects for the near future are also worrisome; only four EU countries appear among the 15 most attractive FDI locations in 2009-2011.[3] The most attractive country is China, followed by the US; the first EU country is the UK, in sixth position. Besides the necessary reforms to improve the business climate, it therefore seems clear that a more efficient promotion of the EU as a regional bloc would be desirable.

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[*] The author wishes to thank John Kline, Armand de Mestral, Manfred Schekulin, and Stephen Young for their helpful comments on this chapter, which was first published as a *Perspective* on March 4, 2010.

[1] See Armand de Mestral, "The Lisbon Treaty and the expansion of EU competence over foreign direct investment and the implications for investor- state arbitration," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2009/2010* (New York: OUP, 2010).

[2] For a detailed review, see chapter 5 above, Laza Kekic, "The global economic crisis and FDI flows to emerging markets."

[3] UNCTAD, *World Investment Prospects Survey 2009-2011* (Geneva: UNCTAD, 2009).

In fact, several initiatives have emerged along these lines in recent years. For example, the European Attractiveness Scoreboard, launched in 2007 as a joint initiative of the governmental IPAs of France and Germany, gives insight into Europe's investment climate and provides a comprehensive overview of Europe's business strengths. The benchmark study compares Europe with competing investment locations, including the US, China, Japan, India, and Brazil, based on a comprehensive range of economic and social indicators.

More recently, the EU chapter of the World Association of Investment Promotion Agencies (WAIPA) has also taken action. WAIPA brings together national and sub-national IPAs from all over the world; its EU chapter, currently chaired by Invest in Spain, comprises all the EU member states except Luxembourg. Invest in Spain has been preparing a first draft of a promotional document entitled “Why Europe?” that has been presented and discussed with the other EU IPAs. This document aims at becoming a marketing piece for the EU as a whole and to serve as an investment guide for international dissemination.

These initiatives should be seen as just the initial phase of intra-EU cooperation, focusing primarily on the elaboration of promotional documents and investment guides. The next (and more controversial) question is whether the EU should further develop common FDI promotion policies and tools. This could be done under the umbrella of an EU IPA, akin to the US’ Invest in America.

Like Invest in America, the EU IPA should focus solely on efforts to promote the EU as a whole. It could develop a website and materials to provide information about the strengths of the EU in different sectors or about the regulatory regime and incentives available at the EU-level. It could provide support to foreign investors, for example helping to find suitable business partners or suppliers or to comply with EU-level competition regulations. It could also aim at stimulating collaboration and synergies among national IPAs, for example by organizing joint seminars and missions abroad. Finally, it could play an important policy advocacy role in Brussels, by suggesting possible solutions to the business climate concerns of foreign investors. It should always remain neutral and refer foreign investors to the different national contact points when asked about specific locations within the EU. This agency would not need a big resource structure; for example, Invest in America operates with around seven employees.

The first priority of common EU investment promotion should be to communicate better the strengths of the EU as a location for innovation and R&D, since many of the recent developments of the so-called European Research Area remain obscure to foreign investors. The EU aspiration to become “the most competitive knowledge-based economy in the world” requires not only encouraging European companies to invest more in R&D, but also attracting the R&D activity of foreign MNEs.

The key challenge ahead will be to balance the natural competition among member states with the need for stronger cooperation to compete better globally as a regional block.

Chapter 14

Investment incentives and the global competition for capital

Kenneth P. Thomas[*]

Investment incentives (subsidies designed to affect the location of investment) are a pervasive feature of global competition for FDI. They are used by the vast majority of countries, at multiple levels of government, in a broad range of industries. They take a variety of forms, including tax holidays, grants and free land. Politicians, at least in the United States, may have good electoral incentives to use them.[1]

The Philippines has been estimated to spend 1% of GDP on "redundant" investment incentives (the investment would have come without subsidy); Vietnam's incentives were estimated at 0.7% of GDP in 2002; and US state and local governments spend approximately US$ 46.8 billion per year on location subsidies.[2] This is just the tip of the iceberg, as most countries' incentive spending is poorly reported.

Like all subsidies, investment incentives tend to be economically inefficient and make income distributions more unequal (by transferring funds from average taxpayers to owners of capital). At times, they subsidize environmentally harmful projects, such as building a shopping center in a wetlands area.[3] Incentives are not always a bad policy, but their use requires taking potential problems into consideration.

Bargaining over incentives is characterized by major information asymmetries, leading to the likelihood of a government paying more than needed to attract an investment. Companies often conduct an incentives auction even when they have already made their location decision,[4] a clear sign of rent-seeking behavior.[5]

The past two decades have seen the spread of incentives to developing countries. Sometimes they find themselves in direct competition with industrialized countries for a particular investment. There are numerous cases in which developing countries have paid much higher incentives than those paid for similar investments in developed countries, reducing funds for infrastructure and education. A recent example is Goiás state's (Brazil) US$ 125 million subsidy to Usina Canada for a US$ 25 million investment in an ethanol facility in 2009, which came to over US$ 200,000 per job. In India, Gujarat state won a

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[*] The author wishes to thank Magnus Blomstrom, Marie-France Houde and Charles Oman for their helpful comments on this chapter, which was first published as a *Perspective* on December 30, 2011.

[1] Nathan M. Jensen and Edmund J. Malesky, "FDI incentives pay—politically," *Columbia FDI Perspectives,* No. 26 (June 28, 2010).

[2] Kenneth P. Thomas, *Investment Incentives and the Global Competition for Capital* (New York: Palgrave Macmillan, 2011).

[3] C.D. Selzer, "The low road," *Riverfront Times*, August 18, 1999.

[4] Greg LeRoy, *The Great American Jobs Scam* (San Francisco: Barrett-Koehler, 2005), p. 54.

[5] Anne O. Krueger, "The political economy of the rent-seeking society," *American Economic Review*, vol. 64 (June 1974), pp. 291-303.

2008 competition for the right to produce the Tata Nano. While subsidy estimates vary widely, they start at about US$ 800 million, far above the cost of Tata's investment.

Given the potential problems and risks of using incentives, many analysts have sought policies to control them. The most comprehensive approach is embodied in EU regional aid policy, which sets a maximum level of subsidy for every region in the European Union, with the highest subsidies allowed only in the European Union's poorest regions; many richer areas are banned from providing regional aid to any company. Moreover, these maxima are progressively reduced for investments over € 50 million, which helps put the brakes on the size of incentives. EU state aid rules require subsidies to be notified in advance to the European Commission and provide the Commission wide discretion to approve, prohibit or modify a proposed subsidy. The notification rules ensure a level of transparency seen in few other parts of the world. The EU rules have meant that Member States have given much smaller subsidies than US state governments for similar investments. For example, Hyundai received incentives of about US$ 117,000 per job from Alabama in 2002, but only about US$ 75,000 per job from the Czech Republic in 2007. Alabama's per capita income in 2006 was US$ 29,414 while the Czech Republic's was US$ 12,680 at current exchange rates and US$ 21,470 at purchasing power parity exchange rates. This and similar comparisons strongly suggest that EU regional aid control is effective in reducing investment incentives.

At the global level, no comparable rules specifically address location subsidies, although the WTO Agreement on Subsidies and Countervailing Measures applies to all subsidies and the OECD Declaration on International Investment and Multinational Enterprises provides for consultations. Subnational agreements in Australia and Canada prohibit subsidizing the relocation of existing operations (more successfully in the former than in the latter), and Vietnam, like the European Union, has variable subsidy limits for its provinces based on their per capita income.

Outside the European Union and several US states, information on incentives is only as good as a country's press corps. Australia and Canada collect reports on incentives from their states and provinces, but do not make this data public. Thus, transparency is the first step to reform in most of the world.

Beyond transparency, other reforms can make incentive policy more effective. This would include banning relocation subsidies, adopting job quality guidelines and "clawback" policies to reclaim incentives from firms that do not meet their investment or job creation commitments, requiring linkages with local enterprises, and adopting regional incentive control rules like those in the European Union.

Chapter 15

FDI incentives pay -- politically

Nathan M. Jensen and Edmund J. Malesky [*]

Despite broad skepticism about the benefits of globalization, the majority of US states have offered lucrative tax incentives to attract investment.[1] The size of these incentives is generally considered too large to be welfare enhancing, and many economists are skeptical of the effectiveness of these policies. Yet despite the mounting evidence to the contrary, the incentives offered by US states (and foreign countries) continue and have actually increased in their generosity over time.

In the fall of 2009, we sought to solve this puzzle by conducting an Internet survey of 2,000 Americans as part of a Cooperative Congressional Election Study (CCES) project. In this survey, we included questions to assess how individuals feel about FDI and the individuals' efforts to hold politicians accountable for its attraction.[2] Our central finding is that politicians can use tax incentives to take credit for investment flowing into their district, or deflect blame for losing the competition for mobile firms. Thus, fiscal incentives, while economically inefficient, may be a useful tool for politicians to win reelection.

Our first question in the survey asked: "In recent years ____ companies have invested in the United States. Do you think these investments are good for the US economy?" One-third of the respondents had the above blank filled in with the word "*foreign*," one-third with "*Japanese*," and one-third with "*Chinese*." When asked about foreign companies, the majority of respondents (55%) indicated that these investments are good for the US economy. A sizable percentage disagreed (22%) or answered "don't know" (23%). Support for investment increased when asked about Japanese investment, where 61% of the respondents answered "yes," and the remainder answered "no" (18%) and "don't know" (21%). This support plummeted to only 35% when asked about Chinese investment, with 45% answering "no" and 20% "don't know" (annex figure 1).

These survey results reveal mixed support for FDI with sizeable minorities either skeptical or uncertain of its benefits. When asked about Chinese investment, the skeptics outnumber the supporters, likely due the perception of China as our closest foreign

[*] The authors thank the Center for Empirical Legal Research and the Weidenbaum Center for the Study of Economy, Government, and Public Policy for funding this survey. They also wish to thank David Leblang, Glen Biglaiser, and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on June 28, 2010.

[1] The 2008 Pew Global Attitudes Survey found that only 25% of Americans thought foreign investment had a "very good" or "somewhat good" impact on the United States while 67% answered "negative" or "very negative" opinion. http://pewglobal.org/category/data-sets/.

[2] Nathan M Jensen, Edmund Malesky, Mariana Medina, and Ugur Ozdemir, "Pass the bucks: investment incentives as political credit-claiming devices. Evidence from a survey experiment," Paper presented at the 2010 Globalization and Governance Conference, (Washington University in St. Louis, 2010).

competitor. We imagine that a similar survey in the 1980s may have found skepticism toward Japanese investment, when Japan was seen as our closest rival.

A second set of questions[3] asked citizens about their voting intentions for governor. While many factors affect voting for governor, attracting investment (foreign or domestic) has become central to many governors' economic development strategies. We asked respondents to imagine a 1,000-job manufacturing facility either choosing to locate in the respondent's state or in another state, and how this affected voting intentions for the governor.

Our results were striking. The attraction of investment, without knowing the firm-specific reasons for the location decision, led 20.9% more respondents to say they would vote for the incumbent governor than in states that did not receive the investment, after controlling for individual and state determinants. This was especially apparent for independent voters (23.6%), whereas partisan voters (strong Democrats or Republicans) were less swayed by this information (annex figure 2).

We also provided information on tax incentives, asking respondents to consider a situation in which the state provided either above-average or below-average incentive packages. Again, our findings were clear. For states that received the investment project, the governor received an additional 5.6 percentage point vote bonus for offering tax incentives from independents. This bears repeating. Independent voters preferred governors that provided tax incentives to attract investment to governors who received investment without offering generous tax incentives.

When states "lost" our hypothetical investment project, the contrast was even clearer. Governors who did not receive the investment were always worse off than governors from states who attracted the investment, but the "punishment" was much less severe if tax incentives were offered. Put another way, if you are a governor of a state and are certain that a firm is going to locate within your borders, offering a tax incentive gets you an extra 5.6 percentage points of votes from independent voters. Go ahead and take credit for the investment. If you know your state is going to lose the project, the decision is easier still. Offering the tax incentives provides an extra 5.3 percentage points of all votes and 11.2 percentage points of independents. "It's not my fault, we offered them tax incentives!"

The findings from the survey indicate two clear points related to public policy. First, the tax wars among states, and possibly among countries, are strongly driven by domestic politics. Politicians may be trying to take credit for investment that is going to come anyway and/or trying to minimize blame for investment that does not come. Even without

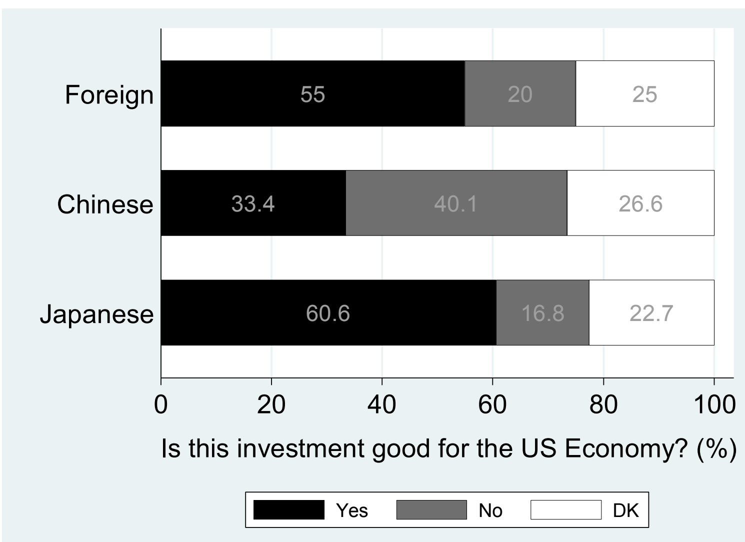
[3] YouGovPolitmetrix uses a sample matching methodology to account for non-response bias in Internet surveys and simultaneously generates a nationally representative sample of respondents. We administered our questions to 2,000 respondents, who matched the national population demographically. The sample matching correction for Polimetrix has been shown to deliver highly representative samples and accurate forecasting predictions in repeated studies of this nature. See Lynn Vavreck and Douglas Rivers, "The 2006 Cooperative Congress Election Study," *Journal of Elections, Public Opinion, and Parties,* 18.4 (2008), pp. 355-366.

any tax competition, politicians may be taking advantage of voters' perceptions (or misperceptions) of competition.

Second, despite some popular rhetoric against FDI, and specifically Chinese FDI, we find strong evidence that there are massive political benefits to attracting FDI.[4] Although many voters are skeptical of its benefits nationally, they clearly reward politicians for attracting investment to their state.

Congressional pollsters have noticed a strange pattern over time. While nobody seems to like the institution of Congress or incompetent politicians, survey data (and the 90% reelection rate) suggest that voters like *their* members of Congress. Our findings point to an interesting parallel with the perceptions of Americans on FDI: there is some skepticism of the benefits of FDI, unless it is creating jobs in *their* state.

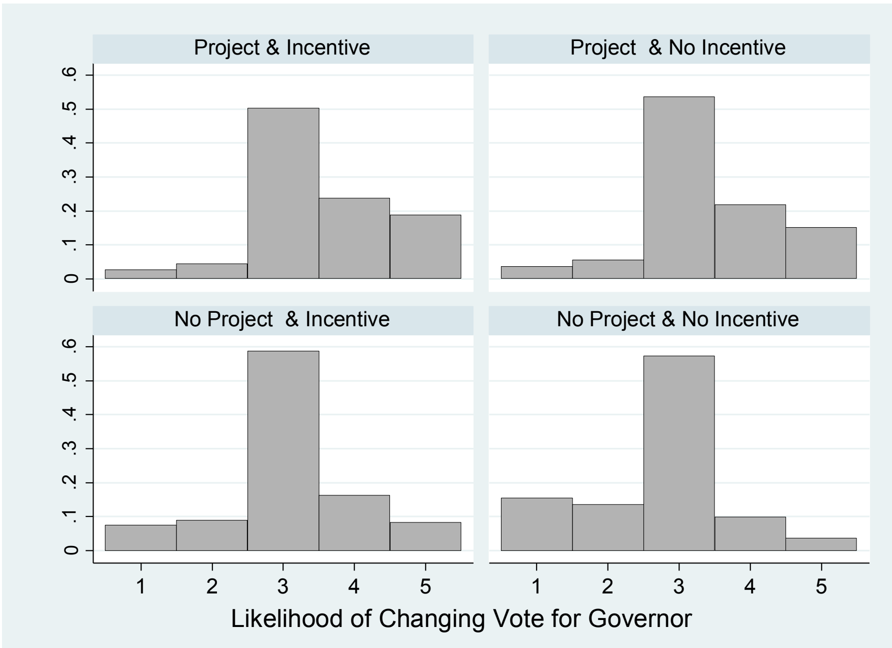
Annex figure 1. FDI incentives: is this investment good for the US economy? (%)[a]



[a] Results from all voters, sample size 1,944. "In recent years [foreign], [Chinese], [Japanese], companies have invested in the United States. Do you think these investments are good for the US Economy?" (Options randomized into three groups).

[4] One example is the increasing concern about FDI and national security. See Edward M. Graham and David M. Marchick, *US National Security and Foreign Direct Investment* (Washington D.C.: Peterson Institute for International Economics, 2006).

Annex figure 2. FDI incentives: likelihood of changing vote for governor [a]



[a] Results from independent voters, sample size 453. Horizontal Access likelihood of voters changing support for Governor from 1 (very unlikely) to 5 (very likely).

Chapter 16

Improving infrastructure or lowering taxes to attract foreign direct investment?

Christian Bellak and Markus Leibrecht[*]

A crucial challenge to all countries in the current economic crisis is to stimulate investment, including FDI. Countries striving to attract FDI often resort to two types of policies: improving infrastructure or lowering taxes, as a means of attracting new FDI, or keeping existing FDI. Indeed, recent empirical studies (e.g., Bénassy-Quéré et al. 2007; Bellak et al. 2009) confirmed that both lower taxes and improved infrastructure exert a considerable influence upon MNEs' decision to invest in a particular country, when controlling for other important location factors (including market size and labor costs).

Excellent infrastructure is not only a key determinant for foreign investors but also helps to improve the competitiveness of domestic firms. High taxes – corporate income taxes in particular – are often seen as a deterrent to MNEs, as they directly reduce their after-tax profits. Alternative locations with a lower tax burden – and otherwise similar investment conditions – can change the investment decisions of MNEs (e.g., de Mooij and Ederveen 2008).

Policy-makers are pressed by limited budgets to find the optimal policy-mix to maximize FDI at a minimum cost to the government and taxpayers. Given the important effects of improved infrastructure and lower taxes on FDI, policy-makers must consider two important questions when designing their policies:

1. What is the relative importance of lower taxes and improved infrastructure for attracting FDI?

2. How does the possible negative effect of high taxes on FDI change if a country invests more in infrastructure? This is an important question, since often both policies, (i.e., lowering taxes *and* investing in infrastructure), cannot be achieved simultaneously, since the former are required to fund part of the latter. It is worth noting though, that in most cases infrastructure is not funded solely by taxes on mobile factors but via general budget revenues including debt.

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[*] The authors wish to thank Agnès Bénassy-Quéré and Jack Mutti for their helpful comments on this chapter, which was first published as a *Perspective* on June 3, 2009.
References: Christian Bellak, Markus Leibrecht and Joze P. Damijan, "Infrastructure endowment and corporate income taxes as determinants of Foreign Direct Investment in Central- and Eastern European Countries," *The World Economy*, vol. 32 (2009) 2, pp. 267-290; Agnes Bénassy-Quéré, Nicolas Gobalraja and Alain Trannoy, "Tax and Public Input Competition," *Economic Policy*, vol. 22 (2007) 4, pp. 385-430; and Ruud A. de Mooij and Sjef Ederveen, "Corporate tax elasticities: a reader's guide to empirical findings," *Oxford Review of Economic Policy*, vol. 24 (2008) 4, pp. 680-697.

The empirical study by Bellak et al. (2009) revealed that taxes are somewhat less important as a location factor (standardized coefficient of -0.25) than infrastructure (0.27). Moreover, the study revealed that, among the various types of infrastructure, information and communication infrastructure is more important (0.45) than transport infrastructure (0.19) and electricity generation capacity (0.06). Moreover, the significant impacts of taxes and infrastructure are robust not only across different specifications but also with respect to countries included in the analysis. Concerning the latter, the study is based on FDI measured by bilateral FDI outflows of seven major home countries of FDI -- Austria (AUT), Germany (DEU), France, Great Britain (GBR), United States (US), the Netherlands (NLD) and Italy (ITA) -- to eight important Central and Eastern European host countries -- Czech Republic (CZE), Hungary (HUN), Poland (POL), Slovakia (SVK), Slovenia (SVN), Bulgaria (BGR), (Croatia) HVN and Romania (ROM) -- during the period from 1995 to 2004. The gross national product at current market prices per head of population was as follows in 2004, in € 1,000: AUT: 28.3, DEU: 27.1, FRA: 26.8, GBR: 30, US: 32, NLD: 31, ITA: 23.8, CZE: 8.2, HUN: 7.7, POL: 5.2, SVK: 6.1, SVN: 13.4, BGR: 2.6, HVN: 7.2, ROM: 2.7. The EU average value was 21.7.[1] Therefore, the results are derived based on a set of countries with a wide range of development. Finally, it has to be stressed that the host countries of FDI included are rather heterogeneous in both key variables, the tax burden levied on FDI as well as the endowment with infrastructure.

With respect to the second question, the study also measured the interaction between taxes and infrastructure, and the analysis shows that the negative impact high taxes have on FDI are negatively correlated with a country's infrastructure endowment; in fact, the negative effect of taxes even vanishes for countries with relatively high levels of infrastructure (see also Bénassy-Quéré et al. 2007). Put differently, infrastructure generates specific advantages of a location, which allow higher taxes on profits from FDI without discouraging such investment.

Conclusions

The policy implications of this important result for a country seeking to attract FDI (especially countries currently debating the relative merits of cutting taxes versus increased spending, such as the United States) actually depend on the tax regime of the country.

High tax countries should continue to invest in infrastructure, and do not have to participate in the "race to the bottom" in tax rates, as well-developed infrastructure will negate the potentially negative effects of high taxes on attracting and keeping FDI. Countries with an above average infrastructure endowment can – at least in part – afford to finance their infrastructure by taxing corporations. In other words, a policy of contributing to improvements in productivity investments in production-related infrastructure in fact compensates MNEs for higher taxes.

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[1] Source: AMECO database, available at:
http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm.

The remaining policy issue for such governments is how much they should invest in infrastructure and which types of infrastructure should a country focus on. As mentioned above, information and communication infrastructure has been shown to be the most effective for attracting FDI, followed by transport infrastructure. Moreover, information and communication infrastructure is shown to be more important than corporate taxes as determinant of FDI (standardized coefficients of 0.45 and -0.25, respectively). Thus, it would be better to invest in information and communication infrastructure than lowering corporate taxes to attract and keep FDI.

For *low tax countries* with an inferior infrastructure endowment, like many developing countries and transition economies, the importance of tax policy is still relatively important, since the infrastructure endowment does not compensate for the costs of high taxes. The silver lining, however, is that FDI does react to changes in tax rates, so such countries can adjust their tax policies to attract more FDI. In the short term, such countries will likely be most successful in attracting FDI by relying on a strategy of low corporate income taxes. In the longer term, however, these countries should harness the positive contribution of FDI in their countries to invest in improving their infrastructure.

These results are of relevance to the current economic crisis, where countries have been scrambling to design stimulus packages that will increase investment, by domestic firms and foreign MNEs.

PART II

THE RISE OF EMERGING MARKET INVESTORS

Chapter 17

From the FDI triad to multiple FDI poles?

Persephone Economou and Karl P. Sauvant[*]

Twenty years ago, in the inaugural issue of the *World Investment Report*,[1] the United Nations highlighted a shift in the global pattern of FDI from bipolar, dominated by the United States and the European Community, to tri-polar (the FDI Triad), dominated by the European Community, the United States and Japan.

This Triad needs to be revisited, given the rise of FDI from emerging markets (EMs).[2] To qualify as a Triad member, a "pole" has to account for at least 10% of global FDI outward stocks and flows. While an arbitrary cut-off share, it is indicative of a considerable presence in the world FDI market.

Since 1991, the share of the European Community (modified to include all 27 members of the European Union) declined from 85% in 1990 to 74% in 2009 in world outward FDI *stock* and from 85% during 1990-1992 to 74% during 2007-2009 in world outward FDI *flows*.[3] Of the three poles of the original Triad, Japan's share in the global FDI outward *stock* slumped from 10% to 4% between 1990 and 2009, while its share in global *outflows* fell from 16% during 1990-1992 to 5% during 2007-2009. According to the "at-least-10%" cut-off share, Japan no longer qualifies as a Triad pole.

The ascendancy of EMs makes them a candidate for a Triad pole. Their share in the world's outward FDI *stock* rose from 7% in 1990 to 16% in 2009. Moreover, the momentum is on their side: their share of global FDI *outflows* jumped from 8% during 1990-1992 to 25% during 2007-2009.

Admittedly, EMs are a large group of economies at different stages of development. However, only 20 together accounted for 85% of FDI outflows from all EMs during 2005-2009 (excluding tax havens). This smaller group is roughly comparable, at least in number, to the 27 members of the European Union, also a rather diverse group of countries at different levels of development.

The share of the top 20 (all at least middle-income economies) EMs in global FDI *stock* rose from 6% to 13% between 1990 and 2009. Their share in global *outflows* grew from 6% in 1990-1992 to 14% in 2007-2009. With a share of over 10% in both outward flows and stocks, EMs (essentially the top 20) could be seen as having replaced Japan as a pole in a new FDI Triad, alongside the United States and the European Union.

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[*] The authors wish to thank Laza Kekic, John Kline, Ted Moran, and Louis Wells for their helpful comments on this chapter, which was first published as a *Perspective* on July 18, 2011.

[1] UNCTC, *World Investment Report 1991: The Triad in Foreign Direct Investment* (New York: United Nations, 1991).

[2] Emerging markets" are all economies not classified as "developed countries" by UNCTAD.

[3] All data are from UNCTAD's FDI database.

However, EMs as a Triad pole may be a short-lived phenomenon. The BRICs as a group are emerging as strong candidates for a pole. As of 2009, they had not made the cut-off in terms of *stocks*, together accounting for only 4% of global outward FDI stocks; even if Hong Kong, China and Macao, China are included in China's stock, their share would reach only 8%.[4] However, the BRICs may soon reach the 10% cut-off in terms of *flows*: over the period 2008-2010, their share in global FDI outflows jumped to 9%; if Hong Kong, China and Macao, China are included, that share becomes 13%.

Furthermore, regional integration schemes (e.g. ASEAN), or individual EMs (e.g. China) -- could become FDI poles. This would signify a fuller transition from the old FDI Triad to a multi-polar FDI world, one in which smaller poles coexist with the dominant members of the former Triad.

What are policy implications of these changes? On a practical level, investment promotion agencies need to target these new poles when attracting FDI. Also, the new players (and established investors) will need to understand that countries no longer look just for *more* FDI, but for *sustainable* FDI -- investment contributing as much as possible to economic, environmental and social development in the framework of mechanisms that ensures a fair distribution of the FDI benefits and on the basis of the commercial viability of individual projects.

Most importantly, the rise of FDI from EMs, crystallizing moreover in multiple FDI poles, is likely to influence international rule-making. In particular, the perspectives of industrialized countries and EMs regarding the rights and responsibilities of host countries and MNEs under international investment law are likely to become more similar, now that the most important among these markets have become significant outward investors. Should this occur, the conditions could be ripe for negotiating a multilateral framework for investment.

[4] Double-counting probably still exists as an unknown share of outflows from Hong Kong, China and Macao, China consists of transshipment FDI from China and other countries or involves "round-tripping" investment back to China.

Chapter 18

How BRIC MNEs deal with international political risk

Premila Nazareth Satyanand[*]

Hitherto, political risk has worried developed country MNEs investing in developing country markets. But as more emerging market firms invest overseas, they too must grapple with this subject. *World Investment and Political Risk 2009* looks at this issue for the first time and finds that Brazilian, Russian, Indian, and Chinese (BRIC) firms appear to worry more about political risk than global counterparts.[1] Though these results are based on a small sample of 90 of the largest BRIC investors, they are thought-provoking nonetheless.

Already, emerging market FDI outflows have tripled from US$ 100 billion in 2000 to US$ 350 billion in 2008 according to UNCTAD, driven largely by burgeoning investments from Brazil, Russia, India, and China.[2] Although the bulk of this FDI has gone into developed economies, BRIC firms have also stepped up the size and spread of their investments in other emerging markets.

Protecting against political risk

As mentioned earlier, survey data suggests that BRIC firms see political risk as more of a concern than global counterparts when investing in emerging economies. This is not surprising, since BRIC firms invest heavily even in those developing economies they consider among “the world’s five most politically risky," in contrast to global counterparts who stay clear of the markets they consider most unstable. Brazil, for instance, lists Venezuela as one of its five key emerging markets, even while ranking it as one of the world’s five most high-risk markets. China does the same with Indonesia; India with Russia and Africa; and Russia with Kazakhstan and the Commonwealth of Independent States. Also important is that the BRIC sample also had a higher percentage of natural resource firms, which are more vulnerable to political risk.

BRIC firms, like their global counterparts, worry most about breach of contract and transfer and convertibility restrictions. But Russian and Brazilian firms worry most about breach of contract; Chinese firms about war and civil disturbance; and Indian firms about transfer and convertibility restrictions. Also, while just 9% of Indian firms worry about expropriation, an average of 26% of Brazilian, Russian and Chinese firms do.

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[*] The author wishes to thank Persa Economou, Mark Kantor and Lauge Poulsen for their helpful comments on this chapter, which was first published as a *Perspective* on May 5, 2010.

[1] Multilateral Investment Guarantee Agency, *World Investment and Political Risk 2009* (Washington, D.C.: World Bank Group, 2009). The BRIC data are based on a survey conducted by the Vale Columbia Center on Sustainable International Investment (VCC).

[2] Between 2000 and 2008, Brazilian outward investment rocketed from US$ 3 billion to US$ 21 billion; Russian from US$ 3 billion to US$ 52 billion; Indian from US$ 336 million to US$ 18 billion; and Chinese from US$ 2 billion to US$ 52 billion.

BRIC firms, like global counterparts, are confident about their ability to assess political risk and implement existing mitigation strategies.[3] However, they are far less so about anticipating new political risks, evaluating new mitigation strategies and assigning roles for political risk management. They also rely on the same non-formal political risk mitigation strategies as global counterparts, according them different priorities. While global firms rely heavily on engagement with host governments and risk analysis, the Russian firms surveyed rely most on host country engagement, the Chinese on risk analysis and the Indians and Brazilians on local tie-ups. Half the Brazilian sample also relies on scenario planning.

BRIC MNEs and political risk going forward

Like global counterparts, few Brazilian, Indian and Chinese firms purchase political risk insurance (PRI), but Russian firms rely heavily upon it. More significant, 27% of the BRIC sample said they were unfamiliar with PRI products and 48% pointed to the lack of appropriate offerings, double the percentages in the global sample. Some BRIC firms said that current PRI offerings define political risk too narrowly to be of practical use. They had thus purchased it only under pressure from financiers. Some said they were deterred by PRI's high cost and cumbersome contracting.

Equally significant, some said that current PRI thinking does not take adequate cognizance of the types of "political" risk challenges they confront. Key among these is the fear of sudden policy and regulatory shift in developed markets, which are core to their global competitive strategy and where they have billions of dollars invested. India's IT globalizers, for instance, have been hurt by sudden restrictions in US visa and outsourcing-related rules. Earlier, developed markets were completely "safe," but they are now subject to worrying protectionist pressures. A sudden reversal in established business rules can abruptly disrupt a global business model, causing as much if not more of a loss as expropriation or terrorism in a less strategic emerging market. This said, 53% of BRIC firms said they would consider political risk insurance going forward, with Chinese and Indian firms highly enthusiastic, in contrast to just 40% of global respondents.

Home country governments could respond in two ways. First, they could establish or expand political risk protection for their globalizing firms. While global private sector insurers and international donors offer such protection, many BRIC globalizers find their government agencies more responsive to their needs. They also need to more pro-actively market their PRI offerings, as do private PRI players. Second is to build local private insurers' ability to provide PRI cover by permitting them to enter into reinsurance agreements with overseas insurers. As yet, few emerging market insurers have

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[3] However, companies all over the world feel more prepared to deal with financial and business, rather than political, risk. Three-fifths of respondents to *Treasury and Risk* magazine's 2009 Enterprise Risk Management Survey (June 2009 issue) felt "very confident" about identifying, assessing and managing financial risk, but only "somewhat confident" about doing so for political risk. Survey results are available at: http://www.treasuryandrisk.com/Issues/2009/June%202009/Documents/June2009Survey.pdf.

independently offered such protection, given that PRI is a specialized product, their insurance capacity is limited and, in some countries, insurance rules are still restrictive.

Chapter 19

Is Chinese FDI pushing Latin America into natural resources?

Miguel Pérez Ludeña[*]

Chinese FDI in Latin America is a recent phenomenon. Although the China National Petroleum Corporation and other companies have been present in Peru, Ecuador and Venezuela since the early 1990s, large projects have been pursued only since 2006, following an extended period of high commodity prices. The Economic Commission for Latin America and the Caribbean (ECLAC) estimated that there were US$ 15 billion of Chinese FDI inflows into Latin America in 2010, 90% of which were in extractive industries.[1] This further contributed to the already high percentage of Chinese FDI flows to the region that are in natural resources. At a time of high economic growth fueled by commodity exports and strong currency appreciation (particularly in Brazil), FDI into extractive industries strengthens the region's specialization in primary products at the expense of manufacturing and other activities.

Because of the size of their investments (and their potential to grow over the coming years), Chinese companies are singled out for aggravating this problem. Nevertheless, Chinese companies are still far from having a dominant position in the region's extractive industries. The highest concentration so far is reached in copper mining in Peru, where Chinese companies will control 25% of production by the end of the decade if all planned investments are implemented. In the oil industry in Brazil, Sinopec will have access to one billion barrels of reserves, only a small fraction of the 30 billion that Petrobras will handle. In fact, China's most important contribution to the region's extractive industries is not through FDI but through trade: the county is the most important destination for the copper, soya and iron ore produced in the region.

Another reason for focusing on FDI from China is the special role that its Government plays in the international expansion of its companies. Not only are the largest Chinese MNEs state-owned, but the Chinese Government vets investment projects abroad and promotes those that fit its development strategy with significant financial support. This means that Chinese MNEs could in principle respond to a centralized strategy that deliberately concentrates higher value-added activities in China, while pushing companies to expand mining and oil extraction in Latin America and Africa, in this way mitigating China's lack of natural resources. However, this is difficult to prove, as a close look at the strategy followed by Chinese oil and mining companies in Latin America shows that it is similar to that of their European and North American peers: they look for vertical integration and a hedge against price fluctuations.

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[*] The author wishes to thank Andrea Goldstein, Teresina Gutiérrez Haces, Marcílio Moreira, and José Antonio Ocampo for their helpful comments on this chapter, which was first published as a *Perspective* on July 18, 2011.

[1] ECLAC, "Foreign direct investment in Latin America and the Caribbean 2010 (Santiago: ECLAC, 2011), LC/G.2494-P.

Beyond that, Chinese FDI in Latin America is not limited to oil and mining operations. There are investments in other sectors, and these are likely to increase in the coming years, offering Latin American countries opportunities to improve infrastructure and develop certain manufactures beyond today's focus on the extractive industries. It should be remembered that Japanese and Korean outward FDI also started as primarily resource seeking, until rising local costs and technological progress pushed their companies into other types of investments.[2]

Infrastructure construction is a sector in which important Chinese investments can be expected in the next few years. But Latin American Governments and Chinese companies should move away from commodity-for-infrastructure deals (as it is done in Africa and some Latin American countries), toward a more transparent and market-based framework for undertaking projects.

In manufacturing, Chinese companies are attracted by the large and growing internal market in Brazil.[3] Much as China did 30 years ago, Brazil and other large economies could leverage their attractive internal market by requiring Chinese MNEs to build local capacities through using local suppliers or setting up joint ventures with local companies. In the case of Mexico and other countries specialized in export-oriented manufacturing, Chinese investments have been very modest, but there is now a new window of opportunity as rising labor costs in China during the past few years are closing the wage gap with Mexico. The current focus on competition with Chinese exports in international markets can slowly shift toward integrating Mexican manufacturing into the production networks of Chinese companies.

Chinese FDI continued to flow into Latin America in 2011, and the majority is still into natural resources. However, Chinese companies do not have different strategies from other mining and hydrocarbon companies, and Latin American governments concerned with excessive specialization in primary products should respond with integrated strategies that include macroeconomic management, fiscal measures and industrial policies. Attracting FDI into manufacturing or infrastructure (including Chinese FDI) can also help to expand capacities in other sectors.

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[2] ECLAC, "Foreign direct investment in Latin America and the Caribbean 2000" (Santiago: ECLAC, 2001), LC/G.2125-P; ECLAC, "Foreign direct investment in Latin American and the Caribbean 2006" (Santiago: ECLAC, 2007), LC/G.2336-P.

[3] Conselho Empresarial Brasil-China, "Investimentos Chineses no Brasil: Uma nova fase da relação Brasil-China" (May 2010), available at: http://www.cebc.com.br/sites/500/521/00001674.pdf.

Chapter 20

Is China's outward investment in oil a global security concern?

Ilan Alon and Aleh Cherp [*]

The motivations prompting China's dramatic increase in outward foreign direct investment (OFDI) are not always clear, especially regarding OFDI by state-owned enterprises (SOEs) in energy and natural resources. First, both commercial and governmental interests are intertwined, although not necessarily in lock-step. Chinese SOEs listed in the West may worry about the reputational risks to their global corporate citizenship, while government stakeholders may instead focus on diplomatic international relations. Second, subsidies for oil investments may be viewed as serving Chinese national interests and threatening the national security of the host countries. Whether China's OFDI will benefit or harm global energy security, economic development and diplomatic relations is still hotly contested.

China is acutely concerned about the security of its oil supplies. In the 1950s, the newly established People's Republic of China was at the mercy of the Soviets for oil. The Sino-Soviet split in the 1960s led to critical oil shortages and jeopardized the Chinese military. The Daqing Oilfield production starting in 1963 gave China temporary independence from oil imports. However, due to the depletion of Daqing and rising domestic consumption, China again became a net oil importer in 1993, sparking old anxieties and precipitating China's national goal "to provide reliable and adequate supply of oil [to the Chinese people] at a reasonable price."[1]

Each of China's three oil-related objectives -- adequacy, reasonable price, reliability -- is linked to OFDI in oil.[2] First, such investment contributes to the adequacy of oil supply by increasing the flow of oil into the market. Second, supply by national oil companies is deemed to be more reliable than foreign-sourced supplies, especially in the event of crises when state-controlled assets (such as the tanker fleet) can be directed to serve national oil needs. However, national ownership does not protect from natural disasters, political instability in producing countries, terrorist attacks, or military intervention in the Straits of Malacca.[3] Finally, subsidized investment may provide for more stable and predictable prices -- at least if it can be sustained in the long term and thus investment can be protected from market volatility.

Thus, China's investment in foreign oil assets is linked to the country's national energy security objectives. It is not surprising that, in our recent survey of nine state-owned oil

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[*] The authors wish to thank Deborah Brautigam and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on October 22, 2012.

[1] Guy C. K. Leung, "China's energy security: Perception and reality," *Energy Policy*, vol. 39 (March 2011), p. 1332.

[2] Ibid.

[3] Zhong Xiang Zhang, "China's energy security, the Malacca dilemma and responses," *Energy Policy*, vol. 39 (December 2011), pp. 7612-7615.

companies,[4] government encouragement and resource security were among the top motivations for outward oil investment. But does this investment represent a security threat to other countries?

There are two arguments supporting this concern: first, it is argued that the contest over scarce oil resources may spark confrontation between the US and China; and second, it is argued that China will exert military power to protect its oil assets, by, for example, developing a blue-water navy to shield its tanker fleet or assert its claims on disputed island chains or other territories with strong potential for energy development. Both of these arguments have been frequently challenged.[5] For example, oil produced by Chinese SOEs abroad is sold on the global market and thus benefits all consumers, not only China. Also, China's outward energy investments address a major global energy security concern, namely the lack of investment repeatedly highlighted by the International Energy Agency (IEA).[6] Further, Chinese concerns about the vulnerability of sea lanes and chokepoints are shared by other nations; thus, Chinese efforts to protect them and to diversify trade routes should be welcome.

There are, however, other reasons to be cautious about the rise of China's OFDI in oil. Conventional oil is ultimately a limited resource that produces greenhouse gases. By funding oil exploration and extraction, China is subsidizing greenhouse gas emissions and diverting resources from needed investment in alternative energy technologies. In addition, investment in countries owning oil resources sometimes protects regimes the West considers unsavory.

Investing in oil abroad is not the only Chinese strategy to enhance its energy security. Domestic investments in renewables soared to US$ 50 billion in 2010,[7] as compared to fossil fuel subsidies estimated at US$ 40 billion in 2008[8] and OFDI in oil at US$ 18 billion in 2009.[9] It should also be in China's best interest to see poorly governed oil-rich nations stabilize and more fully integrate into the global trading system. At the same time, the global energy organizations such as the IEA, largely influenced by European and US interests, should actively involve China in order to ensure more global cooperation and equitable distribution of power.

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[4] Unpublished survey on Chinese SOEs going global, in collaboration with Euromed, Shanghai; data collected Summer 2011.
[5] Leung, op. cit.
[6] International Energy Agency, *World Energy Outlook 2011* (Paris: OECD/IEA, 2011).
[7] Renewable Energy Policy Network for the 21st century, *Renewables 2011: Global Status Report* (Paris: REN21, 2011), p. 35.
[8] International Energy Agency, *World Energy Outlook 2010* (Paris: OECD/IEA, 2010).
[9] Julie Jiang and Jonathan Sinton, "Overseas investments by Chinese national oil companies: Assessing the drivers and impacts," IEA Information Paper, February 2011.

Chapter 21

Will China relocate its labor-intensive factories to Africa, flying-geese style?

Terutomo Ozawa and Christian Bellak[*]

China has developed increasingly close economic relations with Africa in its quest for oil and minerals through investment and aid. The World Bank recently called upon China to transplant labor-intensive factories onto the continent. A question arises as to whether such an industrial relocation will be done in such a fashion to jump-start local economic development -- as previously seen across East Asia and as described in the flying-geese (FG) paradigm of FDI.[1]

Many studies have examined China's -- and other countries' -- investments in Africa's light industries (notably leather goods and textiles) and pointed out a host of difficulties they face because of poor local institutional conditions.[2] Hence, this Chapter evaluates mostly China-side factors that may decisively induce a transmigration of labor-intensive factories, specifically to the sub-Saharan region. Judging from Asia's FG model, three factors are the crucial inducements for FDI in low-end manufacturing: (1) labor costs; (2) exchange rates; and (3) institutions.

Labor costs

Successful catch-up growth necessarily leads to a rapid rise in wages, rendering labor-intensive exports uncompetitive. But how fast wages rise depends on the size of rural labor reserves that need to be shifted to industry. In this respect, unlike Japan and the newly industrialized economies (NIEs) that had a relatively limited reserve of rural labor because of their small geographical size, China has a massive rural labor force yet to be tapped. 750 million people still live in China's countryside with the average rural income only one third of its urban counterpart. Nevertheless, the recent labor unrest and the sharp wage hikes in the coastal provinces will prompt a shift of factory jobs elsewhere. Here, China's present income-doubling plan (by 2020) for its rural regions will promote intra-country industrial migration. Thus, China's own vast interior seems more attractive as new production sites than any faraway countries.

Exchange rates

Currency appreciation in effect "taxes" exports but "subsidizes" outward FDI and imports. Japan and the NIEs submitted to swift and sharp rises in their currencies as they

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[*] The authors wish to thank Deborah Brautigam, Daniel van den Bulcke and Stephen Young for their helpful comments on this chapter, which was first published as a *Perspective* on August 17, 2010.

[1] For the essentials of the paradigm, see Terutomo Ozawa, *The Rise of Asia: the 'Flying-geese" Theory of Tandem Growth and Regional Agglomeration* (Cheltenham: Edward Elgar, 2009).

[2] See, *inter alia*, Deborah Brautigam, *The Dragon's Gift: The Real Story of China in Africa* (New York: OUP, 2009).

succeeded in catch-up growth. True, the yuan has considerably appreciated over recent years -- but only slowly and not drastically enough to trigger a massive relocation of labor-intensive manufacturing overseas -- largely because China is not quite ready to dismantle labor-intensive industries that still provide much-needed jobs at home. This *gradual* pace of appreciation gives exporters more time to raise productivity or to relocate inland, thereby allowing them to hang on a while.

Institutions

Institutional factors weigh on both sides. Infrastructural deficiencies (e.g., unreliable power and water supply, transportation, communication, poor governance, inhospitable regulatory environments, work ethic) in Africa are well known. This explains why foreign MNEs in general, let alone China's, have not yet seriously advanced into the continent in search of low-cost labor. The governments of the Asian NIEs quickly realized the potential of Japanese and Western FDI and thus were prepared to provide relevant infrastructure, particularly special economic zones (SEZs).

Since 2006, as part of its strategy to assist sub-Saharan Africa in attracting manufacturing, China has been helping establish SEZs, a scheme modeled on its own SEZs. Currently, the Chinese SEZ in Zambia serves as a model for such zones in Africa. At the moment, nevertheless, there exists China's tendency toward ethnicity-bound groupism, as evidenced in the employment of Chinese construction workers in large numbers for aid projects, the settlement of Chinese migrants and petty merchants/caterers in host countries and the one-sided presence of Chinese consortia for overseas investments without much participation of local and other countries' MNEs.

In contrast, Asia's SEZs succeeded in hosting not only foreign MNEs but many local firms as well, and host governments took proactive measures to use their SEZs as a learning conduit for modern technology and advanced business practices, a situation not yet commonly observable in sub-Saharan Africa. Lest China-sponsored SEZs that are presently in the early stages of development turn into "industrial Chinese diasporas," so to speak, they would need multi-national participation, especially by African manufacturers themselves. South African MNEs, in particular, ought to participate in such zones. Recently, the International Finance Corporation decided to fund US$ 10 million as a joint financier of a commercial complex project (worth about US$ 33 million) in Tanzania with a Chinese company and a local non-profit organization, inviting a third party to fund an additional US$ 6.5 million[3] -- an arrangement designed to encourage multi-national participation and adherence to internationally acceptable social and environmental standards. In addition, the New Partnership for Africa's Development (NEPAD)-OECD Africa Investment Initiative aims to strengthen the capacity of African countries to design and implement reforms that improve their business climate and to unlock investment potential in the continent. Also, the US's African Growth and Opportunity Act (AGOA) may nudge China to invest more in democratic and market-based economies.

[3] "World Bank unit to finance Chinese Africa venture," *Financial Times*, April 22, 2010.

Conclusion

All in all, even though China may be serious about relocating low-cost factories to sub-Saharan Africa, there are hurdles to clear on both sides. In the near term, China still can relocate labor-intensive manufacturing inland or to its low-cost neighbors, and sub-Saharan Africa itself is institutionally not quite ready to host labor-seeking FDI on a scale substantial enough to spark catch-up industrialization, flying-geese style, as has happened in Asia.

Chapter 22

The backstory of China and India's growing investment and trade with Africa: Separating the wheat from the chaff

Harry G. Broadman[*]

The dramatic increase in recent years of trade and FDI in sub-Saharan Africa by firms from Asia -- notably China and India -- has become an emotionally charged issue. This is not surprising, since the resulting greater integration into international markets is exposing African firms and workers to greater competition, an inevitable by-product of development in today's globalized economy. Most assessments of this topic, with few exceptions,[1] have relied on anecdotes and subjective judgments. Meaningful policy recommendations require systematic, objective analysis.

A critical starting point is to establish the proper context. What Chinese and Indian firms are doing in Africa is not unique or new. South-South commerce has been growing rapidly for over two decades. South-South trade doubled from about 8% of world trade in 1990 to over 16% in 2007. The share of developing countries' exports going to developing countries increased from 29% in 1990 to 47% in 2008.[2]

Rigorous analysis of systematically collected data reveals several weak spots in the conventional wisdom about Chinese and Indian firms' activities in Africa. Most observers believe Chinese (and to a lesser extent Indian) firms dominate Africa's economies. This presumption does not fit the facts. About 90% of the stock of FDI in Africa still originates from Northern companies, especially those from the European Union and the United States. The confusion arises because FDI inflows in recent years have been dominated by Chinese and Indian MNEs (as well as other firms from the South).

Received wisdom also has it that the "new" Southern investors in Africa are exclusively involved in natural resources. But Chinese and Indian MNEs in Africa are increasing their investments into other sectors, such as telecommunications, financial services, food processing, manufacturing, infrastructure, back-office services, and tourism. Although natural resource-based investments dominate Chinese and Indian investors' portfolios in Africa in *value*, it is evident from the *number* of FDI projects that investment by these MNEs is beginning to diversify rapidly across many sectors.

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[*] The author wishes to thank Andrea Goldstein, Daniel Van Den Bulcke and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on February 17, 2011.

[1] Notably Harry G. Broadman, *Africa's Silk Road: China and India's New Economic Frontier* (Washington, D.C.: The World Bank, 2007), and Andrea Goldstein, Nicolas Pinaud, Helmut Reisen, and X. Chen, *The Rise of China and India: What's in it for Africa?* (Paris: OECD Development Centre, 2006).

[2] WTO, *The WTO and the Millennium Development Goals* (Geneva: WTO, January 2010).

Most press articles and the few recent books on this topic focus only on Chinese enterprises. But doing so raises serious methodological questions about the quality of these analyses' policy conclusions and trend prognostications. Without including comparator or control countries, such as India, Brazil or others from the South increasing commerce with Africa, it is difficult to make meaningful assessments of the status quo, let alone of any counterfactuals.

New business case studies and firm-level survey data on the African operations of Chinese and Indian firms show that, due to inherent differences in ownership and other facets, Chinese and Indian firms generally perceive investment risks differently, and this colors their business strategies in Africa.[3] The average Chinese firm operating on the continent is a large state-owned enterprise (like most Chinese MNEs operating globally) and tends to enter new markets by building *de novo* facilities, is highly vertically integrated, rarely encourages the integration of its management and workers into the African socioeconomic fabric, conducts most of its sales in Africa with government entities, and (able to avail itself of its home government's deep pockets,) exploits its ability to out-compete other bidders for government procurement contracts.

The typical Indian firm, tends to be in the private sector, varies in size, enters African markets by acquiring established businesses, engages in vertical integration (but much less so than its Chinese counterpart), facilitates -- indeed, sometimes encourages -- the integration of management and workers into the African socioeconomic network (through informal ethnic networks or by participating in local political activities), and engages in large local sales with private entities rather than solely government agencies.

These new data also show that Chinese and Indian firms have much in common in their African operations. MNEs from both countries have begun to play a significant role in facilitating mutually reinforcing links between trade and FDI in Africa. One consequence of their presence is that inward FDI is engendering an increase in Africa's exports.

Chinese and Indian businesses, by dint of their generic organizational structures, can achieve larger operations in Africa -- and thus greater economies of scale and higher productivity -- than their African counterparts. They can thus export goods from Africa that are more diversified and higher up the value chain than can African firms in the same sectors. They are also integrating horizontally more extensively across Africa's own internal market -- a critical objective for a continent comprising many landlocked countries with individual markets far below commercial scale. Chinese and Indian MNEs, increasingly in joint ventures with African firms, are fostering exports from Africa to a wider set of markets outside the continent.

Much is at stake for the 800 million people in sub-Saharan Africa, especially the 50% of them who are among the world's poorest, in the policy debate concerning the continent's accelerated integration into the world economy through South-South commerce, now led by China and India. The quality of this debate needs to be improved. It could start by:

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[3] Harry G. Broadman, "China and India Go to Africa," *Foreign Affairs*, vol. 87, no. 2, (March/April 2008), pp. 95-109.

development of systematic empirically-derived, cross-country and cross-sectorally consistent data; application of a rigorous analytical methodology; and use of an objective, coherent framework from which one can draw dispassionate policy conclusions for all concerned -- Africans (businesses, workers, consumers, policy makers), foreign investors and their home country constituencies, and the international community.

Chapter 23

What will an appreciation of China's currency do to inward and outward FDI?

Karl P. Sauvant and Ken Davies[*]

What will an appreciation of the Chinese yuan do to China's inward and outward direct investment? The discussion so far has been almost exclusively about the impact on China's trade balance. But it is at least as important to see what effect it may have on the country's inward FDI (IFDI), which plays such a crucial role in China's economic development, and its outward FDI (OFDI), which is receiving increased attention worldwide.[1]

China has been the developing world's largest recipient of IFDI since the mid-1990s, attracting US$ 95 billion in 2009.[2] A revaluation of the yuan will make it more expensive for foreign firms to establish themselves (or expand) in China (the world's most dynamic market), giving an advantage to foreign firms already established there over new entrants. At the same time, exports of foreign affiliates, which account for 54% of total exports,[3] will become less competitive internationally, although the increased costs will be partly offset by lower costs of imported inputs. Foreign affiliates can also expect to repatriate higher profits from sales in China in terms of their own currencies.

However, the most notable development of recent years has been the take-off of the country's OFDI since the government in 2000 adopted the "go global" policy encouraging Chinese firms to invest overseas.[4] China's OFDI doubled from US$ 12 billion in 2005[5] to US$ 27 billion in 2007, and then doubled again the following year, to reach US$ 56 billion.[6] Outflows continued to rise to US$ 57 billion in 2009, even as world FDI flows collapsed by 50%. In 2009, China was the world's fifth largest outward investor.

The increasing international competitiveness of Chinese firms and an encouraging government policy have been the main drivers of this surge. The 20% revaluation of China's currency against the US dollar in 2005-2008 undoubtedly provided a favorable

[*] The authors wish to thank Laza Kekic, Al Litvak and Edward Turner III for their helpful comments on this chapter, which was first published as a *Perspective* on October 18, 2010.

[1] For a most recent overview of China's IFDI and OFDI, see Ken Davies, "Inward FDI in China and its policy context," *Columbia FDI Profiles*, October 18, 2010, and Ken Davies, "Outward FDI from China and its policy context," *Columbia FDI Profiles*, October 18, 2010.

[2] UNCTAD FDI statistical database http://stats.unctad.org/.

[3] Figure for the first eight months of 2010 from MOFCOM website: http://www.fdi.gov.cn/.

[4] See Qiuzhi Xue and Bingjie Han, "The role of government policies in promoting outward foreign direct investment from emerging markets: China's experience," in Karl P. Sauvant and Geraldine McAllister, with Wolfgang A. Maschek, eds., *Foreign Direct Investment from Emerging Markets: The Challenges Ahead* (New York: Palgrave, 2010), pp. 305-324.

[5] Not including financial FDI.

[6] Ministry of Commerce, *2009 Statistical Bulletin of China's Outward Foreign Direct Investment* (2010).

condition facilitating this in the case of host countries whose currencies did not also appreciate against the US dollar. There is ample evidence in the academic literature that a weaker exchange rate induces increased IFDI.[7]

China's OFDI is poised to grow sharply again in 2010, judging by the first half of the year, when it was rising at an annual rate of 44%.[8] Revaluation would accelerate this trend. This is precisely what happened with Japan after the yen was revalued by over 50% against the US dollar between 1985 and 1987, following the 2005 Plaza Accord.[9] Japan's OFDI tippled from US$ 6.5 billion in 1984 to US$ 19.5 billion in 1986, peaking at US$ 48 billion in 1990.[10]

A renewed yuan appreciation would boost China's OFDI growth even further by lowering the cost of overseas assets for Chinese firms, which have strong cash reserves from both retained earnings and large-scale state credit allocations that put them in a position to invest internationally. Like competitors elsewhere, they need to invest abroad to acquire a portfolio of locational assets to protect and increase their international competitiveness through better access to skills, technology, natural resources, and markets.

Revaluation would combine with already rising wage pressures inside China. Labor-intensive firms in China's coastal provinces are under pressure to seek lower labor cost by either investing in China's interior of abroad. Already more than 700 Chinese affiliates have been established in Vietnam.[11] Revaluation would push even more in that direction.

Suspicions of non-commercial motivations behind China's OFDI are widespread because most of the country's OFDI is by state-owned enterprises (SOEs). However, there is no systematic evidence that China's SOEs, like their counterparts elsewhere, are driven by more than normal commercial considerations. At the same time, private or semi-private entities have been investing abroad. As their operations are less visible, it is likely that their OFDI, and therefore China's total OFDI, is understated.

Fears of Chinese OFDI, as of Japanese and Korean investment in earlier decades, are misplaced. It is good for China and for host countries: Chinese FDI, like all FDI, can

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[7] See e.g. Kenneth A. Froot and Jeremy C. Stein, "Exchange rates and foreign direct investment: an imperfect capital markets approach," *The Quarterly Journal of Economics*, vol. 106 (1991) 4, pp. 1191-1217; and Kathry L. Dewenter, "Do exchange rate changes drive foreign direct investment?," *The Journal of Business*, vol. 68, (1995) 3, pp. 405-433.

[8] Invest in China website: http://www.fdi.gov.cn.

[9] Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States (Plaza Accord) September 22, 1985. University of Toronto G8 Information Centre: http://www.g8.utoronto.ca/ .The yen went from 238 to the dollar in 1985 to 168 in 1986, 145 in 1987 and 128 in 1988. See Zhang Zongbin and Yu Hongbo [张宗斌/于洪波], "Comparative research into China's and Japan's OFDI" [中日两国对外直接投资比较研究], *World Economy and Politics* [世界经济与政治] 2006.

[10] JETRO, Japanese Trade and Investment Statistics, JETRO website: http://www.jetro.go.jp/.

[11] *China Daily*, August 31, 2010, p. 14.

bring to host countries a bundle of tangible and intangible assets needed for economic growth and development. While a good part of China's OFDI initially takes the form of trade-supporting FDI, it can be expected to lead relatively quickly to a shift of some production out of China, including to the US and Europe, thereby reducing exports from China. Moreover, OFDI is a key mechanism for integrating China into the world economy and making it a responsible stakeholder in it.

However, Chinese firms will have to learn from the past mistakes of other emerging multinationals about how to operate in the highly sophisticated developed-country markets and in developing countries. They need not only to overcome the "liability of foreignness" that any multinational faces when establishing itself in a foreign market, but they also need to overcome the "liability of the home country." In particular, they need to establish a good social brand name so that they are seen as making not only a positive economic contribution to their host countries, but are also seen as good corporate citizens. The Chinese government can play a crucial role by adopting a code of conduct for all Chinese enterprises investing abroad, in line with internationally accepted norms and taking into account the increasing importance of sustainable FDI. For their part, host countries need to accept the "new kids on the block" and not discriminate against Chinese investment, nor establish protectionist barriers against it.

Chapter 24

The unbalanced dragon: China's uneven provincial and regional FDI performance

Karl P. Sauvant, Chen Zhao and Xiaoying Huo[*]

Among developing countries, China attracts most FDI. Where is this investment located *within* China, what explains its distribution and what are policy implications?

We used UNCTAD's FDI Performance Index to answer the first question.[1] Although developed for *countries*, it can be applied to *sub-national* units. It uses provincial GDP to ascertain whether a given territorial unit has received FDI inflows as expected from its economic size. Standardizing the data accordingly reveals three clusters of provinces for 2007-2010 (see annex tabels 1 and 2; see annex figures 1 and 2):

- The first cluster encompasses virtually all coastal provinces: they have an index value above 1, i.e. perform better than their economic size would lead one to expect. They account for 9 of the top 11 performers of Mainland China's 31 provinces, municipalities and autonomous regions ("provinces").
- The provinces in the middle cluster underperform (index value of 1-0.5). They include 5 central provinces, but also 3 western and 2 coastal provinces.
- The provinces in the bottom cluster underperform significantly (index value below 0.5), comprising primarily the country's western provinces (8 out of the 10 provinces in this cluster).

Clearly, the further away a location is from the coast, the less FDI it attracts: the Coastal Region over-performs, the Central and especially the Western Region under-perform. These three clusters roughly correspond to China's administrative regions (Coastal, Central and Western Regions), respectively.[2]

The Coastal Region has always been the best performer. Importantly, however, its share in China's total FDI inflows declined from 89% in 1987-1990 to about 75% in 2007-2010; that of the Central Region rose from below 4% to about 17%, and that of the Western Region fluctuated mainly below 10%. Still, the share of the Coastal Region in total FDI inflows remains higher than its share in China's GDP (84% vs. 56%); for the Central Region (10% vs. 25%) and the Western Region (6% vs. 18%), the reverse is true. However, while the Coastal Region as a whole has always performed better than its GDP predicts, its index value has declined from an average of 1.6 in 1987 to 1.3 in 2010; the

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[1] UNCTAD, *World Investment Report 2002* (Geneva: UNCTAD, 2002), p. 23. The Index has several limitations (ibid.), but it can serve as an initial benchmark that reflects the extent of success regarding a province's FDI performance.

[2] See http://www.chinamap.com/html/baodaoshuoming2.aspx.

Central Region improved its index value, but remained under 1; the Western Region remained under 0.5 for most of the period 1987-2010. This shows a moderate shift of FDI flows away from the coast to the interior.

Why this pattern and what to do about it?

First, while China's overall *regulatory framework* is the same for all provinces, the Coastal Region benefitted from early economic liberalization and the establishment of Special Economic Zones; this created an enabling environment for export-oriented and market-seeking FDI. Liberalization began only later for other parts of China. While the Central and Western provinces have advantages that apply only to them, more could be done, e.g. granting longer tax incentives (and compensating tax losses centrally). Also, the degree of ease of doing business in provincial capital cities shows a pattern (see table at www.vcc.columbia.edu) similar to our index ranking, pointing to a potential to-do for policy makers. Moreover, officials need to understand better what role enterprises play in economic development and how a law-based market system works.

Second, the Coastal Region has the best *economic determinants*: high economic growth and mature markets, developed supplier industries, modern infrastructure, cheap skilled labor, and a favorable business culture; it also benefits from closeness to Hong Kong and strong links with overseas Chinese. Massive efforts are being made to improve the interior's physical infrastructure, strengthen its science and technology capacities and upgrade its educational and skills offerings. These need to continue: they lay the foundations for attracting more investment. Supporting enterprise development and industrial clustering would also be important, as would be higher wages to create a demand-pull.

Finally, all provinces in China have undertaken active *investment promotion*, but the coastal provinces could build on more favorable regulatory and economic conditions. Elsewhere, such promotion needs to be strengthened, by upgrading the capacity of investment promotion agencies (IPAs) to attract and service investors. The appointment of FDI Ombudspersons would help to identify areas for improvements and help mediate conflicts. Since coastal production costs are rising rapidly, the interior provinces could attract labor-intensive production from there, production that otherwise might move abroad. Twinning arrangements between coastal and interior IPAs could facilitate such internal relocation.

China's Government has recognized that the country's uneven development is a challenge that must be met. Key is to increase investment by domestic and foreign firms in the Central and Western Regions. Since, in the end, all investment is local, production conditions there need to be made more attractive. All three sets of investment determinants therefore require further strengthening. At the same time, efforts should not only concentrate on attracting investment, but ensuring that the attracted investment makes a significant contribution to the economic, social and environmental development of the recipient provinces.

Annex table 1. China’s provinces Inward FDI Performance Index, four-year avarage, 1987-2010

Table 1. China's provinces Inward FDI Performance Index, four-year average, 1987 - 2010 a)

1987-1990 Province	Index	Rank	1991-1994 Province	Index	Rank	1995-1998 Province	Index	Rank
Hainan	5.3	1	Hainan	5.3	1	Hainan	3.4	1
Guangdong	4.9	2	Fujian	3.8	2	Tianjin	3.0	2
Beijing	4.0	3	Guangdong	3.4	3	Guangdong	2.8	3
Shanghai	2.7	4	Shanghai	1.9	4	Fujian	2.5	4
Fujian	2.6	5	Beijing	1.5	5	Shanghai	2.1	5
Shaanxi	1.6	6	Tianjin	1.4	6	Beijing	1.6	6
Tianjin	1.4	7	Jiangsu	1.2	7	Jiangsu	1.5	7
Liaoning	0.8	8	Liaoning	0.9	8	Liaoning	0.9	8
Guangxi	0.8	9	Shandong	0.8	9	Guangxi	0.7	9
Jiangsu	0.5	10	Guangxi	0.8	10	Shandong	0.7	10
Shandong	0.4	11	Zhejiang	0.5	11	Zhejiang	0.5	11
Chongqing	0.3	12	Chongqing	0.5	12	Shaanxi	0.5	12
Zhejiang	0.3	13	Hubei	0.4	13	Hebei	0.5	13
Xinjiang	0.3	14	Shaanxi	0.3	14	Jilin	0.5	14
Qinghai	0.3	15	Jilin	0.3	15	Chongqing	0.5	15
Heilongjiang	0.2	16	Jiangxi	0.3	16	Hunan	0.4	16
Henan	0.2	17	Hebei	0.3	17	Hubei	0.4	17
Hubei	0.2	18	Tibet	0.3	18	Jiangxi	0.4	18
Hebei	0.2	19	Hunan	0.3	19	Heilongjiang	0.4	19
Sichuan	0.2	20	Sichuan	0.2	20	Anhui	0.3	20
Guizhou	0.1	21	Henan	0.2	21	Henan	0.3	21
Tibet	0.1	22	Heilongjiang	0.2	22	Shanxi	0.2	22
Jiangxi	0.1	23	Anhui	0.2	23	Yunnan	0.2	23
Yunnan	0.1	24	Ningxia	0.2	24	Ningxia	0.2	24
Jilin	0.1	25	Gansu	0.2	25	Sichuan	0.2	25
Ningxia	0.1	26	Yunnan	0.1	26	Gansu	0.1	26
Shanxi	0.1	27	Guizhou	0.1	27	Inner Mongolia	0.1	27
Anhui	0.1	28	Inner Mongolia	0.1	28	Guizhou	0.1	28
Hunan	0.1	29	Shanxi	0.1	29	Tibet	0.1	29
Gansu	0.1	30	Xinjiang	0.1	30	Xinjiang	0.1	30
Inner Mongolia	0.0	31	Qinghai	0.0	31	Qinghai	0.1	31

1999-2002 Province	Index	Rank	2003-2006 Province	Index	Rank	2007-2010 Province	Index	Rank
Guangdong	2.5	1	Jiangsu	1.9	1	Tianjin	2.7	1
Fujian	2.2	2	Tianjin	1.9	2	Liaoning	2.3	2
Tianjin	2.2	3	Shanghai	1.9	3	Jiangsu	1.8	3
Hainan	2.0	4	Hainan	1.7	4	Hainan	1.8	4
Jiangsu	1.9	5	Jiangxi	1.4	5	Shanghai	1.6	5
Shanghai	1.7	6	Liaoning	1.4	6	Chongqing	1.3	6
Beijing	1.4	7	Zhejiang	1.4	7	Jiangxi	1.3	7
Liaoning	1.1	8	Fujian	1.3	8	Beijing	1.2	8
Shandong	0.9	9	Guangdong	1.3	9	Guangdong	1.2	9
Zhejiang	0.7	10	Shandong	1.2	10	Zhejiang	1.1	10
Hubei	0.6	11	Beijing	1.2	11	Fujian	1.1	11
Guangxi	0.5	12	Qinghai	0.9	12	Anhui	0.9	12
Jiangxi	0.5	13	Hubei	0.8	13	Hunan	0.8	13
Hunan	0.5	14	Hunan	0.7	14	Inner Mongolia	0.7	14
Qinghai	0.4	15	Inner Mongolia	0.5	15	Shandong	0.7	15
Shaanxi	0.4	16	Heilongjiang	0.5	16	Heilongjiang	0.7	16
Jilin	0.4	17	Hebei	0.4	17	Hubei	0.7	17
Hebei	0.4	18	Shaanxi	0.4	18	Qinghai	0.6	18
Shanxi	0.3	19	Chongqing	0.4	19	Henan	0.6	19
Chongqing	0.3	20	Jilin	0.3	20	Sichuan b)	0.5	20
Sichuan	0.3	21	Anhui	0.3	21	Hebei	0.5	21
Anhui	0.2	22	Henan	0.3	22	Shaanxi	0.4	22
Heilongjiang	0.2	23	Sichuan	0.3	23	Jilin	0.4	23
Ningxia	0.2	24	Ningxia	0.3	24	Shanxi	0.4	24
Henan	0.2	25	Guangxi	0.3	25	Yunnan	0.3	25
Inner Mongolia	0.2	26	Shanxi	0.2	26	Guangxi	0.3	26
Yunnan	0.1	27	Tibet	0.1	27	Tibet	0.2	27
Gansu	0.1	28	Yunnan	0.1	28	Ningxia	0.1	28
Guizhou	0.1	29	Guizhou	0.1	29	Guizhou	0.1	29
Xinjiang	0.0	30	Xinjiang	0.0	30	Xinjiang	0.1	30
Tibet	0.0	31	Gansu	0.0	31	Gansu	0.1	31

Source: The authors, based on China Data Center http://chinadataonline.org/.

Color code:
- Coastal provinces accordingly to official classificiation.
- Central provinces accordingly to official classificiation.
- Western provinces accordingly to official classificiation.

a) The Index is calculated according to the following formular: Index = $(FDI_{province} / FDI_{China}) / (GDP_{province} / GDP_{china})$; The horizontal dotted lines indicate the clusters. No official data on utilized FDI at the provincial level are available, although MOFCOM's, China Foreign Investment Report 2011 (Beijing: Economics and Management Press, 2011) contains such data for a few years. For this reason, the provincial FDI data reported by the China Data Center at the University of Michigan have been used. A comparison of the data available from the MOFCOM Report with the data available from the China Data Center for the respective years suggests a similar pattern.

b) 2007-2009 figures only.

Annex table 2. China's provincial capitals, World Bank's Doing Business Index ranking, 2008

Table 2. China's provincial capitals, World Bank's Doing Business Index ranking, 2008

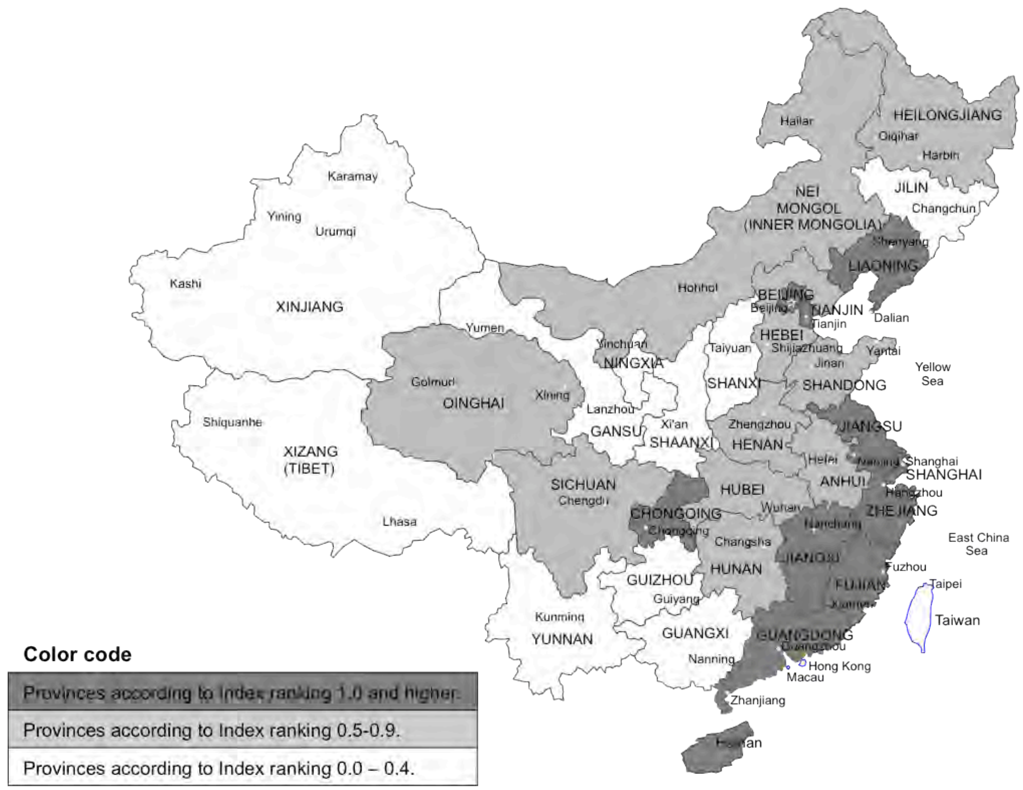
Provincial capital	Starting a business	Registering property	Enforcing contracts	TOTAL	Overall ranking [a]	Inward FDI Performance Index ranking 2007-2010
Guangzhou, Guangdong	3	2	1	6	1	9
Nanjing, Jiangsu	2	5	2	9	2	3
Shanghai	5	1	4	10	3	5
Hangzhou, Zhejiang	1	7	3	11	4	10
Ji'nan, Shandong	4	4	5	13	5	15
Tianjin	8	6	5	19	6	1
Fuzhou, Fujian	7	3	12	22	7	11
Beijing	6	12	9	27	8	8
Shenyang, Liaoning	9	14	10	33	9	2
Chongqing	17	9	8	34	10	6
Xi'an, Shaanxi	25	10	5	40	11	22
Changchun, Jilin	10	8	25	43	12	23
Haikou, Hainan	13	23	11	47	13	4
Honhot, Inner Mongolia	11	18	19	48	14	14
Urumqi, Xinjiang	14	13	22	49	15	30
Shijiazhuang, Hubei	16	21	14	51	16	17
Harbin, Heilongjiang	18	14	20	52	17	16
Chengdu, Sichuan	19	11	23	53	18	20
Yinchuan, Ningxia	26	16	13	55	20	28
Zhengzhou, Henan	12	27	16	55	19	19
Nanchang, Jiangxi	21	20	15	56	21	7
Wuhan, Hebei	15	25	17	57	22	21
Taiyuan, Shanxi	20	26	18	64	23	24
Hefei, Anhui	27	17	26	70	24	12
Xining, Qinghai	23	19	28	70	25	18
Changsha, Hunan	22	24	27	73	26	13
Kunming, Yunnan	23	22	29	74	27	25
Nanning, Guangxi	28	30	20	78	28	26
Guiyang, Guizhou	30	28	24	82	29	29
Lanzhou, Gansu	29	29	30	88	30	31
Lhasa, Tibet	31	31	31	93	31	27

Source: The authors, World Bank, "Doing business in China 2008", at http://www.doingbusiness.org/Rankings/china/, and China Data Center.
a) Calculated by adding the ranking scores of the individual indicators.

Color code	
	Coastal provinces accordingly to official classificiation.
	Central provinces accordingly to official classificiation.
	Western provinces accordingly to official classificiation.

Annex figure 1. China's provinces Inward FDI Performance Index, three clusters, ave. 2007-2010

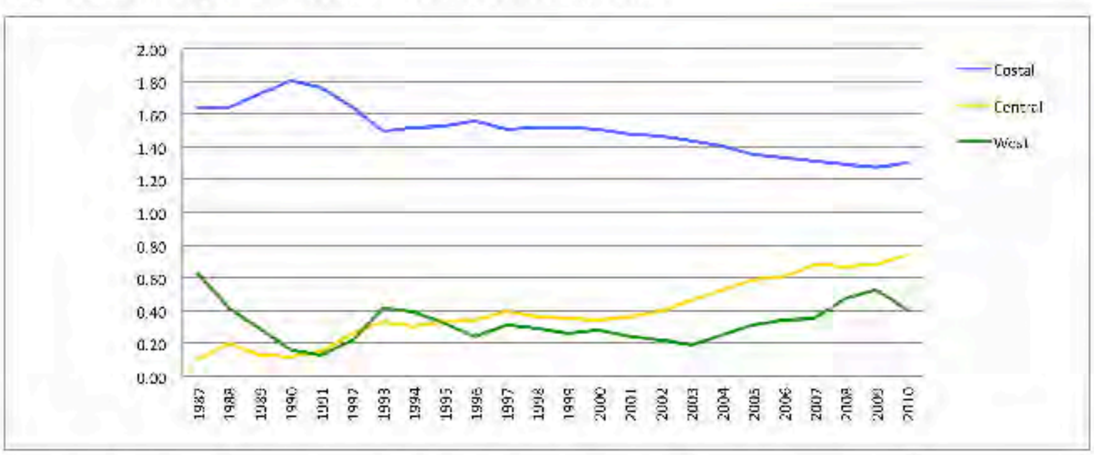
Figure 1. China's provinces Inward FDI Performance Index, three clusters, average 2007-2010



Source: The authors, based on China Data Center http://chinadataonline.org.

Annex figure 2. China's regions Inward FDI Performance Index, 1987-2010.

Figure 2. China's regions Inward FDI Performance Index, 1987 - 2010 a)



Source: The authors, based on China Data Center http://chinadataonline.org/.
a) Calculated by adding the FDI inflows for the region divided by the GDP of that region.

Chapter 25

A new geography of innovation: China and India rising

Gert Bruche[*]

With some delay, the internationalization of business R&D is following the globalization of production. Starting on a small scale during the 1970s and 1980s, the emergence of globally distributed R&D networks of MNEs accelerated rapidly in the 1990s. The "globalization of innovation" was facilitated and driven by a complex set of factors, including changes in trade and investment governance, improved intellectual property rights through TRIPS, the growing ease and falling cost of communicating and traveling around the globe, and the concomitant vertical industry specialization and unbundling of value chains. The growing and sustained level of cross-border M&As was one major direct driver, often having the effect that merged firms inherited multiple R&D sites in a number of countries.

Until the end of the 1990s, the geography of (business) innovation was largely congruent with the triad of developed world regions: North America, Europe and Japan. Developing countries played a subsidiary role, either primarily supplying talent (brain drain) or functioning as sector specialists in smaller newly industrializing economies such as Taiwan Province of China, Singapore and Israel. Then, around the turn of the century, two interrelated strategies led to the "iron cage of the triad" starting to open: a R&D FDI shift to the two main emerging economies of China and India, and the upward move of Indian and Chinese vendors and contract research organizations (CROs) from providing routine services to knowledge process and R&D offshoring (Bruche 2009).

By around 2001, the number of MNE R&D centers had only gradually grown to under 100 in each of the two countries from the days of Texas Instruments' early engagement in India in the mid-1980s and Motorola's pioneering R&D investments in China in the early 1990s. The subsequent upsurge in MNE R&D centers in China and India calls to mind a take-off situation. In a rather sudden shift, the number of MNE R&D centers in China rose more than tenfold to around 1,100 (representing 920 MNEs) by the end of 2008 and to 780 (670 MNEs) in India (Zinnov 2009). The *internal* MNE R&D offshoring growth took place in parallel to the learning processes of Indian and Chinese vendors and CROs, leading to a similar expansion of *R&D offshore outsourcing*. Most surveys point to a continuation of this trend as companies report plans to move future R&D expansion to these two countries.

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[*] The author wishes to thank John Cantwell, Torbjörn Fredriksson and Robert Pearce for their helpful comments on this chapter, which was first published as a *Perspective* on April 29, 2009.

References: Gert Bruche, "The Emergence of China and India as New Competitors in MNCs Innovation Networks," *Competition & Change*, vol. 13 (2009) 3, pp. 267-288; Barry Jaruzelski and Kevin Dehoff, "Beyond Borders: The Global Innovation 1000," *Strategy+business*, (Booz & Co, 2008) 53, pp. 54-67; and Zinnov Management Consulting, "*R&D Globalization: The China Chapter"* (Bangalore: Zinnov, 2009).

Why has there been such a sudden shift to China and India? There are a number of clearly discernible factors. Toward the end of the 1990s, China had established itself as a global lead market and world manufacturing center in a number of high and medium tech industries. While this implied a growing need for local asset exploiting R&D, greater competitive intensity also required increasingly *new* product development for the local market. Compared to the primarily market and customer oriented R&D investments in China, the bulk of R&D offshoring to India is so far mainly asset seeking, designed to take advantage of India's large and growing low cost intellectual infrastructure. In India, especially US-based MNEs profited even more than in China from the large diaspora of highly qualified non-resident Indians in leading positions, and from return migration. The Chinese Government's skillful carrot and stick policy (trading market access for technology) and India's longstanding knowledge export promotion via privately owned science and technology parks are other important determinants. A push factor came from skill shortages in computer science and engineering in the US, and to some extent in Europe and Japan as well.

While after 2000 China and India have become the most favored R&D destinations of MNEs outside of the triad (with the exception of Israel which does however not offer a sizeable market), they are in competition with other emerging economies like Russia, eastern Europe or Brazil for R&D FDI and R&D outsourcing contracts. Although their combination of comparative advantages like market size, the large low cost talent pool, English communication skills (India), very large highly qualified diasporas and reasonably developed R&D ecosystems is a difficult match for competing emerging markets, escalating wage cost and attrition of qualified R&D personnel recently seemed to endanger this position. The financial crisis can in this context be seen as a windfall helping to constrain escalating costs and providing the time and space for a restructuring and further advancement of the talent pools in both countries.

To put the MNE R&D shift to China and India into a broader perspective, some other circumstances need to be taken into account. First, the bulk of business R&D in large triad countries is still carried out in the home country, and R&D FDI flows still take place predominantly *within* the triad (Jaruzelski and Dehoff 2008). Moreover, the new MNE R&D investment and offshoring to China and India is limited in sectoral scope: by far the largest share is accounted for by information and communication technologies, in India focused on software and engineering R&D; the remainder is more or less covered by the health sector (pharma, biotech and various chemical, preclinical, and clinical services) and the automotive industry. Finally, most MNE R&D work is concentrated in only a few regional clusters: taken together, Beijing and Shanghai and Bangalore/Pune/National Capital Region represent 60-80 % of all MNE R&D work.

Even if the argument for a new geography of innovation today may be questioned, one can still ask whether the dynamics of the R&D shift herald the start of fundamental medium-term changes. Despite the dearth of systematic research on this issue, there seems to be a general consensus that the dominant share of MNE R&D in China and India comprises routine activities adapting existing designs or processes, or providing modular contributions transformed into innovative products and processes in the triad's higher order R&D centers. However, scattered evidence points to fast learning and upgrading processes resulting in ever more centers and CROs taking on selective regional or global roles as centers of excellence within MNEs global innovation networks. It is still an open question whether this will also lead to a shift in the geographic *loci* of the eventual innovation – as long as the knowledge generated is globally transferable and China and India lack important complementary assets for its independent application and integration in new products (as, for instance, in pharmaceuticals and automobiles), the innovation may still be realized in the MNE home countries. In this sense, the R&D shift may strengthen rather than weaken the triad countries' economic position, and especially that of the US The argument that the catch-up of China and India can be accelerated by spillover effects of local MNE R&D to Chinese and Indian companies and institutions may have some validity. So far, however, the R&D investment levels even in more advanced Chinese and Indian companies are low and local challengers may even suffer from an *in-situ* brain drain to MNEs able to offer more stimulating and rewarding work to talented R&D professionals. On the other hand, emerging country MNEs such as Huawei from China or Tata from India have started to acquire or establish R&D centers in the US and Europe as a way to tap into advanced knowledge and technology clusters.

It remains to be seen how far the financial crisis will trigger changes in the ongoing R&D relocation plans of MNEs. MNEs under pressure may have to cut R&D spending to maintain core operations in their home countries. Strong companies that closely track their innovation drive, such as, for example, Bosch or Siemens in Germany, or Cisco and Microsoft in the US, as well as companies in less affected industries like pharmaceuticals, may seize the chance to further enhance R&D efficiency and profit from a relaxation in the talent markets in China and India. They may also prepare for even stronger positions after the crisis when China and India may still be the fastest growing markets in the world economy. While the Chinese and Indian Governments will certainly welcome the emergence of a new geography of innovation the current global crisis may trigger a renewal of a more "techno-nationalist" stance among policy makers in the US and Europe and lower the inclination to perceive this development in the frame of a long-term win-win scenario.

Chapter 26

Emerging challengers in knowledge-based industries? The case of Indian pharmaceutical multinationals

Gert Bruche[*]

The growth of outward FDI from developing countries and of a new generation of "emerging MNEs" (EMNEs) has stimulated a flurry of publications. EMNEs have been portrayed as on their way to adulthood, latecomers that leapfrog into advanced positions, emerging giants, and challengers of conventional MNEs from advanced economies.

While some EMNE FDI can be classified as resource-seeking, often by state-owned enterprises, an increasing number of EMNEs, often in private hands, operate in knowledge-based industries. Most EMNEs in knowledge-based industries (KB EMNEs) are headquartered in India or China. They have tended to pursue interrelated asset-augmenting and market-seeking strategies in North America and Europe.

While much research has been devoted to KB EMNE's internationalization and resource-building, the particular structural characteristics of industries in which these operate have been neglected. As the case of Indian pharmaceutical companies demonstrates, the latter factor plays a significant role in whether and how fast KB EMNEs can close the gap with their competitors from advanced economies.[1]

Some of the more prominent Indian pharmaceutical companies, such as Ranbaxy or Dr. Reddy's Limited (DRL), have been cited as instances of a leapfrogging internationalization trajectory leading to fast catch-up in competitiveness with conventional MNEs. However, a closer look at the global pharmaceutical industry reveals a vast scale-gap between Indian pharmaceutical companies and major conventional pharmaceutical companies ("Big Pharma"). In 2009, DRL, India's leading pharmaceutical company by worldwide revenues, was not ranked among the global top 50 pharma companies. DRL's worldwide revenues of US$ 1.5 billion fell far short of the US$ 45 billion generated by the market leader Pfizer (USA) or the US$ 37.6 billion by the Swiss company Roche, ranked fifth, and are still less than the US$ 1.7 billion achieved by the Swedish Meda company, placed 50th.

Research and development (R&D) expenditure is a more specific indicator of global competitive resources. In a lengthy and risky process, more than US$ 1 billion are usually required to bring a new drug to market. Indian pharmaceutical companies spend far less than Big Pharma. The 2009 research spending of US$ 99 million (Ranbaxy), US$ 89 million (DRL) and US$ 67 million (Sun Pharma) compares with US$ 8,570 million by

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[*] The author wishes to thank Florian Becker-Ritterspach, Christoph Doerrenbaecher and Peter Gammeltoft for their helpful comments on this chapter, which was first published as a *Perspective* on July 1, 2012.

[1] For a more thorough discussion see Gert Bruche, "Emerging Indian pharma multinationals: Latecomer catch-up strategies in a globalised high-tech industry," *European Journal of International Management* (May 2012).

the largest spender, Roche, US$ 6,286 million for the fifth largest (GlaxoSmithKline), and are still only roughly half of the 50th in the global ranking (Watson, a generics company).

In addition to critical mass in R&D, other factors such as a worldwide sales force, relationships with key opinion leaders, worldwide regulatory experience, and ownership of intellectual assets present formidable entry barriers into the research-based segment which still dominates the more than US$ 800 billion global pharmaceutical market. Given the valuations of Big Pharma firms, overcoming entry barriers via acquisitions does not seem to be a feasible pathway for Indian pharmaceutical companies.

In view of these barriers Indian pharmaceutical companies pursue more modest upgrading internationalization strategies. Based on location-specific cost advantages and reverse engineering, their FDI is primarily aimed at building international positions as generics (imitator) companies, often by acquiring smaller generics players in the US and Europe. So far they have not yet achieved leading positions in the global generics market partly due to rapid market consolidation and the increasing entry of Big Pharma. Most major Indian pharmaceutical companies have also engaged in manufacturing and R&D outsourcing for Big Pharma, exploiting growth and learning opportunities.

Although leading Indian pharmaceutical companies such as DRL or Lupin Labs have invested in high-risk discovery research with some success, the enormous costs and risks of global development have often led to partnering with Big Pharma. In view of the considerable barriers and uncertain outcomes, a number of family-owned Indian pharmaceutical companies have sold out to Big Pharma in recent years. This sale of India's crown jewels has prompted consideration in Indian Government circles of restrictions on inward FDI in the pharmaceutical industry and led to calls for industry consolidation.

In comparing Indian pharmaceutical companies with other Indian and Chinese knowledge-based EMNEs, it may be useful to distinguish two extremes on a continuum. At one end, there are leapfrogging industries such as telecommunications equipment and IT services, in which knowledge-based EMNEs have captured globally competitive positions in relatively shorter time spans (Huawei or Tata Consultancy Services are prominent examples). At the other end, we have "fortress industries" such as pharmaceuticals, packaged software or certain branded consumer goods segments where, due to the interaction of global oligopolistic structures, complex and multiple complementary resource and capability requirements or intellectual property and brand walls, the catch-up process -- if left to market forces -- may take much longer.

Emerging market government policies may influence this scenario. Massive support of selected state-owned champions may support a faster "invasion" into fortress industries, as the examples of China in wide-bodied aircraft or high-speed trains may indicate. Governments may also pursue infant industry protection of national private champions. Both cases raise important governance issues and may eventually trigger political reactions in the developed world.

Chapter 27

Outward investment by Trans-Latin enterprises: Reasons for optimism

Michael Mortimore and Carlos Razo [*]

Despite the current economic crisis, outward FDI (OFDI) by Latin American and Caribbean enterprises continued its upward trend in 2008 (annex figure 1). OFDI by firms in the region reached nearly US$ 35 billion in 2008, an increase of 42% with respect to 2007 (ECLAC, 2009a). However, several of the factors that fostered such growth have recently changed, possibly affecting OFDI prospects for 2009. This Chapter briefly explores these changes and their potential effects on firms' investing behavior, as well as some important countervailing factors that may cushion the effects of the economic crisis on Latin American firms' investment plans.

The recent increase is the result of the accelerated efforts of some Latin American companies (Trans-Latins) to expand operations beyond their borders (annex table 1). Brazilian firms led this trend, as their OFDI in 2008 accounted for over 60% of the region's total. Chile was the second highest investor, followed by Venezuela (annex figure 2). In contrast, Mexico's Trans-Latins were severely hit by the economic downturn in the North American market. This was manifested in the sharp contraction of the country's OFDI from over US$ 8 billion in 2007 to US$ 686 million in 2008, although it did recover in early 2009.

The internationalization trend of Trans-Latin enterprises resulted from a combination of factors: global and regional economic growth trends,[1] increases in productivity and innovation, knowledge transfer, improved supply chain capabilities, high international commodity prices, improved access to credit, and strong corporate profits among others. A number of these conditions have now changed. GDP in Latin America is expected to contract by 1.9% in 2009 (ECLAC, 2009b) and, coupled with falling commodity prices, tightening credit markets and increasing debt levels, will undoubtedly make investment more difficult for most Latin American firms.

The global crisis has already hit some of the iconic Trans-Latin corporations hard. For example, CEMEX, the Mexican cement giant burdened with a US$ 14.5 billion loan for the acquisition of the Australian firm Rinker in 2007 and most of its assets concentrated in the deteriorated North American market, was forced to cut capital investment by over 50% in 2009 and attempted to sell assets to pay off its current debt (ECLAC, 2009a). Sudamericana de Vapores (Chile), the biggest shipping company in the region, searched for buyers for certain operations in order to acquire cash. Sadia (Brazil), the region's biggest chicken producer, had losses of over US$ 800 million in the last quarter of 2008,

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[1] In 2008, Latin America and the Caribbean achieved its sixth consecutive year of positive economic growth (see ECLAC 2008).

mostly as a result of investment in financial derivatives (*America Economía*, 2009). In other words, some Trans-Latins are feeling the effect of the current crisis quite severely.

Nevertheless, there are some powerful countervailing factors that may keep the Trans-Latin expansion going, especially by firms with low debt levels and good liquidity positions. For instance, Latin America, the main market of the Trans-Latins, has been contracting at a slower pace than other regions since the crisis began, making it more attractive for investment.

Investment in natural resources, an important niche of Trans-Latin companies, usually focuses on long-run prospects. Projects in oil, gas and mining mature slowly, making some investments relatively less sensitive to the current recession. In the oil sector, Petrobras (Brazil) announced at the beginning of 2009 a rise in its investment plan for the next four years[2] and Ecopetrol (Colombia) increased its planned investment by 35% over 2008 (*PODER*, 2009).

The expansion of Trans-Latins will also continue in sectors in which the income-elasticity of demand is relatively low (e.g., products for mass consumption). For instance, Bimbo (Mexico) has acquired the assets of the baked products branch of Weston (Canada) in the US (annex table 2). New investment will take place in countries or markets with better prospects. As an example, the Chilean retailer, Cencosud y Falabella, will probably continue expanding its business to countries such as Peru, Colombia and Brazil.

A third factor that may encourage Trans-Latin outward investment has to do with the steps taken by Latin American governments to confront the current economic crisis.[3] One of the most widely used measures is the promotion of investment in infrastructure. Such measures may trigger investment not only by firms in the construction business, such as the Mexican firms IDEAL and ICA, or Brazilian companies like Odebrecht and Camargo Correa, but also by some natural-resource-based manufacturers, such as the iron and steel producers Gerdau (Brazil) and Ternium (part of the Argentine Techint group).

Also worth mentioning because of its resilience in the current crisis, and the important role played by one of the biggest Trans-Latins in it, is the information technology (IT) sector. Digital convergence obliges providers to invest in mobile and Internet technologies and networks to remain competitive in the region. In this regard, América Móvil (Mexico) is expected to invest another US$ 3 billion in the region.

All this said, it should nonetheless be emphasized that there are no guarantees that outward investment by Latin American firms will continue growing or will outpace investment by firms from other regions. Whether that happens depends largely on the

[2] The Petrobras investment plan for 2009-2013 amounts to US$ 174 billion, from which 10% is expected to be invested abroad in exploration and production in West Africa, Latin America and the Gulf of Mexico (ECLAC, 2009a).

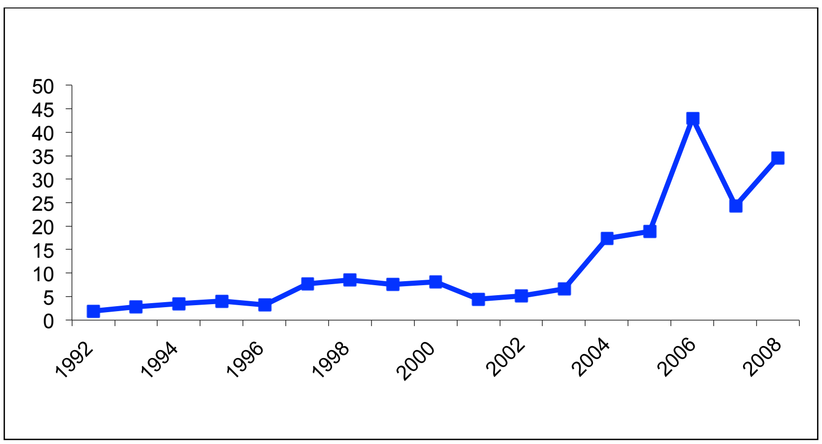
[3] For more details about the different measures taken by the governments of the region to confront the crisis, see ECLAC, 2009c.

particular circumstances of a relatively small number of firms in a handful of countries in Latin America. This corporate concentration is greater than in other regions and the corporate response thus depends on fewer investors.

Still, first indications are positive. According to the latest available figures, although OFDI from the top regional investors as a *group* is down by 28% in the first quarter of 2009, compared to the same period in 2008, some countries (Argentina, Chile, Colombia and Mexico) have registered increases in their OFDI (annex tables 2 and 3).

A number of favorable impacts of OFDI on the home country have been identified, especially with regard to international competitiveness. If governments in the region wish to see their OFDI increase they are advised to design and implement more focused national policies for that purpose. Such initiatives range from eliminating barriers to OFDI (relaxing controls and raising financial limits for investments abroad) to actively promoting OFDI as a strategic tool to integrate with global markets and production systems (by way of the provision of information, matchmaking, incentives and insurance coverage, etc.).[4] In this, Latin America and the Caribbean is far behind the policy initiatives of many Asian developing countries.

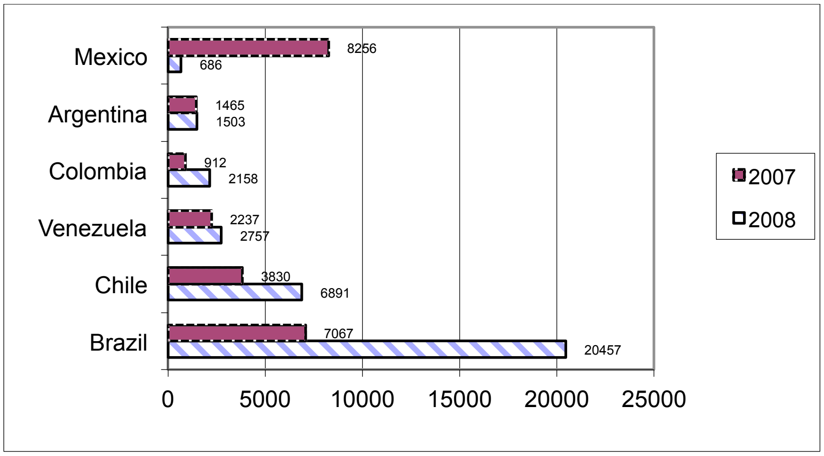
Annex figure 1. Latin America and the Caribbean: Net OFDI flows, 1992-2008 (US$ billion)



Source: ECLAC (2009a).

[4] For further discussion of these points, see UNCTAD, 2006.
References: "Especial Multilatinas: Ser global en una crisis global," *América Economía,* May, 10 2009; ECLAC (Economic Commission for Latin America and the Caribbean), *Preliminary Overview of the Economies of Latin American and Caribbean 2008*(Santiago, Chile: United Nations Publication, 2008); ECLAC (2009a), *Foreign Direct Investment in Latin America and the Caribbean 2008* (Santiago, Chile: United Nations, 2009); ECLAC (2009b), *Economic Survey of Latin America and the Caribbean 2008-2009* (Santiago, Chile: United Nations, 2009); ECLAC (2009c), *The Reactions of the Governments of Latin America and the Caribbean to the International Crisis: An Overview of Policy Measures up to 31st May 2009* (Santiago, Chile: United Nations, 2009); "Inversión en Uruguay hará de Arauco el primer productor mundial de celulosa," *La Tercera*, June, 28, 2009; "500 Empresas más poderosas de América Latina y el Caribe," *PODER*, April 13, 2009; and UNCTAD, *World Investment Report 2006 − FDI from Developing and Transition Economies: Implications for Development* (New York and Geneva: United Nations, 2006).

Annex figure 2. Latin America and the Caribbean, OFDI by principal investor countries, 2007-2008 (US$ million)



Source: ECLAC, 2009a.

Annex table 1. The top 25 non-financial companies and groups of Latin America and the Caribbean with investments outside of their country of origin, ranked by 2008 sales (US$ million)

	Company	Sales	Country	Sector
1	PDVSA	115,446	Venezuela	Petroleum/gas
2	Petrobras	111,967	Brazil	Petroleum/gas
3	América Móvil/Telmex	33,960	Mexico	Telecommunications
4	Cia Vale Do Rio Doce	30,184	Brazil	Mining
5	TECHINT (Tenaris, Ternium)	20,598	Argentina	Steel, steel pipes, construction, others
6	Gerdau	17,932	Brazil	Iron and steel/ metallurgy
7	Cemex	17,582	Mexico	Cement
8	Codelco	14,425	Chile	Mining
9	GrupoJBS	12,983	Brazil	Food products
10	Ecopetrol	12,283	Colombia	Petroleum/gas
11	Coca-Cola FEMSA	12,147	Mexico	Beverages
12	ENAP	10,095	Chile	Petroleum/gas
13	Cencosud	9,459	Chile	Commerce
14	Grupo Alfa	8,400	Mexico	Various diversified
15	Grupo Camargo Correa	7,175	Brazil	Diversified
16	Cia. Siderurgica Nacional	7,118	Brazil	Iron and steel/ metallurgy
17	Falabella	6,132	Chile	Commerce
18	Grupo Bimbo	5,951	Mexico	Food products
19	Embraer	5,725	Brazil	Aerospace industry
20	Grupo Modelo	5,448	Mexico	Beverages
21	Sadia	5,341	Brazil	Food products
22	TAM	5,201	Brazil	Transportation/logistics
23	Oderbrecht	4,950	Brazil	Construction, others

Source: The authors, based on information from *América Economía* (2009) and *PODER* (2009).

Annex table 2. Latin America's top six foreign investors, OFDI first quarter 2008 and 2009 (US$ million)

Country	First quarter 2008	First quarter 2009	Difference (percentage)
Argentina	346	393	14
Brazil[a]	7,537	944	-87
Chile	1,959	2,193	12
Colombia	384	1,168	204
Mexico	-501	2,939	…
Venezuela	1,068	80	-93
Total	10,793	7,717	-28

Source: The authors, on the basis of official figures as of 20 July 2009.
[a]Reported OFDI for Brazil covers the period January to May 2009.

Annex table 3. Main acquisitions by Trans-Latins outside their countries of origin, announced or concluded in 2009 (US$ million)

Company or assets acquired	Country of company or assets acquired	Acquired by	Country of origin of acquiring company	Seller	Country of seller	Announ-ced Value	Sector
Operations announced prior to 2009 and concluded in 2009							
Fresh bread & baked goods business	USA	Grupo Bimbo	Mexico	Weston (George) LTD	Canada	2,500	Food
Coal assets	Colombia	Vale	Brazil	Cementos Argos SA	Colombia	305	Mining
Operations announced and concluded in 2009							
Offshore International Group	USA	Ecopetrol SA, Korea National Oil Corp.	Colombia, Republic of Korea			900	Petroleum
INB Financial Corp/ McAllen TX	USA	Grupo Financiero Banorte	Mexico	INB Financial Corp/McAll en TX	USA	146	Finance
Potash Assets	Argentina, Canada	Vale	Brazil	Rio Tinto PLC	United Kingdom	850	Mining
Operations announced in 2009							
Refinería Dominicana de Petróleo	Dominican Republic	PDVSA	Venezuela	Dominican Republic (Govt.)	Dominican Republic	130	Petroleum
Petro Andina Resources	Argentina, Colombia, and Trinidad and Tobago	Pluspetrol S.A.	Argentina	Petro Andina Resources	Canada	320	Petroleum
Celulosa y Energía Punta Pereira SA, Eufores SA, Zona Franca Punta Pereira SA.	Uruguay	Arauco, Stora Enso.	Chile, Finland	Grupo empresarial ENCE S.A.	Spain	344	Paper/ pulp

Source: ECLAC, on the basis of data provided by Bloomberg as of July 20, 2009.

PART III

NATIONAL POLICIES

Chapter 28

National companies or foreign affiliates: Whose contribution to growth is greater?

Alice H. Amsden[*]

A priori, is there a growth/efficiency justification for government programs designed to support and promote national companies (public and private) as opposed to, and in competition with, opening the doors to MNEs? In competitive markets, there should be no difference. Where national companies close in capabilities to foreign affiliates do not exist, FDI may stimulate development, if a country is lucky enough to attract it. But in the imperfect markets that characterize the BRICs and other emerging markets, where foreign affiliates may crowd out excellent but inexperienced national firms, the question arises as to which type of enterprise policy makers should encourage for the long run. Historically, policy makers used tariffs to promote national firms (a "race to the bottom"). Today they use investments in science and technology (a "race to the top").

National firms are likely to be the more entrepreneurial of the two types because national firms know their local markets best.[1] But foreign affiliates may have synergistic advantages from operating in more countries than the typical national firm. Still, in today's global markets, there are eight relatively new functions that normally only national firms can perform, giving them a wide edge over foreign affiliates. More specifically, without private or public nationally owned enterprises to secure home markets:

- Supplying outsourcing services to developed countries is unrealistic. Outsourcers, by definition, look overseas for national firms to undertake production, especially in electronics (a US firm may establish its own affiliate as an outsourcer, but typically experienced national outsourcers are faster and more efficient).
- Establishing brand names is very difficult (a brand name is company specific, and a company usually originates in a given country that has proprietary technology).
- Dislodging a foreign legacy position in a natural resource industry like oil is undoable (to supplant a foreign concession, a domestic firm is required as demonstrated by OPEC members but not yet by Africa's new oil-producing countries).
- Reversing brain drain of top national talent is more difficult (a glass ceiling may obstruct nationals from reaching the position of CEO if a company is foreign-owned).
- The illegality of imposing local content requirements under WTO law is binding. While foreign affiliates cannot be subjected to local content regulations, national enterprises have more incentive to build their own local supply chains and state-owned enterprises can help in this respect via procurement.

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[*] The author wishes to thank Duncan Kennedy, Ben Ross Schneider and Andrés Solimano for their helpful comments on this chapter, which was first published as a *Perspective* on February 13, 2012.

[1] Charles Kindleberger, *American Business Abroad: Six Lectures on Direct Investment* (New Haven: Yale University Press, 1969).

- The benefits of outward FDI undertaken by foreign affiliates located in the country ultimately accrue to the parent company at home.
- Foreign affiliates conduct almost no research and development in emerging markets; so competing in high-tech industries is problematic, unless governments are able to take a hard line with foreign investors, as in India and China.
- Small and especially medium-size enterprises must be brought up to speed as subcontractors, and FDI rarely makes a large impact in this firm-size range, which is the object of numerous government programs.

There are other reasons to believe that the best national firms in the fastest growing emerging markets (for example, the Republic of Korea's Samsung, India's Infosys and Brazil's Embraer) tend to be more entrepreneurial than foreign affiliates.[2] The latter today are typically bureaucratic -- operating with relatively dense levels of management and cookie-cutting single models throughout the world. For now, when most national firms enjoy both family ownership and professional management, they display minimal bureaucracy. If a developing country relies on FDI, every "new" industry requires the entry of yet another MNE, whereas the conglomerate group, a typical national business structure in the de-colonized world, can diversify faster and at lower cost.

The thin layer of bureaucracy in national firms, due to familial relations, improves information flows. National firms are often super-quick in entering new industries and then in designing the integration of parts and components to win the global race to market. One national firm in the Indian pharmaceutical industry reached the market faster than the Indian foreign affiliate of the MNE that had invented the drug.[3] In many industries, national firms were the first movers. They diversified forcefully and fast -- the origin of the diversified business group structure.

All this suggests that research on FDI must change. In the past, FDI was compared with no FDI, as if national enterprise had nothing to contribute. Now, the presence or absence of foreign affiliates must be compared against that of well-managed national firms. How different the results will be remains to be seen, depending on policy formulation and implementation. National firms must be nursed and nurtured to fulfill the functions that foreign affiliates are less likely to undertake. There is little substitution. For this reason, specific institutions must be built to promote national assets. Good models in Asia are the Republic of Korea and China, and in the Middle East, many OPEC members.

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[2] Alice Amsden, *A Rational Revolution: Developing from Role Models, Deserting Deductive Theory* (Cambridge: Harvard University Press, in process).

[3] Mona Mourshed, "Technology transfer dynamics: Lessons from the Egyptian and Indian pharmaceutical industries," doctoral thesis (Cambridge: MIT, 1999).

Chapter 29

The role of multinationals in sparking industrialization: From "infant industry protection" to "FDI-led industrial take-off"

Terutomo Ozawa[*]

Although not yet fully conceptualized as a new catch-up model in mainstream development economics, the infant industry argument (protectionism designed to replace imports with domestic substitutes) is giving way to a FDI-led model of industrialization.

Industrialization used to be an arduous long-term process of structural upgrading. It took Britain nearly a century subsequent to the Industrial Revolution to become the world's industrial leader in the second half of the 19th century. The United States replaced Britain in only about half a century. The spectacular rise of China has shortened the catch-up process even further, with the country having swiftly surpassed Japan in 2010 to become the world's second-largest economy within three decades after the adoption of an open-door policy in 1978. Behind this time-compressing trend of economic growth is the ever-accelerating dissemination of industrial knowledge from advanced to emerging markets. Most recently, this advance comes at the hands of MNEs and through breakthroughs in information technology.

To absorb and assimilate modern technology, the currently advanced economies used to resort to "infant industry protection" in their early stages of growth. The prime examples are the United States, Germany and Japan, which achieved great success with the catch-up strategy of infant industry protection or "import substitution" (two phrases used interchangeably in development economics).

This approach required the catching-up economy to go through a sequence of imports, domestic production and finally exports (if practical) -- involving the "visible hand" of government as a way of building up *nationally owned* industry under protectionism. During the course of technological learning, a protected industry had to secure industrial knowledge abroad (via many avenues, from licensing to copying) or create its own, which would be costly, time-consuming and often fruitless.

In many instances, protected industries stayed in the import substitution phase without attaining export competitiveness. The required government involvement often resulted in inefficiency, corruption and monopolies. During its heyday of import substitution, Latin America fell victim to this *dénouement*, especially since it neglected to build export-oriented labor-intensive industries, in which the region would have had a strong comparative advantage, thereby failing to mobilize its most abundant factor, labor, to trigger bottom-up industrialization. Latin America depended on "protected-market-seeking" FDI in its comparatively disadvantaged industries (those incommensurate with

[*] The author wishes to thank Joze P. Damijan, Lutao Ning and Charles P. Oman for their helpful comments on this chapter, which was first published as a *Perspective* on June 6, 2011.

its prevailing factor endowments and technology). Its reliance on "resources-seeking" FDI in particular led to a collusive alliance between MNEs and local elites, a form of the "resource curse."

In sharp contrast, however, China's catch up now tells a quite different story, an alternative approach that is in tune with the *zeitgeist* of today's global economy and can comply with WTO rules. China has unequivocally demonstrated the efficacy of what may be called "FDI-led industrial take-off," a strategy that is a much quicker (indeed, virtually instant) and more effective means of acquiring modern technology and export competitiveness than old-fashioned import substitution.

In comparison to infant industry protection, this FDI-led take-off strategy can create an entirely new export-driven industry practically overnight -- either wholly or jointly foreign-owned, depending on the host country's policies. MNEs generate and possess industrial knowledge and, above all, access to export markets. Inward FDI can instantly complete the otherwise-prolonged three-stage sequence of imports, domestic production and exports. It also produces technological spillovers to the host economy. Indeed, China skillfully carried out this new strategy by actively welcoming MNEs -- early on, in its comparatively *advantaged*, labor-intensive light industries (notably, apparel, footwear, toys) and, more recently, in its capital-intensive, scale-driven industries (especially, automobiles, consumer electronics), thereby emerging as the workshop of the world. In this process China lifted hundreds of millions out of abject poverty.

In addition, China is adopting a more directly outward-focused approach: "knowledge absorption via acquisition" (i.e. buying out technologically advantaged firms overseas), as best exemplified by Lenovo (which acquired the former IBM PC division in 2005) and Volvo (which was purchased by Geely in 2010). Although this newer approach is often blocked by political concerns in host countries (as is the case of Huawei's recent attempt to purchase 3Leaf Systems in the US), FDI thus works both ways in China's efforts to acquire industrial knowledge. Most interestingly -- and paradoxically, given its state-dominated polity -- China's approach is far more outwardly integrative and far more strongly market-driven than the conventional "closed-economy" strategy of import substitution pursued earlier, say, by postwar Japan.

On the whole, therefore, China's policymakers have made effective use of a new catch-up model that is powered by the logic of MNEs' profit-seeking activities. The model of FDI-led take-off has rendered that of infant industry protection obsolete. It is true that China now has to reformulate and refine its growth strategy as it climbs higher on the ladder of development, which increasingly requires more autonomous technological capacity. Nonetheless, China's initial growth strategy and the way this has been implemented need to be conceptualized as a new approach that capitalizes on MNEs' participation in export-driven, labor-intensive industries as a jump-starter of industrialization. The days of infant industry protection are clearly over in the annals of catch-up doctrines.

Chapter 30

Knowledge, FDI and catching-up strategies

Francisco Sercovich[*]

A recent *Perspective* by Terutomo Ozawa[1] singles out protectionism FDI as alternative drivers for the take-off phase of catching-up industrialization. This dichotomy neglects the rich and nuanced variety of strategic options revealed by recent successful industrialization experiences. Consider:

- Strong diffusion-oriented science and technology (S&T) capability-building policies focused on specialized small and medium-sized enterprises (SMEs) were key to Taiwan Province of China's industrialization strategy.
- The Republic of Korea focused on fostering learning and the acquisition of technological competence by *chaebols*, so that these organizations could achieve critical mass to compete globally in capital and technology-intensive industries.
- The allocation of public resources to engineering education, technical training and S&T has been critical to the development of scores of highly internationally competitive Brazilian private firms. Brazil's development bank subsidizes consolidations between local private firms, with the goal of achieving economies of scale high enough to engage successfully in R&D competition with MNEs.
- China's own brand of catching-up industrialization[2] relies heavily on strengthening indigenous enterprises, fostering S&T capabilities (particularly in high-tech sectors) and attracting FDI complying with stringent domestic technology absorption policies.

Key factors in shortening catching-up periods have been:

Education and training. Successful catching-up countries have reached record rates of growth in the supply of university graduates, particularly in natural sciences and engineering (most relevant to technology absorption).

Innovation and technology diffusion. The Republic of Korea, Taiwan Province of China, Brazil, and China have given high priority to speeding up technological learning, incremental innovation and domestic knowledge diffusion through institutional innovations.

Entrepreneurship development. Fostering personnel and technology knowledge flows among research labs, universities and the private sector has helped to bridge imbalances

[*] The author wishes to thank John Cantwell, Richard Nelson and Robert Pearce for their helpful comments on this chapter, which was first published as a *Perspective* on December 19, 2011.

[1] Terutomo Ozawa, "The role of multinationals in sparking industrialization: From 'infant industry protection' to 'FDI-led industrial take-off,'" *Columbia FDI Perspectives*, No. 39 (June 6, 2011).

[2] Carlos A. Magarinos, Long Yongtu and Francisco Sercovich, eds., *China in the WTO: The Birth of a New Catching-Up Strategy* (Hampshire: Palgrave Macmillan, 2002).

in the supply and demand of S&T and entrepreneurial skills, promoting competence building and fostering efficiency gains. Brazil's government established state-owned enterprises and then privatized them once they acquired the abilities necessary to perform competitively. The strategy supporting the formerly state-owned Embraer was over 60 years in the making, starting with targeted state support of massive education and training, along with learning subsidization.

MNEs. These can also help in the catching-up process when favorable domestic conditions exist, particularly regarding technology absorption and capability-building policies.

These strategies often relied on a covenant between the state and the private sector whereby the state subsidized technological learning and orchestrated the levers -- financial, external, fiscal, regulatory, and institutional -- conducive to the effective exploitation of the outputs of such learning for production for world markets, while the private sector achieved sustainable standards of technological mastery and international competitiveness through increasing R&D, innovation and training efforts. Clear and effective rules applied so that the goals sought were achieved within specific timeframes.

FDI played a significant role in catching-up industrialization in some cases (China, Brazil). However, on the whole, FDI flows *did not lead, but rather were led* by host country policies and strategies.[3] Understanding the role of FDI in host countries first requires grasping the underpinnings of host countries' strategies, policies and institutions. Hence, FDI should not be seen as entirely exogenous, nor should *infant development policies* be considered as necessarily non-WTO compliant or antagonistic toward FDI.

Actual policy focuses ranged from domestic SME development (Taiwan Province of China) to fostering *chaebols* (Republic of Korea), from indirect state incentive orchestration (Republic of Korea) to "market socialism" (China) and from heavy reliance on FDI (China, Brazil) to arm's length technology deals with MNEs (Taiwan Province of China), including various blends of the strategies above. Commonalities include a capability-building focused strategy, the subsidization of domestic learning processes and the promotion of domestic entrepreneurship and export-orientation, along with episodes of import-substitution, which for the most part, when successful, were turned into export-oriented ventures and, when unsuccessful, were phased out. The key to such policies today is the building and strengthening of domestic knowledge systems and the promotion of an internationally competitive private sector capable of embarking upon *sustainable* innovation trajectories.

The issue is not, therefore, whether MNEs are on board, but rather whether domestic pre-conditions are met so that MNEs can effectively contribute to sustainable catching-up development -- through FDI or otherwise. Accelerated international technology diffusion rates associated with FDI and information technology breakthroughs have *not* made lengthy domestic technological development efforts redundant, and subsidizing domestic

[3] Alice H. Amsden, *The Rise of the Rest: Challenges to the West from Late-Industrializing Economies* (New York: OUP, 2001).

learning processes is normally indispensable and not necessarily inefficient. Yes, catching-up has become faster over time; but costly endogenous learning processes are not passé. Sweeping leapfrogging alternatives are not available.

Without domestic absorption and innovative capabilities, little if any advantage can be taken of international knowledge flows, either through FDI or otherwise. *Infant development policies* are naturally -- not paradoxically -- consistent with outward integration.

Chapter 31

FDI, catch-up growth stages and stage-focused strategies

Terutomo Ozawa[*]

This is a reply to Francisco Sercovich's commentary[1] on my chapter on FDI-led industrial takeoff in which I described FDI as an ignition for catch-up industrialization.[2] He emphasized "the rich and nuanced variety of strategic options"[3] (e.g., S&T policies, engineering education, *chaebol*-type enterprises for technology absorption, R&D capabilities), which are, however, relevant only to *higher*-stages of catch-up, but *not* to the *kick-off* stage with which my previous *Perspective* was concerned. Economic development derives from structural changes at different stages of growth, requiring stages-focused strategies.

The FDI-led takeoff applies to the *beginning* stage of catch-up in which labor-abundant emerging economies have an endowed comparative advantage in low-end manufacturing. Higher stages are obviously built increasingly on knowledge and demand more sophisticated approaches. As I stated, "China now has to reformulate and refine its growth strategy as it climbs higher on the ladder...."[4] Each stage calls for different preparatory measures, institutions and strategies.[5]

Also, the notion of infant industry protection (IIP) has come to be stretched to cover practically any type of development measure. The FDI-led model was conceptualized as opposed to the *conventional* IIP theory epitomized in the Alexander Hamilton-Friedrich List approach that stresses import substitution to build a *locally owned* industry under protection-cum-promotion -- *not* under general development policies, *allowing* foreign advances into domestic industries.

In this respect, postwar Japan effectively pursued the Hamilton-List IIP strategy in modernizing its capital-intensive industries (e.g., steel, machinery, automobiles) by borrowing and improving on Western technologies. However, war-devastated Japan re-started *first* with then-comparatively advantaged, labor-intensive light industries and quickly redeveloped exports (e.g., toys, textiles). Japan's light industries did not need -- and in fact, *avoided* -- investments by foreign MNEs.

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[*] The author wishes to thank Raphael Kaplinsky, Rajah Rasiah and Dennis Tachiki for their helpful comments on this chapter, which was first published as a *Perspective* on May 28, 2012.

[1] Francisco Sercovich, "Knowledge, FDI and catching-up strategies," *Columbia FDI Perspectives*, No. 53 (December 19, 2011).

[2] Terutomo Ozawa, "The role of multinationals in sparking industrialization: From 'infant industry protection' to 'FDI-led industrial take-off,'" *Columbia FDI Perspectives*, No. 39 (June 6, 2011).

[3] Sercovich, op. cit., para. 1.

[4] Ozawa, op. cit., para. 9.

[5] For a policy framework, see a "leading-sector growth" model in Terutomo Ozawa, "The (Japan-born) 'flying-geese' theory of economic development revisited -- and reformulated from a structuralist perspective," *Global Policy*, vol. 2 (October 2011), pp. 272-285.

In contrast, Singapore, Taiwan Province of China and the Republic of Korea deliberately had to set up export-processing zones to attract labor-seeking FDI in the 1960s-70s, since they lacked the experience of producing manufactured exports. And they quickly succeeded in attracting labor-intensive manufacturing, the *first* step to industrial modernization. China, too, emulated its neighbors' successes by opening up for trade and FDI in 1978. China's special economic zones and low-wage labor enticed foreign MNEs to build China's low-cost, export-driven manufacturing, swiftly alleviating poverty.

The FDI-led kick-off has thus become a *new* jump-starter of industrialization and a more *expedient* alternative to the inward-looking IIP strategy. Such a start of industrial modernization *does not* require the sophisticated measures cited by Sercovich. In fact, this is the reason why the World Bank is urging China to relocate low-wage factories to Africa in order to help spark industrialization, although Africa (other than South Africa) *still* lacks nuanced strategic capacities (like S&T capabilities, *chaebol*-type technological competence and R&D competition with foreign MNEs).

As to *chaebol*-type conglomerates as a strategic option, they were actually not needed when the Republic of Korea was exporting labor-intensive goods (e.g., wigs, toys, footwear), initially from its Masan export-processing zone opened in 1970. Only in the *subsequent*, *higher* stages of catch-up (i.e., heavy and chemical industrialization and the development of assembly-based industries) *chaebols* became a powerful instrument -- just as Japan's postwar *keiretsu* firms did -- for building scale-driven, capital-intensive industries (e.g., shipbuilding, machinery, microchips, automobiles). True, the government sagaciously began to make efforts to establish these higher-stage industries under IIP-cum-subsidies, starting as early as the late 1960s (e.g., the Electronics Industry Promotion Law of 1969 initially to encourage *assembly* operations of monochrome TVs, i.e., from the *low*-end of a knowledge-based industry). All these industries, however, grew internationally competitive *only in later and more recent decades*. Interestingly, *chaebols* may now be even considered outdated in an era of entrepreneurship and start-ups spawned by information technology.

Thus, the criticality of a stages perspective cannot be overstressed. For instance, to ask Africa's unindustrialized countries to organize *chaebol*-type enterprises and invest in S&T capabilities is premature *at the moment*; instead, Africa should *first* apply its *limited* development resources (including policy capacity) to attracting FDI in labor-intensive manufacturing to ignite an FDI-led takeoff. This must be what the World Bank has in mind. True, there may be other options, such as fostering small and medium-size domestic manufacturers in hopes of an autonomous export-led kick-off. Some even propose a skipping-a-step strategy to enter a high-end industry. But this approach, even if workable, risks unbalanced development, leaving the region's comparative advantage in labor-intensive industries untapped -- hence, the impoverished masses still under and un-employed. Once it gets kick-started, however, more intricate higher-stage strategies are needed to sustain catch-up. In sum, it makes sense *first* to exploit *endowed* advantages and then try to "create" new ones.

Chapter 32

Much ado about nothing? State-controlled entities and the change in German investment law

Thomas Jost[*]

The rise of sovereign wealth funds (SWFs) and state-owned enterprises (SOEs) -- together state-controlled entities (SCEs) -- has led to concerns that SCEs could threaten national security by following political rather than mere commercial goals with respect to their FDI. While developed countries acknowledged that the rise of SCEs should not lead to new barriers to FDI, several have changed their legislation to expand government oversight of FDI flows. In 2009, Germany also tightened its foreign investment regime. What are the first experiences with this change in German investment law?

In April 2009, an amendment to the German Foreign Trade and Payments Act entered into force. According to the new law, the Federal Ministry of Economics and Technology (BMWI) can review foreign investments and can suspend or prohibit transactions that threaten to impair national security or public order. The new law applies to an acquisition of voting rights of 25% or more of a listed or non-listed German company by non-EU or non-European Free Trade Association purchasers; it does not explicitly discriminate between private or public foreign investors.[1] The law was prepared mainly before the financial crisis and was patterned, at the end, on US legislation.

According to current legislation, it is not mandatory for foreign investors to submit notifications of the acquisition of a German firm. Rather, the BMWI collects information about M&As by foreign investors and may review these transactions within three months. In 2008, the BMWI expected that only about ten foreign investments per year would be reviewed. Foreign investors who are not sure whether their investments raise national security concerns can request a certificate of non-objection. Many economists and political commentators criticized the change of the German investment law, whereas the Government argued that the new law is only pre-emptive and will not be used to discriminate against SCEs.

So far, the German authorities have applied the new law carefully. From April 2009 to December 2011, no foreign acquisition of a German company was suspended or prohibited, and no review process was initiated by the BMWI. There were 99 cases during that period in which foreign companies applied for certificates of non-objection. In 98 cases, the foreign investors received the certificate, on average, within two weeks. In

[*] The author wishes to thank Rudolf Dolzer, Justus Haucap, Steffen Hindelang, and Joachim Steffens for their helpful comments on this chapter, which was first published as a *Perspective* on June 4, 2012.

[1] Thomas Jost, "Sovereign wealth funds and the German policy reaction," in Karl P. Sauvant, Lisa Sachs and Wouter P.F. Jongbloed, eds., *Sovereign Investment: Concerns and Policy Reactions* (New York: OUP, 2012).

one case, the potential foreign investor refrained from its investment for unknown reasons.[2]

In recent years, investments by SCEs in the German corporate sector have risen noticeably. Their FDI is not shown separately in the German inward FDI stock statistics; but FDI from economies that host SCEs (e.g. China, Iran, Russia, United Arab Emirates) has risen strongly in the past decade -- from less than US$ 2 billion in 2000 to US$ 8.5 billion in 2009.[3] SWFs have acquired stakes in several well-known German companies. For example, at the end of 2009, Qatar Investment Authority acquired a large stake in Volkswagen AG for US$ 9.6 billion, raising its share in the world's third largest car producer to 17%. Most of these investments were under the 25% threshold that could provoke a review in case of security concerns. However, SCEs from countries of the Gulf Cooperation Council have also acquired several smaller sized German companies that are not listed on stock exchanges. In most of these cases they acquired more than 50% (and often 100%) of the equity capital of the German company.

Despite the change of its legislation, Germany has remained open for FDI. In 2010, the OECD continued to rank Germany among the most open countries for inward FDI worldwide, far ahead of France, Japan, the United Kingdom, and the United States. In the United States, for comparison, the Committee on Foreign Investment reviewed 313 transactions within a period of three years (2008-2010), of which 30% resulted in investigations.[4]

The careful handling of the new law and the increase of SCEs' investments in Germany can be interpreted in different ways: on the one hand, the change of the investment law was successful and passed a practical test as Germany remained an open business location. On the other hand, one could ask whether the German authorities had overreacted in changing the law by doing much about nothing. Like in most other economies, the public debate on restrictive measures against SCEs' investments has calmed down in Germany. In 2011, there were no reported changes of national investment laws with respect to national security in developed countries. Since the Lisbon Treaty took effect, the EU has gained the competence concerning FDI. Practical implications for Germany's legislation are still uncertain.

[2] Information provided by BMWI. An official published report of the Ministry is not available.

[3] Thomas Jost, "Inward FDI in Germany and its policy context, update 2011," *Columbia FDI Profiles*, November 19, 2011.

[4] Committee on Foreign Investment in the United States, *Annual Report to Congress*, December 2011.

Chapter 33

National security with a Canadian twist: The Investment Canada Act and the new national security review test

Subrata Bhattacharjee[*]

On March 12, 2009, the Canadian federal government passed significant amendments to the Investment Canada Act (ICA), Canada's foreign investment law of general application.[1] Though the amendments generally liberalize important aspects of the Canadian foreign investment review regime, they also include a broadly worded national security test that now allows the responsible minister to review proposed investments in Canada on national security grounds.[2] On July 11, 2009, the government published draft regulations that provide the details of the new national security review process. A detailed summary of the amendments and regulations is included in an extended note available at www.vcc.columbia.edu.[3]

At a time when many jurisdictions, including the US and certain EU members, have or are contemplating national security reviews, it is unsurprising that the Canadian government has put a similar process in place. Indeed, the Canadian national security review raises issues akin to those raised in other jurisdictions with similar tests, including uncertainty about the meaning of "national security," concern that the new test may be used to target sovereign investment (particularly in the natural resources and energy sectors), and the likelihood of politicization of national security reviews.[4]

As is the case in new processes, which lack precise statutory or regulatory definition, it is unclear how the new test will be applied, and there are reasons to believe that it could be applied in a wide range of situations. There are at least three possible dimensions of national security: (1) economic welfare; (2) national security; and (3) super-national security.[5] The application of any of these dimensions to a merger review raises the possibility that a potential transaction that will increase economic efficiencies is rejected for political reasons. First, an interest in economic welfare may raise concerns that

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[1] It is important to note that foreign investment in Canada may be subject to sector specific legislation depending on the industry in question. See e.g. Donald G. McFetridge, "The role of sectoral ownership restrictions," paper prepared for the Competition Policy Review Panel (2008).

[2] The ICA provides that the federal minister of Industry is responsible for administering the legislation in all contexts save those relating to investment in a Canadian "cultural business" (as the term is defined at section 14.1(5) of the ICA). The administration of the ICA as it relates to such businesses is the responsibility of the minister of Canadian Heritage. Investments that are both cultural and non-cultural may be subject to the jurisdiction of both ministers: http://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk00053.html (accessed March 30, 2009).

[3] The link for the Extended Note is: http://vcc.columbia.edu/pubs/documents/ICAextendednote-Final.pdf.

[4] See, e.g. Edward M. Graham and David M. Marchick, *U.S. National Security and Foreign Direct Investment* (Washington, D.C., Institute for International Economics, 2006).

[5] Deborah M. Mostaghel, "Dubai Ports World under Exon-Florio: a threat to national security or a tempest in a seaport?" *Albany Law Review*, vol. 70 (2007), pp. 607-614.

domestic industries should be protected from being bought out by foreign investors. In the past, producers of "clothespin[s], peanut[s], pottery, shoe[s], pen[s], paper and pencil[s]" in jurisdictions around the world have invoked the economic welfare dimension of national security to protect their industry.[6] Second, an interest in national security may refer to a concern that sectors of a country's economy that are strategically sensitive for defense reasons should not be owned by foreign companies. Finally, an interest in super-national security may refer to the overarching imperative to "protect the homeland" from investment by countries that are viewed as a security risk.

Recently, it could be argued that the federal government and Canadian public view *all* three of these dimensions as relevant to national security reviews in Canada. Successive federal governments have expressed concern over investments by state-owned enterprises (SOEs) in Canadian businesses, exemplified by public debate over inbound investments by United Arab Emirates' SOEs and the issuance of review guidelines under the ICA specific to SOEs.[7] The current government's decision (seemingly supported by all parties) to block the Alliant/MDA transaction on the basis of arguably unusual concerns relating to US access to surveillance technology further suggests that there is political will to consider similar restrictions on defense related acquisitions, even emanating from countries like the US.

Finally, public concern over the alleged "hollowing out" of corporate Canada, whether through elimination of Canadian head offices, stock exchange listings or reduced R&D has been apparent in the context of high profile acquisitions of Canadian businesses. Indeed, the consultation undertaken by the federal government, which preceded passage of the amendments to the ICA, explicitly considered the issue in its deliberations, and did not rule out the possibility, for example, that the loss of Canadian head offices due to foreign acquisitions of Canadian businesses could have negative consequences for the Canadian economy, though it did not recommend further direct restrictions on foreign investment.[8]

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[6] Mostaghel, "Dubai Ports World under Exon-Florio: a threat to national security or a tempest in a seaport?," op. cit., p. 608.

[7] Industry Canada, Guidelines, "Investment by state-owned enterprises: net benefit assessment," (December 2007). The guidelines are a statement of policy and, as such, do not have any legal effect or introduce any legislative amendments to the ICA. Instead, they specify particular factors that the minister should consider when applying the six economic factors under the ICA's net benefit test to a proposed investment by an SOE, being:

- The SOE's adherence to Canadian laws, practices, and standards of corporate governance, including commitments to transparency and disclosure, independent members of the board of directors, independent audit committees and equitable treatment of shareholders;
- The nature of and extent to which the SOE is controlled by a foreign government; and
- Whether the acquired Canadian business will continue to operate on a commercial basis.

The guidelines also suggest that SOEs should submit specific undertakings to the minister in support of a proposed transaction. Examples of possible undertakings include:

- Appointing Canadians as independent directors on the board of directors;
- Employing Canadians in senior management positions; incorporating the new business in Canada; or
- Listing the shares of the acquiring company or the Canadian business on a Canadian stock exchange.

[8] Competition Policy Review Panel, *Compete to Win: Final Report* (Government of Canada, June 2008).

When these tendencies are considered in light of the breadth of the national security test, the federal government should be cautious in adopting an over-expansive approach to the application of the new test. The above tendencies demonstrate the country's preoccupations with national champions, Canadian control over natural resources and domestic head offices. Allowing these preoccupations to dominate a national security review would counter the intended purpose of the test, and instead of functioning as a transparent tool to be used by the federal government in the limited circumstances in which foreign investment may threaten Canada's national security, the national security test would become a meaningless catchphrase to be touted against unpopular, but legitimate foreign investments. Having said this, and as of the writing of this Chapter, the seemingly smooth progress (to date) of the recently announced acquisition by China Investment Corporation (CIC) of a minority voting interest in Teck Resources Ltd. (a major Canadian mining concern) under the new national security test is a welcome sign.[9] This transaction, involving a leading Chinese sovereign wealth fund acquiring a stake in a Canadian natural resource company, was precisely the type of acquisition that was to be scrutinized under the new test.

Foreign investors considering investments that could be subject to the new process will also have to adjust to a review process that is no longer primarily administrative, but essentially political. The national security review process is highly consultative in nature, and invites input from the cabinet of the federal government, departments of the federal government, as well as provinces affected by the transaction. All of these constituencies are heavily influenced by public concern about high profile transactions, especially those that are the subject of extensive media comment. Prudent foreign investors are well advised to recognize this at an early stage of their planning and to consider government relations and public relations strategies that are consistent with the approach taken to review under the ICA. Investors who appreciate the multifaceted nature of the Canadian foreign investment review process will have the most success in securing ministerial approval in a timely and acceptable manner.

[9] "Teck Resources announces C$1.74 billion private placement," News Release (July 3, 2009), available at: www.teck.com.

Chapter 34

A new economic nationalism? Lessons from the PotashCorp decision in Canada

Sandy Walker[*]

In its *World Investment Report 2011*, UNCTAD reported that liberalizing investment policy measures taken globally in 2010 outnumbered restrictive measures.[1] Without the benefit of statistics, investors might have drawn the opposite conclusion, witnessing what appears to be a rising tide of national resistance to foreign takeovers: the Australian Foreign Investment Review Board's rejection of a takeover of the Australian Securities Exchange by the Singapore Exchange, Italian concern over a French company's takeover of dairy giant Parmalat and the US Government's requirement that Chinese company Huawei divest certain assets it had acquired from 3Leaf.

In Canada, the rejection by the Canadian Government of the takeover of Potash Corporation of Saskatchewan (PotashCorp) by Australian mining giant BHP Billiton (BHP) has raised similar anxieties. However, closer scrutiny of the PotashCorp decision reveals that it does not portend a sea-change in the foreign investment review process in Canada. Rather, it underlines that politics can occasionally hijack the review of foreign investments, in contrast to other areas of law (such as merger control under competition law) that tend to have a more predictable, less open-ended framework of analysis.

The PotashCorp decision represented only the second time in Canada's history of foreign investment review legislation (Investment Canada Act or ICA) that a foreign investment outside the cultural sector has been rejected. PotashCorp is the largest producer of potash (a key ingredient in fertilizer), reported to have about 20% of global potash capacity. The Canadian Government found that BHP's bid did not meet the "net benefit to Canada" test for approval under the ICA. Among other factors, the Canadian Government was not satisfied that BHP was prepared to make sufficient commitments in respect of capital expenditures or PotashCorp's membership in the potash export consortium, Canpotex.[2] At the time, the federal Minister of Agriculture also referred to potash as a "strategic resource."[3]

Despite these explanations, the PotashCorp decision is properly viewed as an exceptional and largely political response to a number of factors:

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[*] The author wishes to thank Subrata Bhattacharjee, Andrea Bjorklund and Gus Van Harten for their helpful comments on this chapter, which was first published as a *Perspective* on August 27, 2012.

[1] See http://www.unctad.org/templates/webflyer.asp?docid=15189&intItemID=2068&lang=1&mode=downloads.

[2] See Cassandra Kyle, "BHP Billiton withdraws potash bid, citing 'net-benefit' bar," *Postmedia News,* Nov. 15, 2010, available at: www.canada.com/news/Billiton+withdraws+potash+citing+benefit/3827505/story.html.

[3] Eric Reguly, Andy Hoffman and Brenda Bouw, "BHP's hopes fade as Ottawa calls potash 'strategic,'" *The Globe and Mail*, November 5, 2010, p. B1.

- The Premier of Saskatchewan's success in galvanizing opposition to the deal across Canada, based on expressed concerns over a significant reduction in tax revenues and foreign ownership of a "strategic" resource.
- The ruling Conservative Party's minority government status, which made it vulnerable to a potential loss of seats in the 2011 election -- particularly in the province of Saskatchewan where there was strong support for the Premier's opposition.
- The hostile nature of BHP's bid.

The absence of official reasons for the PotashCorp decision fostered anxiety about the Government's openness to foreign investment. This was particularly the case in light of the significant and, in some respects, unprecedented undertakings BHP had offered Canada. The latter included foregoing tax benefits, remaining a member of the Canpotex potash export consortium for five years and establishing its global headquarters in Saskatoon. BHP also offered a US$ 250 million performance bond to the Government to backstop its undertakings, likely to allay public concerns about compliance.

There are (at least) three lessons to be drawn from this decision. First, potential stakeholders in the Investment Canada process, particularly the provinces, have learned that political agitation can yield concrete results. However, whether this lesson will translate readily to other transactions is open to question: provincial leaders typically have more diverse and conflicting constituencies than Saskatchewan where the potash industry is very significant, and the federal government is no longer politically fragile, having won majority government status in May of 2011.

Second, the Canadian Government is sensitive to criticism that its decision regarding PotashCorp could discourage foreign investment in Canada and, accordingly, has portrayed this case as exceptional and not indicative of a potentially worrisome trend of deploying national interest tests in a way that impedes the flow of international investment.[4] Indeed, no deals have been rejected in the year since the decision, although it is telling that the Government has still not brought into force a 2009 amendment to the ICA that would increase the review threshold and thereby reduce the number of foreign investments subject to review.

Third, some foreign investors may increasingly turn to self-help measures to address uncertainty over the Government's approach to foreign investment. For example, by making minority investments of less than a third of a corporation's shares, foreign investors can avoid scrutiny under the ICA, unless the investment is potentially injurious to Canada's national security. In addition, in the resources sector, foreign businesses may negotiate "off-take agreements" entitling them to a share of production as a means of securing access to natural resources.

[4] See Peter Lichtenbaum and David Fagan, "Lessons in mediating for dairy warriors," *Financial Times*, April 20, 2011.

Chapter 35

The revised national security review process for FDI in the US

Mark E. Plotkin and David N. Fagan[*]

On December 22, 2008, new regulations setting forth the US Government's national security review process for foreign mergers and acquisitions of US businesses became effective. They are the ultimate step in a lengthy effort to revise and strengthen the reviews undertaken by the Committee on Foreign Investment in the United States (CFIUS).[1]

CFIUS administers the so-called Exon-Florio statute, which provides the US President with the authority to review mergers, acquisitions and takeovers that may result in foreign control over a US person or entity engaged in interstate commerce in the United States. (Greenfield investments are not subject to CFIUS review.) For M&As that threaten to impair US national security in a manner that cannot be mitigated or that is not, in the President's judgment, otherwise addressable through other US laws, the President can suspend or prohibit such foreign investments -- a decision not subject to any judicial review. The Exon-Florio statute itself, and CFIUS as the statute's administering body, came under political attack in the wake of the 2006 Dubai Ports World debacle. Some in the US Congress sought to tighten drastically the legal regime for foreign investment in the United States. Fortunately, through the leadership of certain key members of Congress, the administration and the business community, the debate shifted to improving the review process in a manner that protects national security while preserving the openness of the US to foreign investment. The end result was the Foreign Investment and National Security Act of 2007, which thoughtfully enhanced Exon-Florio and the CFIUS process. The Treasury Department, working with the other CFIUS agencies, has now issued final regulations implementing the Act.

The amended CFIUS process maintains the formal existing timeframes for reviewing M&As, providing a critical measure of certainty to foreign investors and US parties. The timeframe for CFIUS review -- and Presidential action, when necessary -- can be summarized as follows:

- CFIUS conducts an initial 30-day review following receipt of a voluntary notice filed jointly by the foreign acquiror and the US business. The vast majority of CFIUS cases are concluded following this initial 30-day review.

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[*] This chapter was first published as a *Perspective* on January 7, 2009.

[1] In addition to the Department of The Treasury, which chairs CFIUS, the Committee is comprised of eight other voting members (the Departments of Commerce, Defense, Homeland Security, Justice, State, and Energy; the US Trade Representative; and White House Office of Science and Technology); two permanent non-voting members (the Director of National Intelligence and the Department of Labor); and several other executive branch offices that act as observers and, on occasion, participants in CFIUS reviews.

- For transactions deemed to require additional review following the initial 30 days, the statute authorizes CFIUS to conduct an investigation for up to an additional 45 days.
- If CFIUS has not unanimously resolved a threat to US national security at the end of the 45-day investigation period, CFIUS will provide a formal report to the President. The President then has 15 days to issue his decision in the case. (Few transactions reach the stage of requiring a Presidential decision.)
- CFIUS is now required to report to Congress on its reviews, but those reports occur only after the review is concluded. There is no formal prior role for Congress.

For foreign investors and US parties, there are a number of other notable aspects of CFIUS's authority and jurisdiction under the amended law and regulations. First, the CFIUS regime continues to employ a broadly flexible definition of "control" by a foreign person for purposes of determining CFIUS jurisdiction. Second, the applicable law and regulations do not precisely define the meaning of "national security." CFIUS's national security assessment in turn remains a case-by-case determination. Even the presence of foreign government-control over the investor -- for which there is a statutory presumption of heightened scrutiny -- does not necessarily create a national security risk; CFIUS still considers all facts and circumstances related to the particular M&A at issue in determining what, if any, national security risk is presented. Third, while CFIUS has authority to initiate its own reviews of M&As, the CFIUS review remains an inherently voluntary process, affording parties with discretion on when and whether to notify CFIUS of a "covered transaction" (i.e., a M&A involving investment by a foreign person). Fourth, while CFIUS's amended legal authorities provide, in practice, for a more deliberative process that can result in enhanced scrutiny in certain cases and, in turn, a greater number investigations, they also create an arguably higher bar for CFIUS to extract formal (and potentially costly) risk-mitigation commitments from M&A parties as a condition of approval.

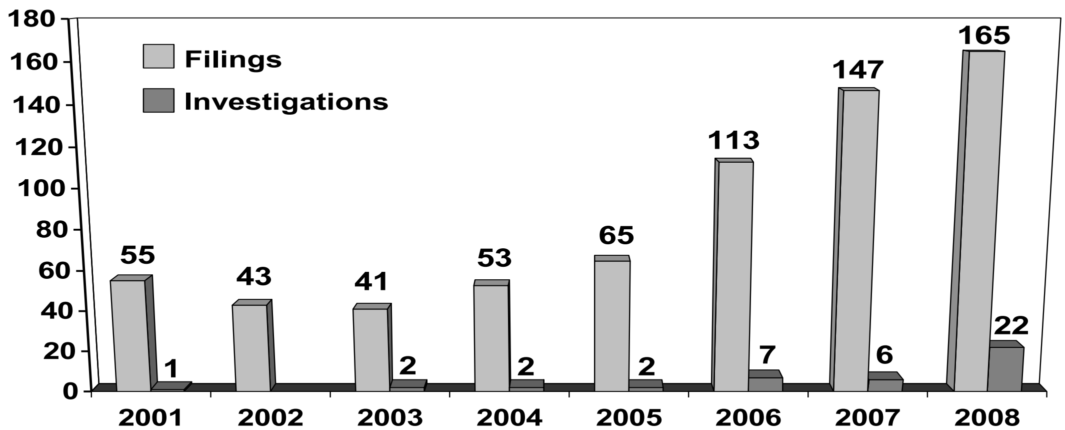
Together, these characteristics of the amended CFIUS regime offer CFIUS the latitude to review transactions likely to raise real (or perceived) national security risks and to address those risks reasonably, without trampling the overall US policy of promoting foreign investment. They also offer transactional parties discretion on whether to condition the consummation of covered M&As upon CFIUS approval. Consequently, while the number of M&As filed with CFIUS has been rising steadily in recent years (see the table below), CFIUS likely will continue to review just a fraction -- generally estimated to be less than 10% -- of foreign investments in US businesses. Furthermore, even with the enhanced number of filings and increased investigations, the vast majority of CFIUS's reviews will continue to conclude in the initial 30-day time period.

It is important to note, however, that M&A parties should tread carefully with their discretion on when and whether to notify CFIUS of a transaction and to require CFIUS approval before closing the transaction. CFIUS does monitor M&A activity, and it is always preferable for parties to raise a transaction with CFIUS voluntarily rather than to have CFIUS formally come calling after the transaction is announced. Moreover, while relatively few covered M&As raise potential national security concerns, the President and

CFIUS have the power to unwind a transaction after closing. Conversely, a CFIUS review and approval provides a form of safe harbor for a transaction that can only be revisited in very limited, exceptional circumstances. Given this dynamic, parties are well advised to assess the CFIUS-related ramifications of a potential transaction involving foreign investment -- and to determine whether a CFIUS review is advisable -- in advance of entering into a covered M&A.

In the end, the revised CFIUS regime largely preserves existing practices and timeframes; provides somewhat greater clarity to transaction parties; establishes greater accountability within the CFIUS process and of CFIUS to the US Congress; and strengthens political confidence in, and respect for, the CFIUS review system. Given the difficult place where the political process commenced after Dubai Ports World, this is a positive result, and benefits foreign investors and US parties alike by assuring greater transparency and stability in the CFIUS review process.

Annex table. CFIUS Filings and Investigations, 2001-2008



Source: US Treasury Department.

Chapter 36

Foreign direct investment and US national security: CFIUS under the Obama administration

Mark E. Plotkin and David N. Fagan[*]

There was considerable public scrutiny of the Obama administration's performance in its inaugural year, but comparatively little focus on one of the administration's key processes governing the flow of investment into the United States -- namely, the Committee on Foreign Investment in the United States (CFIUS). Yet, this is a frequent question we receive from foreign investors -- has the change in the administration affected CFIUS?

The good news for investors and US transaction parties alike is that the overall CFIUS process continues to function well under the Obama administration and has been faithful to the principles of open investment. At the same time, there have been several notable developments in the volume and pace of CFIUS reviews over the past year that should be of interest to those who watch the cross-border M&A market closely.

The slowdown in overall M&A activity contributed to a reduction in filings with CFIUS.[1] In 2008, CFIUS reviewed 155 cases; CFIUS reviewed fewer than half as many transactions in 2009.[2] This is the lowest number of notices since 2005 and the first reversal of an upward trend in nearly a decade.

Perhaps the most significant development for investors was that CFIUS's pace for completing its reviews also slowed materially in 2009. While official figures have not been released, CFIUS escalated a much higher percentage of matters under review to a second-stage 45-day "investigation" to the point that, by percentage, investigation nearly became the rule rather than the exception in 2009. By contrast, through 2007, fewer than two percent of all cases reviewed by CFIUS had proceeded to the investigation phase and, in 2008 (a year in which CFIUS received the most filings in nearly two decades), the number of investigations still was fewer than 15% of all cases.

The slower pace of CFIUS reviews and corresponding increase in investigations may be attributed to several factors. First, there was a natural bureaucratic lag that results from any change in administration and turnover in senior positions in key agencies. The Treasury Department and other CFIUS agencies worked valiantly to move CFIUS cases along for review but often the necessary policy-level approvals were slow in coming.

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[*] The authors wish to thank José E. Alvarez, John Kline and James Mendenhall for their helpful comments on this chapter, which was first published as a *Perspective* on June 7, 2010.

[1] Through the first half of 2009, there was an estimated 86% reduction in overall M&A activity from 2008. Alexandria Zendria, "M&A in 2009," *Forbes,* July 14, 2009, available at: http://www.forbes.com/2009/07/13/mergers-acquisitions-technology-intelligent-investing-healthcare.html.

[2] Final data on 2009 filings are not yet available, but the authors understand that CFIUS received notices for approximately 70 to 75 transactions in 2009.

Second, the Foreign Investment and National Security Act of 2007 (FINSA), which "reformed" CFIUS and codified its review authority, established a presumption of investigation for foreign government transactions and transactions involving critical infrastructure. The number of investigations in 2009 partially reflects the continued role of state-owned enterprises and other sovereign investors even in the slower 2009 M&A market.

Third, and most important, the Executive Order (EO) adopted by the Bush administration to implement FINSA included several provisions aimed at tightening CFIUS's internal administration. In particular, the EO established a more rigorous internal process that CFIUS must undertake before it proposes measures directed at "risk mitigation" for a particular transaction. This internal process, while more disciplined and focused strictly on addressing only true national security issues, also creates an additional layer to the regulatory approval process. The result has been fewer mitigation agreements but a corresponding time lag due to the heightened formality of the internal mitigation process.

This trade-off between fewer mitigations agreements but longer CFIUS reviews has benefits and costs for transaction parties. Investors benefit as the trend reduces longer-term compliance costs associated with CFIUS approvals. On the other hand, delays in the average time for key regulatory approvals can potentially have a negative market impact, making foreign investors less attractive -- and, therefore, requiring higher prices from them -- than potential US acquirors.

To be sure, there are reasons for optimism that equilibrium between mitigation and timing will be reached. Most key political positions with responsibility for CFIUS have been filled (after slow nomination and confirmation processes). As these officials become more comfortable with the inter-agency process, the processes established under FINSA become more routine, and the internal precedent under FINSA grows, the machinery of CFIUS will hopefully pick up pace and restore a balance between expeditious reviews and careful mitigation.

There also are measured steps that transaction parties can take to facilitate the review process. CFIUS encourages transactions parties to engage with CFIUS before filing. More consequential, transaction parties can anticipate and address ancillary regulatory issues -- such as necessary export control-related filings or compliance matters -- that involve member agencies of CFIUS to keep those issues distinct from the CFIUS process. The failure to anticipate such issues can lead to their introduction into CFIUS's deliberations, delaying CFIUS approval until they can be separately sorted with the particular member agency.

Notwithstanding this dynamic nature of CFIUS's considerations and the concerns over the timing delays over the past year, CFIUS in many ways remains a model for preserving open investment while balancing national security considerations. Placing the process in some perspective, it is remarkable that a government regulatory review that requires not just coordination but *consensus* from roughly a dozen federal agencies, each of which has its own perspective and equities -- and each of which may itself require coordination among many internal offices and components -- can be completed in the vast majority of cases within the statutory timeframes (either 30 or 75 days) and with little controversy. And yet this has been, and remains, the regular achievement of the CFIUS process.

Chapter 37

Chinese FDI in the United States is taking off: How to maximize benefits?

Thilo Hanemann and Daniel Rosen[*]

China's outward FDI (OFDI) grew rapidly in the past decade, but flows to developed economies have been limited. Now China's direct investment flows to the United States are poised to rise substantially. This new trend offers tremendous opportunities for the US, provided policymakers take steps to keep the investment environment open and utilize China's new interest productively.

China's OFDI flows grew from an annual average of below US$ 3 billion before 2005 to over US$ 60 billion in 2010, bringing China's total global OFDI stock to more than US$ 300 billion.[1] This investment was concentrated in developing countries and a few resource-rich developed economies. Chinese investments in the US were few and far between.

Since 2008, that story has begun to change. A new dataset allowing a real-time assessment of FDI patterns shows that Chinese FDI in the US is taking off. Direct investment expenditures by Chinese firms in that country have grown more than 130% a year over the past two years. In 2010 alone, Chinese firms spent more than US$ 5 billion in the US on 25 greenfield projects and 34 acquisitions. Today, Chinese firms have investments in at least 35 of the country's 50 states, across a wide range of industries.[2]

This new momentum in Chinese FDI in developed economies is driven by changing economic realities forcing firms to look abroad. In the past, a fast-growing domestic economy and booming export markets overshadowed overseas opportunities. The shift of China's growth model is now forcing Chinese firms to upgrade technology, move up the value chain and augment their managerial skills and staff base. We expect Chinese firms to place US$ 1-2 trillion in OFDI worldwide over the coming decade. Developed economies will receive a big share of this investment.

Japan exemplifies the potential. Japanese firms played a minor role in the US economy when they started to invest there in the 1970s. Today, they employ more than 700,000 workers in that country, with an annual payroll of US$ 50 billion, account for more than US$ 60 billion of US exports and spend more than US$ 5 billion annually on research

[*] The authors wish to thank Clarence Kwan, Joel H. Moser, Oded Shenkar, and Stephen R. Yeaple for their helpful comments on this chapter, which was first published as a *Perspective* on October 24, 2011.

[1] Data from China's balance-of-payments (BOP) statistics, Peoples' Bank of China, available at: http://www.safe.gov.cn.

[2] See Daniel H. Rosen and Thilo Haneman, *An American Open Door?* (New York: Asia Society and Woodrow Wilson International Center for Scholars, 2011), available at: http://rhgroup.net/china-investment-monitor.

and development in the US.[3] However, China will not inevitably replicate Japan's success. Policymakers must take the right steps to ensure these flows materialize and benefits are maximized.

In particular, US leaders must guard against protectionism and defend investment openness. China's modest OFDI has already stoked political fires, and there is a danger that anti-China sentiment may further increase if OFDI levels surge. Washington must work on protecting the national security review process from politicization, improve decision-making transparency and reject calls to expand the reviews to include economic security issues.

The US should not only keep the door open but should actively encourage FDI from China, starting with a clear and bipartisan message that this investment is welcome.[4] Growing FDI from China and other emerging markets is changing the game. The US might lose out in competition with other developed countries if it fails to adapt.

Finally, policymakers need to think how best to leverage China's new overseas investment interest. Threatening to block access to sectors in which foreign firms face restrictions in China would choke off badly needed investment -- while having little effect on foreign investment rules in China. However, the increasing presence of Chinese firms in their jurisdiction gives developed countries greater leverage to demand openness, transparency and adherence to global business norms from those companies and their domestic regulators. The US Government should explore bilateral and multilateral options for using this new leverage.

Formulating a coherent policy response to growing Chinese investment is crucial in preparing for a major shift in the patterns of global capital flows. From 2000 to 2009, the share of emerging markets in global OFDI flows jumped from less than 2% to more than 14% as the rest of the world has started to catch up with developed countries in global FDI flows.[5] China will serve as a test case for how the United States deals with these new realities.

[3] Data points refer to all US affiliates of Japanese companies in 2008. Source: US Bureau of Economic Analysis.
[4] The Obama administration's reaffirmation of the country's open investment policy and the new SelectUSA program that bundles investment promotion efforts were steps in the right direction.
[5] NCTAD's global FDI database. Figures refer to the broadest available definition of emerging markets (Dow Jones EM Index, 35 countries), available at:
http://www.djindexes.com/mdsidx/downloads/brochure_info/Dow_Jones_Total_Stock_Market_Indexes_Brochure.pdf.

Chapter 38

Economic patriotism: Dealing with Chinese direction investment in the United States

Sophie Meunier et al. *

China is investing throughout the world, in industries from automobiles to zinc. In the US, Chinese FDI accounted for only 0.25% of total FDI stock in 2010,[1] but it is likely to increase as China diversifies its holdings and seeks to obtain technology, managerial know-how and easier access to US consumers. As these investments multiply, we expect a few cases to attract negative attention in the media and political arena. Chinese companies are predominately state-controlled, raising the specter that they act to fulfill strategic, rather than profit maximizing, goals. China is also an ideological rival, causing irrational concern that Chinese investment in the US may act as a Trojan Horse of Chinese values and politics -- fueled by rational concerns about subsidies, piracy, and economic espionage.

Even though hosting Chinese FDI in the US is not free from risk, we argue that the benefits outweigh the costs. First, FDI provides an influx of capital into the struggling economy, increasing employment at no cost to the taxpayer. Second, jobs in foreign affiliates are typically better remunerated than similar jobs in domestically owned companies. Third, keeping the US open to foreign investment demonstrates a global example for international openness. Finally, Chinese money refused by the US could alternatively be directed to competitors or even the US's enemies.

We offer five policy recommendations designed to welcome Chinese FDI in the US while dealing with its potential dangers and limiting the inevitable associated political backlash.

1. Without naïveté, the US must avoid incorporating reciprocity into considerations of its openness to FDI. A decision by China to close itself to US investment, in addition to its existing market access restrictions, would damage American economic interests. However, the US should avoid compounding these losses with protectionist policies of its own whenever possible. To be sure, the threat of tit-for-tat provides bargaining leverage and may act as deterrence. Yet inward FDI, exempt a legitimate security issue, should be encouraged no matter its country of origin.

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* This chapter is a summary of the report "Economic patriotism: How to deal with Chinese investment," written by Andrew Budnick, Thomas Gibbons, Michael Jiang, Andrew Sartorius, Thomas Tasche, Derek Wu, and Bradley Yenter, under the direction of Sophie Meunier, as part of the Junior Policy Task Force "Economic Patriotism" at Princeton University in the fall 2011 semester, available at: http://www.princeton.edu/~smeunier/Princeton_Task_Force_Report_Final_2011. The authors wish to thank David Fagan, Thilo Hanemann and Nicolas Veron for their helpful comments on this chapter, which was first published as a *Perspective* on May 14, 2012.

[1] Thilo Hanemann, "It's official: Chinese FDI in the US is soaring," August 25, 2011, available at: http://www.rhgroup.net/notes/its-official-chinese-fdi-in-the-u-s-is-soaring.

2. The US could attract more Chinese investment if Chinese firms did not fear an inhospitable environment. The Department of Commerce (DOC), primarily through its new SelectUSA campaign, and the Organization for International Investment (OFII) should encourage Chinese firms to showcase their investments' contributions to US society. Such measures undertaken and paid for by Chinese firms could include: engaging in philanthropic activities in the state and local community, placing billboards near Chinese greenfield investments, and running ad campaigns outlining how Chinese investments are saving or creating jobs.

3. Potential inward FDI from China might be discouraged by the perception that the process for reviewing investment through the Committee on Foreign Investment in the United States (CFIUS) is arduous, unpredictable and biased against Chinese companies, especially following failed investments such as China National Offshore Oil Corporation's (CNOOC's) attempted purchase of Unocal in 2005 and the automatic investigation of state-owned companies required by the 2007 Foreign Investment and National Security Act -- even if some of these failed transactions never went through a CFIUS review. The Treasury should find ways to better get the message across that the CFIUS process is apolitical, predictable and only restrictive on the grounds of national security -- starting with highlighting CFIUS's factual record and overwhelming openness to investment, with only one transaction ever formally blocked in 1990 (even though other transactions were voluntarily withdrawn before being blocked). Such a statement would also help mitigate the tendency for competing firms and members of Congress to oppose deals for reasons unrelated to national security.

4. Currently, US states compete with each other by offering lucrative incentives to attract investments. Through SelectUSA, the DOC should coordinate local investment attraction efforts, offering a single point of entry and unified front for foreign nationals considering investing in the US. It could work in closer coordination with the State Department to simplify bureaucratic hurdles, such as getting visas and providing assistance to foreign firms. SelectUSA should enlist Chinese-American organizations (such as the Committee of 100) to help these firms adapt to the local environment. SelectUSA, in conjunction with China's Ministry of Commerce, could also establish a US-China bilateral investment fair.

5. If crafted properly, a bilateral investment treaty (BIT) would give both US and Chinese investors more certainty in the marketplace. As a major capital exporter, but also as a country in need of foreign investment, the US must stay relevant in the current race to sign BITs, especially as the European Union and China negotiate their own treaty. Serious negotiations with China would demonstrate US commitment to maintaining an open investment environment.

If the US does not act quickly to implement the above recommendations, it might continue to lose Chinese investment -- expected to top US$ 1 trillion by the end of the decade -- to Europe and other competitors. The US should corral as much of this investment as possible to revitalize the domestic economy and strengthen its image as an active supporter of an international investment openness.

Chapter 39

Can the US remain an attractive host for FDI in the auto industry? New labor policy and flexible production

Terutomo Ozawa[*]

President Obama has been supporting a new bill, the Employee Free Choice Act, designed to promote the labor unions' drive for unionization. This bill, if enacted, will surely be a big boon for unions as it helps enlarge their membership, enhance their bargaining power vis-à-vis businesses, and enrich their coffers to wield political clout. An important issue here, however, is how such reinforced unionism contributes to the US's much needed industrial competitiveness and employment -- and, more specifically, how this new policy will affect the US as a host to FDI in the auto industry.

In 2008, General Motors (GM) yielded its world's top position to Toyota. Unfortunately, Detroit's woes have been caused in significant part by the ever-restrictive work rules and legacy costs (i.e., generous wages and retirement and healthcare benefits) obtained by the United Auto Workers union (UAW). For this, however, the UAW alone should not be blamed. It has been acting in its own interest within an institutional setup that was created by the National Labor Relations (Wagner) Act of 1935, a law that was legislated amid the Great Depression and in understandable sympathy with the plight of massively laid-off workers, the victims of then unbridled capitalism. US unionism was thus fostered by Congress as a way of giving workers countervailing power against "uncaring" management that considered them mere cogs in the machine. Unfortunately, however, labor and management have ever since been trapped in a relationship that was inherently antagonistic and adversarial -- that is, a sort of an institutional curse. True, such unionism helped secure unprecedented benefits for tens of thousands of US workers -- so long as Detroit enjoyed unchallenged competitiveness. The UAW and automakers both shared the spoils of industrial dominance.

It was, however, not long before the rest of the industrialized world had caught up, altering the competitive environment. Most importantly, Fordism-cum-Taylorism came to be outcompeted by flexible production that was initiated by Toyota. Toyotism is now being emulated across industries worldwide -- even the US Postal Service has been endeavoring to adopt flexible techniques in its efforts to raise efficiency and to serve customers better.

Auto FDI in the US (known as "transplants") is centered in non-unionized southern states. Foreign multinationals there can produce automobiles cost-effectively largely because of a flexible workplace that is unencumbered by restrictive union rules. Japanese transplants in particular thrive on Toyota-style management and production. They are known for their workplace "democratization" where the supervisory structure is flattened

[*] The author wishes to thank Mark Barenberg and Hugh Patrick for their helpful comments on this chapter, which was first published as a *Perspective* on October 26, 2009.

and where *both* management and workers share common facilities (such as parking lots, cafeterias, and restrooms) and common activities (group calisthenics and recreations), all designed to promote informal communication and a teamwork spirit. The pay/compensation gap between executives and the rank-and-file is much smaller than that in comparable US companies. Also, the transplants treat workers as "brain" workers who perform multi-tasks on a rotation basis to avoid monotonous single task assignments, and actively suggest ways to improve on work practices (i.e., *kaizen* approach). This is in sharp contrast to the status of workers as "brawn" workers who are assigned to simplified repetitive tasks under mass production (as satirized by Charlie Chaplin's *Modern Times*). Moreover, they minimize layoffs and furloughs during a downturn, retaining and retraining workers. Also, flexible production relies on "just-in-time" delivery (instead of "just-in-case" inventories) of parts and components. The workers at the transplants have so far been turning down the UAW's offer for unionization.

Some of these practices are emulated by US automakers, but their management culture in general and the restrictive work rules in particular are in their way. True, the New United Motor Manufacturing's labor union accepted many of Toyotist techniques, and the factory's efficiency became far better than its GM counterparts. But it has never attained Toyota's (or the transplants') benchmark and remained unprofitable – and is set to close despite an ardent plea from Governor Schwarzenegger to save it. Also, from the start, Saturn's UAW collaborated to eliminate most of its work rules, though decried by its traditionalists. In 2004, however, Saturn's union voted to dismantle such a Toyotist arrangement and went back to the standard UAW contract. It is headed for closure unless a white knight is found.

All in all, the transplants' competitiveness derives fundamentally from Toyotism, though "no legacy costs" certainly help. Flexible production is not intended to exploit labor but to *create* a larger pie to share with workers. Wagner Act-enabled collective bargaining disregards the size of a pie, even if it shrinks because of workplace inflexibility and disruptive strikes. Actually, the transplants pay higher compensation (about 20% more) than the national average -- currently employing more than 400,000 Americans at the average annual pay of US$ 63,538.[1] At least, southern members of Congress, governors, and mayors -- and workers themselves -- understand the benefits of flexible production and are eager to attract more auto FDI so as to create well-paid manufacturing jobs locally. This is the reason why even some Democrats in Congress are opposed to the EFCA.

It is critical for lawmakers -- and management, as well as labor -- all to realize that the antagonistic mode of labor relations institutionalized by the Wagner Act is utterly outdated. A more cooperative relationship is called for. Simply expanding the power of unions by making unionization easier cannot enhance the US's competitiveness. Since Detroit is already unionized, Detroit South will naturally be the new target of unionization. Detroit-style unionization discourages foreign multinationals from coming to the US and encourages the US's own companies to outsource production overseas. It is high time for the President and Congress to treat unions not merely as an electorate but as

[1] "What is an 'American' car?," by Matthew J. Slaughter, *Wall Street Journal*, May 7, 2009.

a vital economic player who can contribute to industrial efficiency and to devise policies for flexible labor. As part of the Detroit bailout conditionality, the UAW agreed to allow for flexibility and cooperation. This type of mandate, at least, ought to be explicitly incorporated into the new bill.

Chapter 40

President Obama's international tax proposals could go further

Reuven S. Avi-Yonah[*]

The Obama administration's 2011 budget proposals include revenues of US$ 122 billion over ten years from "international tax reform." This set of proposals is similar to but narrower than the ones advanced by the administration in May 2009, which would have raised US$ 210 billion.

The two main proposals are substantially repeated from 2009. The first would indirectly limit the deferral opportunity for US-based multinationals by restricting the deductibility of interest expense that is allocated to deferred income. Under current law, US-based MNEs that earn foreign source active business income through their foreign affiliates (CFCs) can defer US tax on such income until the CFCs pay a dividend to their US parent corporation. At the same time, the US parent may deduct currently interest expense even if it is allocated to the deferred income of the CFCs. The same proposal was made in 2009 but applied to a broader category of deductions.

The second proposal restricts the ability of US-based MNEs to repatriate income from CFCs in high-tax jurisdictions while continuing to defer tax on income earned by CFCs in low-tax jurisdictions. Under current law, dividends paid by CFCs carry with them foreign tax credits that are calculated based on a formula that compares the amount of tax paid to the CFCs' earnings. The new proposal would calculate the tax paid and the amount of credit given based on the pooled earnings of all the CFCs of a MNE, including CFCs in low-tax jurisdictions. The result would be a higher US tax burden on the repatriated earnings. This proposal was also made in 2009.

These proposals are interesting because they seem to run counter to the prevailing international trend. In recent years, jurisdictions such as the UK and Japan that used to tax their MNEs on a worldwide basis have moved in the direction of territorial taxation by exempting dividends paid by CFCs to the parent corporation out of active business income but at the same time tightening their CFC anti-abuse provisions. Other OECD members such as Germany, France and Canada that have CFC regimes have always exempted dividends from active business income. By imposing indirect restrictions on deferral and increasing the tax burden on repatriations, the Obama administration risks being perceived as putting US-based MNEs at a competitive disadvantage.[1]

However, in my opinion such a view is mistaken, for three reasons. First, there is no evidence that US taxation of the foreign source income of US multinationals puts them at a disadvantage. Second, our FDI partners tax foreign source income more than we do,

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[*] The author wishes to thank Karen Brown, Lorraine Eden and Jeffrey Owens for their helpful comments on this chapter, which was first published as a *Perspective* on February 11, 2010.

[1] Matthew J. Slaughter, "How to destroy American jobs: Obama's proposals for increasing the tax burden on US-based multinationals would harm our most dynamic companies," *Wall Street Journal*, Feb. 3, 2010.

and that will still be true if the Obama proposals are adopted. Third, even if we want to go further and tax US multinationals on all their foreign source income, we could use the OECD to coordinate such a move with our FDI partners so that no competitive disadvantage would result.

US multinationals have been making the competitive disadvantage argument since 1961, when President Kennedy first proposed to tax them on their overseas profits. At that time, US multinationals dominated the world. General Motors (GM), to take a painful example, had over 40% of the US car market. Since then, other countries have grown, and US multinationals face more competition. But there is absolutely no empirical evidence that any of the myriad changes to our taxation of foreign profits of US multinationals since 1961 has made any difference to their ability to compete. US multinationals succeed when they create products or services the world wants to buy, and they fail (like GM) when they do not.

Nor is it true that our FDI partners tax their multinationals more lightly. They do refrain from taxing dividend distributions from foreign income, but they restrict this to income that was either taxed overseas or that has a real connection to the country it was earned in. We, on the other hand, tax dividends but give a credit for foreign taxes, so that in most cases US-based MNEs do not pay tax on foreign source dividends. And we permit our multinationals to defer taxation on a much broader range of income than our foreign competitors. For example, US banks and insurance companies are free to set up shop in Caribbean tax havens and not pay tax on their earnings there, while our competitors would tax these earnings unless you could show a real connection to the country they are supposedly earned in. As a result, our multinationals pay less tax on their foreign profits than their competitors, and this will not change if the Obama proposals are adopted.

The Obama proposals could have gone much farther. They envisage raising US$ 58 billion over ten years from partially taxing foreign profits, while adopting the Kennedy administration proposal to tax all foreign profits would have raised US$ 250 billion. But even that supposedly radical step could be achieved if we were willing to coordinate it with our FDI partners, most of whom adopted their rules to tax foreign income following our lead. Such coordination is possible, as shown by the OECD adoption of a binding treaty that embodies the principles of the Foreign Corrupt Practices Act (before the OECD treaty, US-based MNEs were the only ones subject to FCPA and were at a competitive disadvantage).

US multinationals currently earn a third of their overseas profits in three low-tax countries (Bermuda, the Netherlands, and Luxembourg). Eight of the top ten locations for US multinational profits have an effective tax rate of less than 10%. The Obama proposals represent a very cautious first step toward making US multinationals pay their fair share of the tax burden, and toward leveling the playing field with small US businesses that are subject to the full 35% tax and that are our principal job creators. Congress should enact them as soon as possible.

Chapter 41

Beyond treasuries: A foreign direction investment program for US infrastructure

Geraldine McAllister and Joel H. Moser[*]

In his jobs address to a joint session of Congress last week, President Obama returned to a familiar theme: a call for nontraditional infrastructure investment as a generator of economic growth and, ultimately, jobs. The President's frequent references to "private investment"[1] and "fully paid"[2] infrastructure are encouraging, yet there is no assurance that domestic private capital investment alone is sufficient to reverse the degradation of the nation's infrastructure. As host to the largest flows of inward FDI, it is time that the United States employs this critical source of capital in tackling the nation's infrastructure deficit.

The use of foreign capital to improve US infrastructure and competitiveness is not without its challenges. First, it requires the government to find a new balance between economic openness and national security concerns -- no easy task, particularly with the inclusion of "critical infrastructure"[3] in the definition of national security. Nevertheless, the Committee on Foreign Investment in the United States, dedicated to reviewing the impact of FDI on national security, has garnered significant experience in this area. Devising a legislative and regulatory framework that provides for domestic security without excluding the United States from access to investment in infrastructure is not beyond the capacity of the government. Ultimately, failure to address this challenge will be to the detriment of both US national security and economic interests. A recent Asia Society report notes: "If political interference is not tempered, some of the benefits of Chinese investment … such as job creation, consumer welfare, and even contributions to US infrastructure renewal -- risk being diverted to US competitors."[4]

Secondly, such inflows must be encouraged and facilitated -- it is not simply a case of *allowing* FDI flow into US infrastructure. Low levels of political risk and a large market still make the United States an attractive investment destination; yet it is but one possible investment location, and competition is vigorous. The US Government must build a

[*] The authors wish to thank Michael Likosky, John T. Livingston and Richard Robb for their helpful comments on this chapter, which was first published as a *Perspective* on September 12, 2011.

[1] See e.g., the remarks by the President in the State of Union Address, January 25, 2011, available at:http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address.

[2] Ibid.

[3] The term "critical infrastructure" means, subject to rules issued under this section, systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security. See, Foreign Investment and National Security Act of 2007, available at: http://www.gpo.gov/fdsys/pkg/PLAW-110publ49/pdf/PLAW-110publ49.pdf.

[4] Daniel H. Rosen and Thilo Haneman, *An American Open Door?* (New York: Asia Society and Woodrow Wilson International Center for Scholars, 2011), p.10, available at: http://media.asiasociety.org/ChinaFDI/AnAmericanOpenDoor_FINAL.pdf.

program to attract and incentivize investment in infrastructure -- for example, by transferring a portion of the federal budget currently spent on funding municipal bond investor tax incentives for the wealthy toward grants and other incentives, perhaps as part of the federal tax overhaul anticipated in the debt crisis resolution and as contemplated by the Simpson-Bowles commission.

Finally, an infrastructure FDI program must be scalable to provide for investment at the requisite levels. The United States has some experience in this area, having adopted public private partnerships for a number of projects. The current limiting factor, however, is deal flow. We propose a pilot program that mandates states to set aside an increasing portion of their capital programs, reaching 10% by decade-end, for funding incorporating an equity component. This federal mandate can be linked to federal funding, such as transportation funding. The net cost of this program (if any) could be borne by gradual reductions in the availability of the costly indirect subsidy of federal tax-exemption on municipal bonds, further shifting the dynamic from public debt to private investment.

A grant-based program could also work; however, whatever method is chosen, the Federal government must act quickly. Experience in other countries has shown that it can take a decade to develop a mature market for private infrastructure investment and development. Given that these may be the final days of the era of easy access to foreign capital in the Treasury bond market, now is the time to take a meaningful step toward building the alternative. Through the sale of Treasury bonds abroad, infrastructure has been substantially financed by foreign capital for decades. It is time to construct a new pathway for this capital before the old routes are washed away.

Chapter 42

FDI in retailing and inflation: The case of India

Nandita Dasgupta[*]

India's food price inflation is a major driving factor behind the country's overall accelerating inflation over the past few years. Agricultural food prices in particular have risen recently: over the past year vegetables have become costlier by 18%, pulses by 14%, milk by 10%, and eggs, meat and fish by 12%. The rise in fruit prices was, however, relatively smaller (5%), and the same happened for cereals (3%).[1] This price escalation is largely due to an inefficient supply chain in agriculture.[2] Some of the supply side constraints have been identified: poor agricultural productivity, lack of corporate involvement in agriculture, ceilings on landholding size, existence of middlemen, hoarding, and, more importantly, insufficient cold storage facilities and transportation infrastructure. Around 50% of fresh produce in India rots and goes to waste between the farm gate and the market because of inadequate cold storage facilities and a poor distribution network.[3] These factors unfavorably affect agricultural supply, create a supply-demand gap and help raise food prices.

Controlling food price inflation has become an urgent policy objective for India because of the regressive tax that inflation imposes, since food occupies a massive share in the consumption basket of a significant section of the Indian population. Moreover, persistent and spiraling food inflation also threatens the macroeconomic stability of the country and the potential for high and sustained economic growth in the future. With the clear objective of curbing inflation, the Indian Cabinet approved 51% FDI in multi-brand retail on November 24, 2011[4] after intense deliberations at different levels that extended over a year. The policy comes with some riders to protect the interests of neighborhood stores, farmers and small and medium-sized enterprises. If effectively implemented, such FDI has the potential to:

- bring in foreign capital, technology and managerial expertise of big international retailers;
- develop an efficient linkage between the back-end supply chain and the front-end via capital investment and technological inputs;
- create a proper farm-to-fork infrastructure through direct purchase from farmers and the resultant control of intermediaries;

[*] The author wishes to thank Premila Nazareth, Andreas Nölke and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on December 5, 2011.

[1] "Wholesale price indices for primary articles and fuel & power in India (Base: 2004-05 = 100) review for the week ended 12th November, 2011 (21 Kartika, 1933 Saka)," Press Information Bureau, Ministry of Commerce, Government of India.

[2] Duvvuri Subbarao, "Factors that drive India food inflation and policy measures to combat it," *CommodityOnline*, November 24, 2011.

[3] BBC.com, "India MPs in uproar over retail reform plan," 25 November 2011, available at: http://www.bbc.co.uk/news/world-asia-india-15885004.

[4] "India Inc welcomes FDI in multi-brand retail," *Business Today, India Today Group*, November 24, 2011.

- bring about efficient movement of produce through the reduction of transit costs;
- minimize the prevailing wastage of fresh produce[5] through improving and adding upon the existing cold storage facilities, transport infrastructure, warehousing technology, and food processing facilities;
- help raise farm productivity through the application of contract farming;
- increase agricultural production, reduce intermediate costs, render remunerative prices to farmers for their produce and eventually lower final food prices to consumers, thus integrating retailers into the value chain; and
- create employment in small and medium-size industries and back-end infrastructure.[6]

Despite the regulatory provisions to ensure domestic competition and protect the domestic retail industry and farmers, the policy has received stiff opposition. Concerns include the possibility of monopoly power of foreign entrants over both farmers and consumers, predatory pricing strategies of the entrants, manipulation of prices for the entrants' own benefit and a fall in income, employment and the eventual destruction of the unorganized indigenous retail sector dominated by small family-run outlets.[7]

But it is important to remember that other countries like Argentina, Brazil, Chile, China, Indonesia, Malaysia, Russia, Singapore, and Thailand have allowed 100% FDI in multi-brand retail since the 1990s and many of them have had encouraging experiences. China, for one, permitted FDI in retail as early as 1992. It has since attracted huge investments in the retail sector without affecting either small retailers or domestic retail chains. Since 2004, the number of small outlets rose from 1.9 million to over 2.5 million in China. Employment in the retail and wholesale sectors increased from 28 million to 54 million from 1992 to 2001.[8] In Indonesia, even after ten years of opening FDI in multi-brand retail, 90% of the business remains with small traders.[9]

Favorable experiences of other emerging markets suggest that the appropriate implementation of FDI in multi-brand food retailing, with effective checks designed to protect indigenous small and medium-size enterprises, will eventually alleviate the supply-side impediments to agricultural production. It will transform the way perishable agricultural produce is acquired, stored, preserved, and marketed -- and thus help control India's persistent food inflation.

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[5] "FDI in multi-brand retail trading," KPMG, Audit Committee Institute (2010).
[6] "FDI in multi-brand retail will create 10 million jobs: Anand Sharma," *The Times of India*, November 26, 2011.
[7] "FDI in multi-brand retail: Industry lauds decision," *India Today*, November 25, 2011.
[8] "Foreign direct investment (FDI) in multi-brand retail trading," Department of Industrial Policy and Promotion Discussion Paper, Government of India (2010).
[9] "FDI in multi-brand retail will create 10 million jobs: Anand Sharma," op. cit.

Chapter 43

Greek FDI in the Balkans: How is it affected by the crisis in Greece?

Persephone Economou and Margo Thomas[*]

The current Greek crisis raises the question of its impact on FDI by Greece on its neighbors in the Balkans.[1] Greek MNEs first began to establish a presence there in the 1990s, following the breakup of the former Yugoslavia. This trend accelerated during the past decade. As of 2009, Greece's outward FDI stock in the Balkans stood at US$ 10.5 billion or 26.5% of Greece's outward FDI stock worldwide.[2]

From the point of view of Balkan countries, Greece is an important source of FDI -- but not the biggest. First place is reserved for Austria, which accounted for 19% of the Balkan's combined inward stock (excluding Albania) as of 2009. Greece accounted for 6% of Balkan countries' combined inward FDI stock, or US$ 10 billion (outside Albania). The highest Greek FDI shares are in Macedonia FYR (13%) and Serbia (10%). Greek FDI accounts for 41% of Albania's inward FDI stock.[3]

Greek banking presence, however, is quite significant for the Balkan host countries.[4] Greek foreign affiliates make up four of Bulgaria's top 10 banks, three of Serbia's top 10 banks and two of Romania's top 10 banks. Greek banks account for about 28% of the banking system's assets in Bulgaria, about a quarter of those in Macedonia FYR and about a sixth of those in both Romania and Serbia.

According to Barclays Capital,[5] the five Greek banks (National Bank of Greece, Piraeus Bank, Eurobank EFG, ATE Bank, Alpha Bank) most exposed to the sovereign debt crisis in Greece, which also operate in the Balkans, hold around US$ 52 billion of Greek sovereign debt. In addition to the recently agreed "haircut" of 50% for private creditors, Greek banks are also required to introduce a 9% core tier-one capital ratio by June 2012. The European Banking Authority reported that Greek banks would need an additional US$ 41 billion in capital for the latter, in principle covered by funds under by the EU-IMF program.[6]

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[1] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia FYR, Romania, and Serbia.

[2] FDI stock data are from the IMF's Coordinated Direct Investment Survey database. Some Greek FDI might have been channeled through holding companies in Cyprus.

[3] As of 2008. Ministry of Economy, Trade and Energy, Report on Foreign Direct Investment in Albania, 2010 (December 2010).

[4] Laza Kekic, "The Greek crisis: The threat to neighbouring Balkan economies," in Will Bartlett and Vassilis Monastiriotis, eds., *South East Europe after the Economic Crisis: A New Dawn or Back to Business as Usual?* (London: LSEE, 2010).

[5] See Figure 1 in "Everyone's problem," *The Economist,* June 22, 2011.

[6] European Banking Authority, **"**The EBA details the EU measures to restore confidence in the banking sector,**"** Press release of October 26, 2011. According to EBA, the existing backstop facility exceeds the results of the EBA capital exercise for Greek banks.

The main issue is the extent to which all of these measures will strain the Greek banking system. The process of recapitalizing Greek banks could force their affiliates in the Balkans to cut back lending. The effects of this would be amplified by a slowdown in lending by other European banks with significant exposure to the Greek sovereign debt crisis. Greek bank affiliates may also be asked to help raise funds for their parent banks in Greece. In September 2011, the National Bank of Greece announced plans to establish a separate bank holding company to manage its foreign affiliates in the Balkans, reportedly to gain independent access to global capital markets.[7] Greek bank foreign affiliates may even be sold off to foreign or local banks. For example, ATE Bank has announced plans to sell its majority stake in ATE Bank Romania by the end of 2012 and exit the Romanian market.[8] One possible option to prevent the reduction in credit availability would be to introduce a framework for coordinating crisis management in the financial sector when foreign affiliates in banking are involved, similar to the "Vienna Initiative" (2009-2011).[9] In the longer term, more attention should be paid to the extent of foreign ownership in banking, which can have important consequences on lending in times of crisis.

In sum, the recession in Greece and financing constraints on Greek MNEs will continue having a direct negative effect on Greek FDI into the Balkans in both banking and non-banking sectors. For most Balkan countries, the impact on FDI overall will be limited given the relatively low levels of Greek FDI in the region. Albania is the exception given its much greater dependence on Greek FDI. Curtailed lending by Greek bank foreign affiliates would also affect any expansion plans of Greek non-financial foreign affiliates already in the Balkans.

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[7] "Greece's NBG plans holding company for Balkan units," *Reuters*, September 12, 2011.
[8] "Greek group ATE Bank plans to sell the majority stake in its Romanian subsidiary," Balkans.com, May 27, 2011.
[9] EBRD, "Vienna Initiative: Moving to a new phase," May 2011.

Chapter 44

Nation states and nationality of MNEs

Seev Hirsch[*]

The purpose of this *Perspective* is to explore the relationship between MNEs and their home countries. I use the term "nationality" when discussing a home country, to stress the contrast with "multinationality" which refers to business enterprises. The question I seek to address is whether, *ceteris paribus*, nation states have an economic interest in becoming home countries to MNEs. This is not a trivial question, bearing in mind that in many countries -- especially those with emerging markets -- outward FDI has been frowned upon long after incoming FDI was generally welcome by local governments and academic scholars.

My tentative answer to the questions posed above is "yes." The MNEs' value activities lower the barriers separating countries from their foreign sources of supply and their international markets. This enables home countries to increase the benefits they derive from the international division of labor, exploitation of economies of scale and the ownership advantages of their MNEs. Other things being equal, an extension of the global reach achieved through cross-border value activities is likely to compensate for the tax loss and the diminution of sovereignty implied by outward FDI.

The theoretical basis of the claim that home country status is generally superior to that of host country status is provided by the concept of the distance penalty (DP). DP is incurred whenever transactions are conducted across national borders. This penalty consists of costs generated by the existence of systematic differences among the cultural, legal and institutional characteristics of domestic and foreign business transactions. It constitutes a barrier to cross-border trade and investment. The tremendous advances of recent decades in transportation and communication have reduced the costs of international interactions dramatically, but have not eliminated them altogether.

In the absence of a cost of doing business abroad, the idea of "home country" would be indistinguishable from that of "host country." Home countries and host countries both increase the reaches of MNEs, and both pay a price in terms of tax losses and diminution of sovereignty. DP makes a difference because it has an asymmetric effect on home and host countries. Home countries benefit from an implicit first refusal when competing with host country counterparts for the establishment of new business ventures. This implies that home countries are able to "bid" on every new business project being considered. It goes without saying that, if a foreign location turns out to be more efficient or otherwise more profitable, the project will be located in that country. But, if the cost benefit calculation indicates equality between the two locations, the home country will be preferred. Similar reasoning applies to cases of relocation, closure and generally of

[*] This *Perspective* is dedicated to the memory of John Stopford who commented on early drafts a few days before his death. The author wishes to thank Lorraine Eden, Rainer Geiger, Niron Hashai, and Steve Kobrin for their helpful comments on this chapter, which was first published as a *Perspective* on January 23, 2012.

gaining access to resources provided by top management. The absence of a distance penalty, due to proximity to the strategic decision makers, endows home country affiliates with advantages, over and above those available to affiliates located in host countries.

The above analysis suggests that, *ceteris paribus*, nation states will prefer being home countries to being host countries. Note, however, that firms rarely get to choose their home country. Their nationality is in most cases “an accident of birth.” Consequently the public policy implications of home countries' preferences are not obvious.

Nationality can become an issue when an MNE is sold abroad. In my own country, Israel, several local MNEs have been sold to foreign companies in recent years, thus changing their nationalities. The latest example is Makhteshim Agan, a multinational producer of generic insecticides, herbicides and fungicides with 4,000 employees and 50 facilities worldwide. Makhteshim Agan was sold in 2011 to ChemChina, a state owned Chinese supplier of agricultural chemicals at a price of US$ 2.4 billion. The transaction undoubtedly made business sense to IDB Holdings, a conglomerate that had a controlling interest in the company. The question that should be considered is whether the transaction was consistent with the public interest. Regrettably, the issue of the public interest was never raised, despite the fact that numerous workers, suppliers and other stakeholders were affected, and that millions of dollars of taxpayers' money had been poured into Makhteshim Agan and similar companies over the years.

I conclude this chapter with a quote from J.M. Keynes who, in the early 1920s, opposed British financial investments abroad. His view of FDI was very different: “The hazarding of capital resources in foreign parts for trading, mining and exploitation is an immemorial practice, which has generally proved of immense benefit to nations with the courage, the temperament, and the wealth to follow it. For the English and the Scots it has been, beyond doubt, the foundation of their national fortunes. The risks are recognized to be great, but the profits are proportionate…. Nothing that I shall say here must be interpreted as casting a doubt upon the national advantage of investments of this kind.”[1]

[1] John Maynard Keynes, “Foreign investment and national advantage,” reprinted in D. Moggridge, ed., *The Collected Writings of John Maynard Keynes*, vol. 19 (Cambridge: Cambridge University Press, 1981), p. 275.

Chapter 45

The times are a-changin' -- again -- in the relationship between governments and multinational enterprises: From control, to liberalization to rebalancing

Karl P. Sauvant[*]

Governments seek to attract FDI undertaken by MNEs because it contributes to the growth of their economies; they seek to maximize the benefits of this investment in the framework of their national economies. Firms undertake FDI because it improves their access to markets and resources and hence increases their international competitiveness; they seek to maximize the benefits of this investment in the framework of their global corporate networks. This difference in objectives and frameworks gives rise to tensions that play themselves out in the approach governments take in national FDI policies and bilateral investment treaties (BITs). During the late 1960s and the 1970s, the dominant approach was to control MNEs. During the 1990s, it was liberalization -- and the approach is again changing.

Consider:

- During the 1990s, 95% of 1,035 national FDI policy changes worldwide[1] made the investment climate more welcoming for MNEs.
- National FDI screening agencies were replaced by investment promotion agencies (IPAs) -- red carpets replaced red tape.
- Reflecting this national approach, the number of BITs -- geared entirely toward protecting foreign investors and, in this manner, hoping to attract more FDI -- rose from 370 in 1989 to 1,719 in 1999.[2]

Thus, by the end of the 1990s, FDI was widely regarded as part of the solution to advancing economic development. Virtually all governments had liberalized their FDI regulatory frameworks, established IPAs and signed BITs. Since then, countervailing considerations are asserting themselves.

Consider:

- The share of national FDI policy changes worldwide that made the investment climate less welcoming rose from 6% in 2001-2002, to 12% in 2003-2004, to 20% in 2005-2006, to 23% in 2007-2008, and to 32% in 2009-2010.[3]

[*] The author wishes Amare Bekele and Hamed El-Kady for their help in preparing this text and José E. Alvarez, Jean Boddewyn, Seev Hirsch, Lise Johnson, Alan Rugman, Stephen Schwebel, and Shefa Siegel for their very helpful comments on it. This chapter was first published as a *Perspective* on May 21, 2012.
[1] UNCTAD, *World Investment Report* (Geneva: UNCTAD, various years).
[2] Ibid.
[3] Ibid.

- A number of countries (particularly developed ones) have strengthened their screening mechanisms of incoming mergers and acquisitions (M&As), in the process also distinguishing between types of investors by singling out state-controlled entities (SCEs). For example, the number of investigations by the Committee for Foreign Investment in the United States rose from 1 in 2000 to 35 in 2010.[4]
- The investment regime seems to be fragmenting as well, with separate rules emerging for SCEs.
- Reflecting the new approach at the national level, the international investment regime itself is becoming less protective of MNEs. In particular, the US (but not yet many other countries) has narrowed certain substantive protections of foreign investors, especially fair and equitable treatment and indirect expropriation; abandoned the umbrella clause; and strengthened the essential security interest clause (which allows governments to disregard BIT commitments under certain circumstances).

Thus, a growing number of governments are now taking a more nuanced approach to the role of FDI in their economies. While they continue to liberalize their FDI policies and conclude BITs, there is a clear trend to make the investment climate less welcoming and less predictable.

What explains this change in approach?

- The consensus that all FDI is equally beneficial is changing as more governments consider (certain) M&As as less beneficial than greenfield investments; conversely, in the future they may encourage more sustainable FDI, i.e. investment that makes a maximum contribution to economic, social and environmental development and takes place within mutually beneficial governance mechanisms while being commercially viable.
- Governments pay more attention to competing objectives, especially national interests/essential security, the promotion of national champions and the protection of national industries.
- Pressure from civil society.
- The growth of FDI from emerging markets brings new players into the global FDI market, and their competition is not welcome by all, especially if they are SCEs.
- The cumulative number of treaty-based investment disputes brought by firms rose from 38 in 1999 to 450 in 2011, involving 89 governments.[5] Importantly, a number of developed countries have become respondents and therefore seek to protect themselves against far-reaching interpretations of international investment law and from losing arbitrations (even if that means weakening important elements of BIT protections).
- Finally, it is unclear how important BITs are to help attract FDI, while it is clear that they restrict the policy space of governments.

[4] CFIUS, *Annual Report to Congress, Report Period CY2010* (Washington, DC: CFIUS, 2011).
[5] UNCTAD, *IIA Issues Note*, no. 1, 2012.

What does all this add up to? For all governments, FDI is a tool. To the extent it serves their objectives, it will be promoted or restricted. We are thus moving toward a regulatory approach that is more protective of sovereigns by allowing more policy space for governments to regulate FDI in the public interest, at the national and international levels. This is being helped by the fact that more and more countries are simultaneously home and host countries.

Rebalancing the investment regime to take into account the interests of both host countries and investors is a welcome development as it strengthens the regime's legitimacy and puts the relations between governments and MNEs on a more solid footing. The challenge is to find the right balance between the rights and responsibilities of governments and MNEs -- a challenge central to the future of the investment regime.

PART IV

SUSTAINABLE INTERNATIONAL INVESTMENT

Chapter 46

Evaluate sustainable FDI to promote sustainable development

John M. Kline[*]

Prescriptions to increase the role of foreign direct investment (FDI) in promoting sustainable development generally focus on the macro level -- getting policies right and otherwise improving the investment climate. These steps are necessary but not sufficient. Effective implementation processes, especially at the micro project level, are also essential to encourage FDI that matches host country development needs and priorities.

The recent UNCTAD Investment Policy Framework for Sustainable Development[1] offers a set of core principles to guide national and international officials making investment policy. The principles recognize the need to establish development priorities to evaluate FDI projects and a companion FDI contribution index[2] provides a starting point that includes some useful indicators. However, the Framework falls short of providing an integrated and applied mechanism for assessing whether FDI meets sustainability criteria.

Thus, the missing component is a process implementation tool that can help evaluate the multiple, interactive effects of a FDI proposal across economic, environmental, social, and governance objectives.[3] One approach is to use a project assessment matrix to evaluate FDI proposals.[4] A broadly inclusive process would select a top five and second five set of priority goals to receive extra weight. The matrix would assess the impact of FDI projects on value indicators representing a country's development priorities, using a plus-five to minus-five range. After multiplying each indicator by its priority weight, the final score provides a cumulative assessment of its desirability as sustainable FDI.

The assessment would quantify qualitative judgments about non-economic indicators so they can be compared and interactive effects evaluated. Easily quantified economic measures currently dominate FDI evaluations, creating a more-is-better mind-set. Regulations force some environmental assessments of FDI projects, but social and

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[*] The author wishes to thank Henry Loewendahl, Howard Mann and Elisabeth Tuerk for their helpful comments on this chapter, which was first published as a *Perspective* on November 5, 2012.

[1] UNCTAD, *World Investment Report 2012: Towards a New Generation of Investment Policies* (Geneva: UNCTAD, 2012).

[2] Ibid., pp. 119-121.

[3] This need was identified by the Millennium Cities Initiative (MCI), a project of Columbia University's Earth Institute, in the course of a Finnish-funded effort to promote sustainable FDI in Africa. MCI devised a ratings format and assessment matrix encompassing a set of 22 important development objectives that can be adjusted to best reflect each country's goals. The matrix was field tested with government authorities and private foreign investors in South Africa and Kenya. Interviews included retrospective evaluations of FDI projects ranging from steel and chemical plants to mattress and molasses production to cut flowers and fish farms.

[4] For the matrix, see John Kline, "Evaluating sustainable foreign direct investment," Working Paper No. 12, Millennium Cities Initiative (New York: Columbia University, 2012), available at: http://mci-admin.ei.columbia.edu/sitefiles/file/Sustainable-FDI-Guidance-Paper-Kline-FINAL.pdf.

governance effects that lack a similar legal mandate are generally overlooked or undervalued. Ironically, economic measures are really just instrumental values whose ultimate worth is reflected in social indicators that represent how a society's way of life can be enriched. The matrix would curb the disproportionate influence now exerted by economic data in favor of a more holistic evaluation of project impacts.

Adopting an easily understood ratings and assessment system encourages transparency and inclusiveness in the evaluation process. A matrix that incorporates economic, environmental, social, and governance indicators highlights FDI projects deserving promotion, pinpoints areas for improvement and discourages potential corruption by revealing the basis for a project's net benefit assessment.

The scarce resources countries devote to FDI promotion and facilitation should be targeted toward projects that advance priority development objectives. Unless improved evaluation tools assess the full range of project impacts, resource allocation will yield sub-optimal and possibly counter-productive results. FDI promotion dominated by macro-economic measures risks missing social and other impacts that more directly affect people's lives.

Is some FDI always better than no FDI? Perhaps, not. Even least developed countries struggling to attract FDI should assure potential projects produce more than an ephemeral spurt in economic indicators. FDI projects that mobilize capital and create jobs offer measurable economic benefits, but a project assessment matrix would evaluate the investment's environmental, social and governance impacts as well. Projects may pollute or deplete the public water supply, displace populations or strengthen entrenched elites. Such FDI can, on balance, leave the host society less well off, compared to the status quo without the FDI, in terms of inclusive growth and sustainable development.

Each nation sets its own priority development objectives and determines what role FDI should play in their achievement. Host countries should communicate their development priorities to prospective investors, requesting an evaluation of how FDI projects would affect relevant objectives. Investors could evaluate and adjust plans to promote societal benefits, recognizing that sustainable FDI requires a win-win outcome for both the country and the company.

Sustainable FDI can contribute to sustainable development, but the outcome is neither automatic nor assured. Within a macro policy framework that encourages FDI, micro process assessments of potential projects are warranted before national resources are committed to their promotion. Both astute policy-making and effective implementation processes are required.

Chapter 47

Shaping global business conduct: The 2011 update of the OECD Guidelines for Multinational Enterprises

Manfred Schekulin[*]

On May 25, 2011, US Secretary of State Hillary Clinton joined ministers from members of the Organisation of Economic Co-operation and Development (OECD) and developing economies to celebrate the Organisation's 50th anniversary and agree on an update of the *OECD Guidelines for Multinational Enterprises*, the fifth revision since their adoption in 1976.[1] This marked the culmination of an intense one-year negotiating process involving a large number of stakeholders, international organizations and emerging economies.

The fact that the business community shares responsibility for sustainable development is no longer disputed. But enterprises need to know how best to respond to societal expectations. As stated by the OECD Secretary-General Angel Gurría, the updated *Guidelines* "will help the private sector grow their businesses responsibly by promoting human rights and boosting social development around the world."[2]

The *Guidelines* are founded on the premise that non-discriminatory treatment of foreign affiliates by host country governments, as provided for by the OECD National Treatment Instrument, should be reciprocated by socially responsible corporate behavior. They constitute the most comprehensive government-backed code of conduct that enterprises are invited to observe wherever they operate.[3] The principles and standards they promote are consistent with applicable laws, internationally recognized standards and OECD instruments on good governance and business. They are known for their implementation procedures that include "National Contact Points" (NCPs) in all adhering countries and a mediation mechanism for addressing complaints involving alleged misconduct by MNEs. Thirty-four OECD members and eight non-OECD countries currently subscribe to them, and several more are in various stages of their application process.

The 2011 update concentrated on three issues:

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[1] The Guidelines form part of the "OECD Declaration on International Investment and Multinational Enterprises," available at:
http://www.oecd.org/document/28/0,3746,en_2649_34889_2397532_1_1_1_1,00.html.

[2] "New OECD guidelines to protect human rights and social development," *OECD Newsroom,* May 25, 2011, available at:
http://www.oecd.org/document/19/0,3746,en_21571361_44315115_48029523_1_1_1_1,00.html.

[3] The Guidelines' eleven chapters cover employment and industrial relations, human rights, environment, information disclosure, anticorruption, consumer interests, science and technology, competition, and taxation.

- The incorporation of a new chapter on human rights, based on the concept "protect, respect and remedy" -- the Framework and the respective Guiding Principles developed by the UN Special Representative for Business and Human Rights, John Ruggie.[4] The *Guidelines* are -- together with the revised International Finance Corporation (IFC) standards -- among the first international instruments to operationalize the UN Framework, and the only one offering a ready-to-use governmental remedy mechanism for cross-border violations of human rights.
- The introduction of the general operational principle of due diligence, i.e. a process through which enterprises can identify, prevent, mitigate, and account for how they address actual and potential adverse impacts as an integral part of their internal decision-making and risk management systems. Due diligence applies not only to harm caused or contributed to by an enterprise itself, but also by business partners with a direct link to its operations, products or services.
- The reinforcement of implementation procedures through clearer and more predictable rules for the handling of complaints by NCPs and a stronger emphasis on problem solving through mediation. Together with a new focus on helping enterprises and other stakeholders cope with difficult situations or circumstances, this constitutes a major shift from merely expressing adhering governments' expectations to actively contributing to the prevention and resolution of conflicts arising out of MNE operations.

Other important improvements include expanded provisions on workers' rights, bribe solicitation and extortion, climate-related issues, sustainable consumption, tax governance, and tax compliance.

The update achieved its objective of redefining the "gold standard" for responsible business conduct in a global context. But while a successful update was a necessary condition for a further increase in the impact of the *Guidelines*, it is not a sufficient one. Exploiting the updated *Guidelines'* potential will require sustained efforts by all involved: Adhering countries will have to review the organization and work methods of NCPs and make available the necessary resources. The OECD will have to reconsider how best to assist NCPs in their tasks as well as how to deepen its relationships and cooperation with non-adhering countries, in particular emerging markets, and with international partners. Recently signed working arrangements, for example with the International Labour Organization, the United Nations Global Compact, the International Organization for Standardization and the Global Reporting Initiative, are important steps toward a coherent global approach to corporate responsibility. Many more will have to follow.

[4] UN, "Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises," A/HRC/17/31, (March 21, 2011).

Chapter 48

Responsible business conduct: Re-shaping global business

John Evans[*]

The *Guidelines for Multinational Enterprises* of the Organisation for Economic Co-operation and Development (OECD) is the Organisation's flagship instrument for responsible business conduct. The *Guidelines* provide non-binding recommendations to MNEs, drawn up and implemented by governments. Updated in 2011, they consist of principles and standards in such areas as sustainable development, governance, disclosure, human rights, employment and industrial relations, the environment, anti-corruption, consumer interests, and taxation. The 42 adhering governments are required to promote the *Guidelines* and to contribute to the resolution of issues arising under the *Guidelines,* including by setting up a complaints mechanism -- "National Contact Points" (NCPs) -- to which trade unions and non-governmental organizations (NGOs) are able to submit specific instances concerning alleged breaches of the *Guidelines.*

Manfred Schekulin stated that the *Guidelines* are the most "comprehensive government-backed" instrument for responsible business conduct and that the recent *Update* achieved its objective of "redefining the 'gold standard.'"[1]

I agree that the *Guidelines* are special. The government-backed complaints mechanism sets them apart from other instruments, significantly increasing their potential to close global governance gaps and to ensure that the fruits of FDI are more equally shared among countries and between labor and capital. However, this potential has not been fulfilled. While, at their best, NCPs have contributed to the timely and effective resolution of issues raised under the *Guidelines*, at their worst, NCPs -- shielded from outside scrutiny -- have failed even to answer their mail.

I also agree that the *Update* delivered significant improvements in the content of the *Guidelines*, in particular by establishing due diligence as an over-arching principle for responsible business conduct, requiring enterprises to "identify, prevent, mitigate and account for how they address their actual and potential adverse impacts;"[2] clarifying that the *Guidelines* apply to the full range of business relationships, including throughout supply chains; adding a chapter on human rights; and requiring companies to pay best possible wages at least adequate to meet the basic needs of workers and their families. Importantly, the Council Decision on the Implementation Procedures also included a new instruction to governments to make available the necessary human and financial resources so that NCPs "can effectively fulfill their responsibilities." However, overall,

[*] The author wishes to thank James Baker, Paul Hohnen and Benjamin Moxham for their helpful comments on this chapter, which was first published as a *Perspective* on November 7, 2011.

[1] Manfred Schekulin, "Shaping global business conduct: The 2011 update of the OECD Guidelines for Multinational Enterprises," *Columbia FDI Perspectives, No. 47* (September 26, 2011).

[2] "Commentary on general policies," in *OECD Guidelines for Multinational Enterprises, 2011*," para. 14, available at: http://www.oecd.org/document/28/0,3746,en_2649_34889_2397532_1_1_1_1,00.html.

the *Update* did not do enough to strengthen the rules governing the functioning of NCPs, falling short in two key areas:

- **Weak authority of the NCPs.** The best performing NCPs play two distinct roles: offering their good offices for mediation and, where this fails, making an assessment of a company's observance of the *Guidelines* (determination). These mediation and determination roles are inter-dependent: mediation is the "carrot" and the threat of determination the "stick" to bring parties to the NCP mediation table. While the *Update* strengthened mediation, it failed to strengthen determination, thus leaving the NCP system weak.
- **Lack of oversight.** Peer review, pioneered by the OECD, is an examination of a government's performance by its peers; it derives its strength from peer pressure. The peer review system of the *OECD Anti-bribery Convention* is widely regarded as a model, underpinning the strength of OECD's flagship anti-corruption instrument. Yet, despite this best practice, the *Update* rejected mandatory peer review in favor of voluntary peer evaluation. It also failed to require NCPs to set up steering or review boards so as to strengthen national level oversight.

The *Update* has generated high expectations. For the *Guidelines* to be regarded as the "gold standard," however, by those workers and communities around the world whose lives and livelihoods are affected by MNEs, the *Guidelines* have to make a difference on-the-ground. This depends on NCPs significantly improving their performance: namely handling cases in a transparent, impartial, predictable, and equitable manner. Now that the latest round of multilateral negotiations is over, adhering governments need to address the remaining deficits. In particular, they should meet their commitments on resources, strengthen their determination role and set up national oversight mechanisms, in line with NCP best practice, and sign up for rigorous transparent and participatory country peer review, based on OECD best practice. And the OECD should take steps to strengthen accountability and transparency by expanding the reporting requirements of NCPs to reflect their new commitments and procedures and by introducing more regular reporting by NCPs at meetings and on-line.

It is essential that governments meet their responsibilities to ensure that the updated *Guidelines* fulfill their potential to promote responsible business conduct in a global context. I join Manfred Schekulin in calling for a sustained effort on the part of the OECD and adhering governments to close global governance gaps that leave millions of women and men around the world working in conditions of poverty, hardship and insecurity and denied access to their fundamental rights. This is long overdue.

Chapter 49

Toward the successful implementation of the updated OECD Guidelines for Multinational Enterprises

Tadahiro Asami[*]

The Business and Industry Advisory Committee to the OECD (BIAC) has accepted[1] the updated *OECD Guidelines for Multinational Enterprises* (*Guidelines*), adopted on May 25, 2011 after a series of negotiations and consultations among members of the Organisation for Economic Co-operation and Development (OECD), adhering governments, BIAC, the Trade Union Advisory Committee to the OECD, and OECD Watch, an international network of civil society organizations. The *Guidelines* are the most comprehensive government-endorsed code of responsible business conduct. The *Update* upheld the voluntary and non-legally binding character of the *Guidelines*, and while the new text introduces important new elements, the *Update* is very carefully formulated and its changes are accompanied by extensive conditionalities.[2]

The new *Guidelines* more clearly define responsible business conduct of MNEs, particularly in the area of human rights. The incorporation of a human rights chapter in the *Guidelines* represents a significant milestone. The OECD and United Nations Special Representative John Ruggie worked together to draft this chapter. As a result, the *Guidelines* fully reflect the *Guiding Principles on Business and Human Rights,*[3] which were unanimously endorsed by the United Nations Human Rights Council in June 2011.

A key provision that has been newly introduced in the *Guidelines* states that MNEs should avoid causing or contributing to adverse impacts on the social, environmental and other interests to which the *Guidelines* relate. This provision covers MNEs' activities and also the direct involvement of MNEs in activities in the supply chain.[4] When an adverse impact occurs to which MNEs did *not* contribute, MNEs are expected to examine possibilities to avoid such impacts if there is a direct linkage between the impacts and the activities of MNEs as a consequence of a business relationship. However, this is *not* intended to shift responsibility from the entity causing an adverse impact to the MNE

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[*] The author wishes to thank Alberto Echarri, Ardanaz and Soichiro Sakuma for their helpful comments on this chapter, which was first published as a *Perspective* on January 17, 2012.

[1] See BIAC, "BIAC statement on the adoption of the update of the OECD Guidelines for multinational enterprises at the OECD Ministerial Council meeting on 25-26 May 2011;" see USCIB, "Business calls on OECD to promote updated Guidelines for MNE's in non-adhering countries," (press release May 25, 2011) available at: http://www.uscib.org/index.asp?documentID=4103.

[2] This *Perspective* is in response to Manfred Schekulin, "Shaping global business conduct: The 2011 update of the OECD Guidelines for Multinational Enterprises," Columbia FDI *Perspectives*, No. 47, September 26, 2011; and John Evans, "Responsible business conduct: Re-shaping global business," *Columbia FDI Perspectives*, No. 50, November 7, 2011.

[3] Guiding Principles on Business and Human Rights: Implementing the Guiding Principles on Business and Human Rights, General Assembly, UN Doc. A/HRC/17/31, March 21, 2011.

[4] The *Guidelines* are not specific as to the tier/level in the supply chain.

with which it has a business relationship: the adverse impact provision is only applicable if there is at least some form of direct involvement of the MNE in the adverse impact.

A new provision expects companies to carry out risk-based due diligence to identify, prevent and mitigate actual and potential adverse impacts as mentioned above. This new provision is applicable to all chapters, apart from those dealing with science and technology, competition and taxation. The *Guidelines* do not formulate any procedural requirements for due diligence, except for in the human rights field.

The procedural aspects of the "National Contact Points" (NCPs) have been substantially improved, for example by establishing an indicative timeframe, the availability of adequate human and financial resources and measures to avoid unmeritorious claims or frivolous campaigns. However, NCPs' role as mediators to resolve potential issues remains unchanged. No (quasi-judicial) prerogative to formulate a judgement on the behavior of companies was introduced.

From the business point of view, the success of the new *Guidelines* will depend primarily on two factors.

- First, success depends on the extent to which the *Guidelines* are incorporated or referred to in MNEs' own codes of conduct for improving corporate responsibility. The *Guidelines* expect the NCPs to play a role in the promotion of the *Guidelines* and also require the OECD Investment Committee to develop initiatives for the effective implementation of the *Guidelines*. BIAC is willing to contribute to these efforts by cooperating with the OECD.
- Second, the extent to which emerging markets adhere to the *Guidelines* is fundamental to securing a global level playing field. The *Guidelines* are currently adhered to by the 34 OECD members and 8 non-OECD countries, but not by major emerging markets such as China, India, Indonesia, Russia, or South Africa. The OECD must undertake determined efforts to encourage emerging markets to adhere to the *Guidelines*.

The *Guidelines* form part of the *OECD Declaration on International Investment and Multinational Enterprises* (*Declaration*). Business considers this link essential, precisely because the *Declaration* also assures that adhering governments promote an open and predictable investment climate by granting MNEs national treatment and avoid conflicting requirements on them. Such a commitment by governments is essential for business to promote responsible business conduct in accordance with the provisions of the *Guidelines*. It is these mutual commitments by governments and business that make FDI prosper.

Chapter 50

A good business reason to support mandatory transparency in extractive industries

Perrine Toledano and Julien Topal[*]

Transparency demands in extractive industries are tied to the complex paradoxical correlation between significant resource endowment and poverty in many resource-dependent countries. Citizens of these countries and international investors alike only have limited means to scrutinize money-flows between governments and companies, disrupting accountability mechanisms.

Improving accountability and access to information is a step toward ending the resource curse. Section 1504 of the Dodd-Frank Wall Street and Consumer Protection Act, known as the Cardin-Lugar Transparency Amendment, requires extractive companies listed at US-securities exchanges to disclose all payments made to host country governments on a country-by-country and project-by-project basis. Amid corporate opposition, the Securities and Exchange Commission (SEC) has only now, more than one year late and after Oxfam America started court proceedings and over 65 Congress members put pressure on the SEC, set a date to vote on the rules.[1] However, despite opposition, there is a business case to be made in support of such mandatory transparency demands.

The debate on the Transparency Amendment has, very broadly, two camps: the opponents -- most expressively represented by the American Petroleum Institute -- and the proponents, including civil society with Publish What You Pay (PWYP) as the main supporter, groups of investors and certain congressional members. While supporting the Extractive Industry Transparency Initiative (EITI), the corporate lobby opposes the SEC rules for allegedly causing high implementation costs, opposing legal demands and a comparative disadvantage for US-listed companies. The second camp has challenged these claims and has argued in favor of the amendment as a promising answer to the limitations of the voluntary EITI.

Companies maintain that implementation costs can exceed US$ 50 million since they will have to re-devise their accounting instruments to disclose project-based and non-material information. Civil society and even *The Economist* have contested the veracity of this claim, noting that much information is already collected and calculating that US$ 50 million is little more than 0.1% of ExxonMobil's last year's revenue.[2] The claims that demands of the Transparency Amendment contradict host country confidentiality laws

[*] The authors wish to thank Laurent Coche, Matthew Genasci, Isabel Munilla, and Jessica van Onselen for their helpful comments on this chapter, which was first published as a *Perspective* on August 13, 2012.
[1] The vote is scheduled for August 22, 2012. Securities and Exchange Commission, available at: http://www.sec.gov/news/openmeetings/2012/ssamtg082212.htm.
[2] "Extracting oil, burying data," *The Economist*, February 25, 2012.

are also ill placed.[3] Civil society rebutted this claim by demonstrating that most countries allow for exceptions based on stock exchanges' disclosure demands.[4]

There is no denying that a certain short-term competitive disadvantage is created for impacted companies -- although the European Council's directive for mandatory payment disclosure limits the scope of not-covered competition. Companies contend they will lose bids either because host countries prefer non-disclosing companies or because disclosed information is commercially sensitive. Here is the reality-check: Angola just awarded deep water oil blocks to Statoil, Eni, Total, and BP, which are all EITI-supporters and covered by the Amendment, which incidentally only deals with non-commercially-sensitive fiscal information widely shared by the industry. Lastly, the competitive disadvantage argument is unduly cynical. Part of the complaint has to do with the limitations on bypassing the Foreign Corrupt Practice Act by "creatively" bribing through either "facilitators" or local partnerships. Bribery is illegal both in the US and Europe; "[k]eeping it hard to expose would not make it more legal."[5]

Companies have a choice to play either destructive or constructive roles in the quest for transparency. The choice consists of either accepting narrow capitalism -- which prescribes short-term profitability and concomitant opposition to regulatory limitations on corporate operations -- or believing in a forward-looking and long-term shared value approach to business. Through a shared value lens, companies seek out benefits for both shareholders and the communities in which they operate since the companies understand that they require a social license to operate to attain long-term success. Increasingly, investors seek out companies based on such long-term credentials.

Various studies by the Vale Columbia Center found that transparency -- measured by companies' country-by-country reporting -- holds a promise for better corporate performance. One such study showed a clear correlation between transparency and better financial results along different measures.[6] Interestingly, those transparent companies are also associated with fewer cases of human rights abuse.

Corporate leaders should change tactics and transform a short-term comparative disadvantage into the comparative advantage of being first-movers. This means to follow in the footstep of BP's former CEO[7] and support recent attempts by the US President to encourage the development of a global transparency regime, which will be achieved either by pushing other stock exchanges -- starting with Europe -- to follow suit or by improving on the disclosure demands of the current host country-led EITI. For their own

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[3] Angola, Cameroon, China, and Qatar have such laws according to API and Shell. API's letter, January 28, 2011: available at: http://www.sec.gov/comments/s7-42-10/s74210-10.pdf. PWYP US (http://www.sec.gov/comments/s7-42-10/s74210-29.pdf and http://www.sec.gov/comments/s7-42-10/s74210-118.pdf) and the Cameroonian organization RELUFA (http://www.sec.gov/comments/s7-42-10/s74210-96.pdf) deny these claims.

[4] VCC's memo to the SEC, available at: http://www.sec.gov/comments/s7-42-10/s74210-52.pdf.

[5] "Transparency rules," *Financial Times* editorial, February 26, 2012.

[6] The results have been communicated to the SEC: http://www.sec.gov/comments/s7-42-10/s74210-115.pdf; VCC memos are available at: http://www.vcc.columbia.edu/content/vcc-memos.

[7] John Browne, "Europe must enforce oil sector transparency," *Financial Times*, April 24, 2012.

sakes, companies should acknowledge that the transparency moment is now and the stakes are high.

Chapter 51

Law at two speeds: Legal frameworks regulating foreign investment in the global South

Lorenzo Cotula[*]

Foreign investment in developing countries' natural resources brings into contact competing interests characterized by an unequal balance of negotiating power -- from multinational enterprises and host governments to people affected by the implementation of investment projects.[1] Economic globalization has been accompanied by extensive developments in national and international norms regulating investment and its impact -- including investment law, natural resource law and human rights law. These norms affect the way the costs, risks and benefits of investments are shared among the multiple parties involved.

An analysis of developments in national and international law and in transnational contracts for natural resource investments in Africa suggests that the balance of legal claims tends to provide stronger protection to foreign investment than to affected people. For the vast majority of rural populations whose rights are protected under national legislation and international human rights law, legal protection is undermined by shortcomings in rule of law, substantive rules and legal remedies. For them, challenging adverse government action is difficult at both national and international levels. State-of-the-art social and environmental management plans developed for some investments go substantially beyond national law requirements, but fall short of creating legal entitlements enforceable by affected people. On the other hand, bilateral investment treaties (BITs), national law reforms, transnational contracts, and international arbitration have gone a long way toward strengthening the legal protection of foreign investment and imposing discipline on the arbitrary exercise of state sovereignty, reflecting significant developing country efforts to attract foreign investment. The resulting regime seems more geared toward enabling secure transnational investment flows than ensuring these flows benefit people in recipient countries.

Take the case of international law. Both investment law and human rights law protect right-holders against arbitrary interference by the state and provide access to international remedies. But the safeguards that investment law provides to foreign investors tend to be more effective than those available to all under human rights law. Expropriation clauses in BITs typically include public purpose, non-discrimination and compensation requirements, and link compensation to market value. On the other hand, the African Charter on Human and Peoples' Rights affirms the right to property but does not require states to compensate right-holders for losses suffered; it merely requires compliance with

[*] The author wishes to thank Howard Mann, Olivier De Schutter and Andrea Shemberg for their helpful comments on this chapter, which was first published as a *Perspective* on June 29, 2012.

[1] This note is based on the author's new book Human Rights, Natural Resource and Investment Law in a Globalised World: Shades of Grey in the Shadow of the Law (London and New York: Routledge, 2012).

applicable law, demonstrating that international human rights law does not address gaps in compensation requirements that may exist under national law.

In addition, human rights law typically requires petitioners first to try all available remedies under national law before accessing international courts, possibly involving lengthy proceedings and several degrees of appeal. Many arbitration clauses included in BITs do not require investors to exhaust domestic remedies -- though some do and others require first trying domestic remedies.

If human rights petitioners win a case, the ruling may have limited legal or practical force. For example, the African Commission on Human and Peoples' Rights only issues non-binding decisions. The recently established African Court on Human and Peoples' Rights issues binding judgments. But only about half the African states are parties to the Court's Protocol. And only four countries issued declarations allowing individuals and NGOs to bring matters to the Court without first going through the Commission. On the other hand, where states have consented to international arbitration, arbitral awards are legally binding. In practice, investment law offers no absolute sanctuary against determined government action. Although enforcing awards can be difficult, arrangements to enforce such awards are generally more effective than those provided by human rights law. By virtue of some widely ratified multilateral treaties, where signatory governments are unwilling to pay up investors can seize assets that the host state holds abroad -- though immunity rules may restrict this option.

Where competing rights come into contest, differences in legal protection can have important implications -- for example, where an investor and affected people bring disputes about the same investment respectively to international arbitrators and human rights bodies. This has recently happened in cases involving Latin American countries.

Investors need effective safeguards against arbitrary treatment. There may be legitimate reasons to treat different rights differently. But as global interest in developing countries' natural resources increases, it is imperative that affected people also have stronger rights. In relative terms, affected people have more to lose from weak protection than large investors -- because the loss of a small plot of land can make them vulnerable to destitution and loss of social identity.

International law must be more balanced, so that the protection it offers to investment is matched by equally strong safeguards for rights that may be affected by investment flows. National law must grant local landholders stronger rights to their resources and a greater voice in decision-making. Investment contracts must be more inclusive, in terms of transparency, accountability and safeguards for local rights where national law falls short of international standards. For these legal reforms to make a difference, they must be accompanied by sustained investment in strengthening local capacity to exercise rights.

Chapter 52

Land grab or development opportunity? International farmland deals in Africa

Lorenzo Cotula[*]

Over the past 12 months, large-scale acquisitions of farmland in Africa, Latin America, Central Asia and Southeast Asia have made headlines in a flurry of media reports across the world. Lands that only a short time ago seemed of little outside interest are now being sought by international investors to the tune of hundreds of thousands of hectares.

Trends and drivers

An article recently published in *The Economist* suggested that foreign investors have acquired or sought some 15-20 million hectares of farmland in poorer countries since 2006, quoting estimates from the International Food Policy Research Institute.[1]

The accuracy of these estimates is hard to assess, but evidence points toward significant levels of activity and upward trends over the past five years. In four African countries alone (Ethiopia, Ghana, Madagascar, Mali), *approved* land allocations to foreign investors since 2004 amount to over 1.4 million hectares of land (just below the size of a country like Swaziland or Kuwait); this excludes allocations below 1,000 hectares, allocations to nationals and pending negotiations. Due to incomplete datasets, this is a conservative figure -- and it is much higher if deals still under negotiation in the four countries are included.

Approved allocations include a 452,500-hectare biofuel project in Madagascar, a 150,000-hectare livestock project in Ethiopia, and a 100,000-hectare irrigation project in Mali. All four countries experience upward trends in both project numbers and allocated land areas, and evidence suggests that investment levels will grow in future. Private sector deals are more common than government-to-government ones, though governments are using a range of tools indirectly to support private deals, and levels of government-owned investments are significant and probably growing.

Concerns about food security (compounded by water shortages in key investor countries and by the food price hikes of 2008) and the biofuels boom are key drivers, but other factors are also at play -- such as business opportunities linked to expectations of rising food prices, agricultural commodity demand for industry, and policy reforms in recipient countries.

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[*] The author wishes to thank Howard Mann, Ruth Meinzen-Dick and Herbert Oberhaensli for their helpful comments on this chapter, which was first published as a *Perspective* on June 22, 2009.

[1] "Buying farmland abroad: outsourcing's third wave," *The Economist,* 23 May 2009, p. 65. See also Joachim von Braun and Ruth Meinzen-Dick, "Land grabbing by foreign investors in developing countries: risks and opportunities," International Food Policy Research Institute, (Washington D.C., 2009). Available at: www.ifpri.org/pubs/bp/bp013.asp.

Mitigating risks, seizing opportunities

This new and fast-evolving context creates risks and opportunities. Increased investment may bring macro-level benefits (GDP growth, greater government revenues), and create opportunities for raising local living standards. Investors may bring capital, technology, know-how, infrastructure and market access, and may play an important role in catalyzing economic development in rural areas.

But as outside interest increases and as governments or markets make land available to prospecting investors, land acquisitions may result in local people losing access to the resources on which they depend -- land, but also water, wood and grazing. National laws may not have sufficient mechanisms to protect local rights and take account of local interests, livelihoods and welfare. Insecure resource rights, inaccessible registration procedures, compensation limited to loss of improvements like crops and trees, and legislative gaps often undermine the position of local people.

Ultimately, the extent to which international land deals seize opportunities and mitigate risks depends on each project's terms and conditions: how risks are assessed and mitigated (for instance, with regard to project location), what business models are used (from plantations to contract farming through to various forms of equity participation by local people), how costs and benefits are shared (including the distribution of food produced between home and host countries), and who decides on these issues and how.

Unpacking land deals

While outright purchases appear common in Latin America and Eastern Europe, land leases are predominant in Africa -- not least due to restrictions under national laws. Leases are often granted by host governments, though deals with local leaders are common for instance in Ghana, and some deals involve separate contracts with host governments and local people. A recent contract from Madagascar entails a combination of lease and contract farming arrangements, including through a direct deal with 13 associations of local landholders.

Lease durations range from short term to 99 years, and are associated with transfers of water rights. Land fees and other monetary transfers tend to be relatively low, linked to efforts to attract investment, perceived low opportunity costs, and lack of well-established land markets. Host country benefits mainly involve investor commitments on investment levels, job creation and infrastructure development -- for example, with regard to the construction of irrigation systems.

Overall, however, some land deals appear rather short and simple, particularly compared to contracts in other sectors such as extractive industries. Key issues like promoting business models that maximize local content, strengthening mechanisms to monitor or enforce compliance with investor commitments, maximizing government revenues and clarifying their distribution, as well as balancing food security concerns in both home and host countries, may be dealt with by vague provisions if at all.

Lack of transparency is a major challenge in many negotiations, with little public access to information and decision-making. This includes many government-to-government negotiations, which may be expected to be subject to greater public scrutiny. Lack of transparency and of checks and balances in contract negotiations create a breeding ground for corruption and deals that do not maximize the public interest.

What needs to happen

Trends in FDI in land for agriculture reflect deep global economic and social transformations, with potentially profound implications for the future of world agriculture. The role of food in human consumption makes it fundamentally different from other commodities. In many parts of the world, land is central to identity, livelihoods and food security, and decisions taken today will have major repercussions for many, for decades to come. While bilateral negotiations are unfolding fast, there is a need for vigorous public debate in recipient countries, so as to base decisions on strategic thinking about the future of agriculture, the place of large and small-scale farming within it, and the role and nature of outside investment.

Where international land deals emerge as a way forward, governments must ask hard questions about the investor's capacity to deliver on very ambitious projects. Sensible regulation, skillfully negotiated contracts and robust social and environmental impact assessments are key. Host governments must create incentives to promote inclusive business models that integrate rural smallholders and family farms, and ensure the respect of commitments on investment levels, job creation, infrastructure development, public revenues, environmental protection, safeguards in land takings, and other aspects. Some recipient countries are themselves food insecure, and robust arrangements must protect local food security, particularly in times of food crisis.

Although extractive industry projects are often controversial, contractual practice in this large-scale, capital-intensive sector may also provide some insights, particularly as the size and value of land deals increases.[2] This might include precise local content requirements (employment, inputs) that evolve over project duration to increase local percentages and extend them to higher-value content (e.g., skilled labor); provisions on local capacity building (training, technology transfer); specific safeguards on land takings and environmental damage; sophisticated revenue sharing mechanisms giving host states a sizeable share of project revenues, possibly increasing it over project duration; and efforts to improve transparency in contracts and revenue management, including through open tendering and civil society oversight (under the Extractive Industries Transparency Initiative).

As interest in land grows, efforts must be stepped up in many countries to secure local land rights, including customary rights, using collective land registration where

[2] "Fixing the Land Deals," *Financial Times*, Editorial, 27 May 2009.

appropriate and ensuring the principle of free, prior and informed consent, robust compensation regimes, the provision of legal aid, and good governance in land tenure and administration.

Chapter 53

Untying the land knot: Turning investment challenges into opportunities for all citizens

*Xiaofang Shen**

Consider the following cases:

- China, 1980s. Newly embarked on its economic transformation, China opened to foreign direct investment (FDI) to obtain capital, technology and access to world markets. Investors hesitated, however, since national law prohibited access to state-owned land. In reaction, the government introduced a long-term lease system, first tested in special economic zones and later applied across the country. This approach enabled China's phenomenal success in attracting FDI in the years to come; it also paved the way for 500 million urban citizens to gain property rights, which in turn inspired the rural population to ask for the same rights today.
- Egypt, 1990s. Mounting economic needs called for diversifying tourism to the Red Sea coast. However, both domestic and foreign investors shied away from the lengthy and unpredictable land approval process. Project approval involved screening by at least five line ministries, from archeological to national security ministries. The bottleneck was finally removed by a negative approval approach, with each ministry mapping out areas along the coast that were *not* sensitive to their legitimate concerns. The areas cleared by all were then made available for priority tourism development. Business prospered immediately, while public interests were protected.
- Namibia, 1990s. As vast communal land was turned into national parks for wildlife conservation, the country's indigenous population faced the threat of losing its traditional livelihood. The government introduced legislation allowing registration of communal conservancies. Having gained this collective right, indigenous groups could borrow from banks and form eco-tourism joint ventures with outside investors. By 2005, over 50 conservancies were up and running, enabling 220,000 communal residents to benefit from businesses consistent with wildlife protection.

What do these cases have in common in terms of non-agricultural investment?

- Well-secured land is essential for investment, foreign and domestic.
- Outdated and counterproductive laws, policies and institutions, seen everywhere, can prevent investment opportunities from materializing, while keeping valuable land resources locked, in de Soto's term, as "dead capital."[1]

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* The author wishes to thank Ward Anseeuw, Lorenzo Cotula and Carin Smaller for their helpful comments on this chapter, which was first published as a *Perspective* on November 19, 2012.

[1] Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 7.

- Most importantly, investment challenges in access to land can be turned into opportunities consistent with public interests. In fact, lasting investment results and social and environment sustainability can be best achieved together, through policies that open up opportunities for all stakeholders.

All around the world, managing land use conflicts is difficult in fast-paced development. Many countries want to attract FDI, especially the kind bringing jobs and helping industrialization; but investors are hindered by the lack of access to well-secured, well-zoned and well-serviced land. Global enterprise surveys indicate over half of the manufacturing firms in Africa find access to such land a major impediment to their businesses; well over one-third of manufacturers in all other regions voiced the same concern.[2] Adding to the results the unknown amount of investment that has never taken place due to land obstacles, the overall situation is much worse.

Foreign and domestic investors are equally concerned, according to the same surveys. However, foreign investors conceivably have more choices -- if not satisfied, they simply move elsewhere. The runaway investment impact is, therefore, likely higher with foreign investors than their domestic peers.

Governments anxious to attract FDI sometimes offer free land and other special deals as investment incentives. Such an approach, however, creates more problems than it solves. Special deals given to few -- usually the large and well-connected -- disadvantage the rest. Moreover, land has a value serious investors are willing to pay for; offering it free makes host countries forego revenue and attracts wrong investors who speculate rather than build on the land -- a lesson many Chinese local governments learned from their earlier experiences.

Some governments have intervened by forcing ordinary citizens off the land to make way for new investment. Such interventions, leading to land grabs in extreme cases, create social injustice defeating the development goal. The popular resentment caused can also backfire against investment, as seen in the well-known case of Tata Steel in Orissa, India. Disrespect for citizens' rights further undermines the confidence of the business community. Many wonder: If land is taken away from someone for us today, can it be taken away from us for someone else tomorrow?

Short-cuts like these are sometimes attempted because fixing the systemic problems is hard. Obstacles imbedded in the lack of market development, unsecured property rights, obsolete rules and, above all, favoritism and corruption are fundamental. They cannot be overcome unless political leaders are willing and able to operate on their own systems, including, sometimes, taking away the power from the powerful.

Further, systemic reforms require efforts not only to dismantle the old machine but also build a new one. Modernizing property laws and land administration, updating zoning and environment regulations and building capacity at all implementing levels -- these

[2] World Bank Enterprise Surveys, 2006-2009, available at: http://www.enterprisesurveys.org.

require persistent efforts based on political leadership, institutional cooperation and, when ready solutions do not exist, a bit of pragmatism and innovation.

Fortunately, progress is possible -- from A to C if not immediately from A to Z. The experiences of China, Egypt and Namibia are just a few examples. Efforts like these are worth making, as they lead to a fair, efficient and transparent system -- exactly what investors want most. They also safeguard vital public interests.

Chapter 54

The coming harmonization of climate change policy and international investment law

Daniel M. Firger[*]

Developments in climate change policy and international investment law may be ushering in a new era characterized by profound harmonization between the two regimes. Although policy instruments such as the Kyoto Protocol's "Clean Development Mechanism" (CDM) have been in existence for years, it is only relatively recently that the international community has turned to low-carbon FDI and away from command-and-control regulation as the preferred means by which to achieve future greenhouse gas emissions reductions. Meanwhile, states have begun to renegotiate international investment agreements (IIAs) or sign new treaties to take into account policy goals, including climate change mitigation, that extend beyond the regime's traditional preoccupation with investor protection. Though still somewhat tentative, emerging trends in both arenas are thus showing unmistakable signs of convergence.

New climate change policies, particularly those related to finance and technology transfer, are proving to be compatible with international investment law in ways inconceivable for traditional environmental measures. Both the 2009 Copenhagen Accord and the 2010 Cancún Agreements, for instance, call on developed-country governments to mobilize hundreds of billions of dollars in private financing for climate mitigation projects in the developing world, while largely eschewing the imposition of hard caps on emissions, as under the Kyoto Protocol. Low-carbon FDI has thus taken center stage in international climate negotiations, with diplomats discussing a range of new financial mechanisms to incentivize private investments in the lead-up to the seventeenth Conference of the Parties in December 2011.

Clusters of states are also initiating a host of national, bilateral and regional initiatives to encourage low-carbon FDI and facilitate a range of public-private partnerships on clean technology transfer. Examples include new national-level programs aimed at attracting greater FDI inflows under existing mechanisms such as the CDM, bilateral agreements on technology transfer such as the US-China Framework for Ten Year Cooperation on Energy and Environment, and regional accords such as the Asia-Pacific Partnership on Clean Development and Climate.[1] The sorts of investment promotion strategies emphasized in these initiatives tend not to conflict with states' international investment law obligations, as do many forms of traditional environmental regulation. Rather, the benefits of a "clear, stable and predictable policy framework"[2] for low-carbon FDI

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[*] The author wishes to thank John Kline, Petros Mavroidis, Kate Miles, and Jorge Viñuales for their helpful comments on this chapter, which was first published as a *Perspective* on May 9, 2011.

[1] For a lengthier examination of these and other related initiatives, see Firger and Gerrard, op. cit.

[2] UNCTAD, *World Investment Report 2010: Investing in a Low-Carbon Economy* (New York: United Nations, 2010), p. xxvii.

become even greater as states seek to facilitate sustainable development through private investment.

At the same time, international investment law is itself undergoing a transformation of sorts, as increasingly multidirectional capital flows call into question long-standing distinctions between capital importing and capital exporting countries,[3] and as more serious consideration is therefore given to host country regulatory flexibility by traditional capital exporters.[4] This give-and-take is reflected in the language of IIAs: recent agreements impose less stringent obligations on host countries and contain more environmentally-minded exceptions and, in some cases, climate-specific language than those concluded just a few years earlier. New initiatives may go even further. The European Commission's proposed regulation on foreign investment, for instance, includes provisions on the environment and discusses the potential imposition of home country obligations in this regard. Such rules could conceivably include low-carbon finance or technology transfer requirements that may further enhance the relationship between climate policy and international investment law.

To maximize the potential for coordination and mutual learning rather than fragmentation and discord, states should take several affirmative steps to consolidate the progress they have made thus far on low-carbon FDI. First, climate policymakers and investment treaty negotiators should communicate early and often. Most immediately, states should craft a coherent, forward-thinking framework for low-carbon FDI to be adopted at seventeenth Conference of the Parties. Second, states should seek to develop novel mechanisms to incentivize low-carbon FDI, particularly if such mechanisms can strengthen rather than undermine existing legal frameworks governing such investments. For example, developed country governments could make export credit guarantees for clean technology firms conditional upon certain performance requirements, such as capacity-building programs, that not only comply with investment treaty provisions but also support host countries' good faith efforts to tackle climate change. Finally, states should accelerate the process of concluding new IIAs with explicit climate-friendly language, while at the same time renegotiating some of the nearly 3,000 investment treaties currently on the books in order to strike the right balance between incentivizing low-carbon FDI and guaranteeing strong protections for all forms of foreign investment.

The international community has come a long way over recent decades in recognizing that the purposes of international investment law include more than merely safeguarding investors' rights. With the threats posed by climate change looming ever larger, states must take affirmative steps to remove barriers to the transition away from carbon-intensive investments and toward sustainable, low-carbon growth.

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[3] *See, e.g.*, Daniel H. Rosen and Thilo Hanemann, *An American Open Door? Maximizing the Benefits of Chinese Foreign Direct Investment* (New York: Asia Society, May 2011).

[4] Canada, for example, announced in 2010 that it would amend its foreign investment law to require greater transparency and accountability from foreign investors. *See* Bernard Simon, "Canada to toughen rules on foreign investment," *Financial Times*, November 7, 2010.

Chapter 55

Responsible agricultural investment: Is there a signification role for the law in sustainability?

Nicolás Perrone[*]

The world food situation is back in the headlines as price levels surpass 2008 peaks, confirming the rising trend in food markets.[1] Higher prices pose challenges to both food importing and exporting countries. One serious barrier to increasing food output remains the lack of necessary capital and technology in countries that have the potential to increase production rapidly.[2] To avoid a food crisis, international organizations and several governments have increasingly turned to promoting FDI by MNEs in agriculture. This may be an effective solution, but some obstacles stand in the way of the establishment of such projects and, more importantly, their long-term sustainability.

Agriculture is a socially very sensitive area, and foreign investors should expect its regulation to change frequently.[3] This political risk, however, is only one side of the story. All too often, for host countries and their populations FDI has been associated with land grab, dispossession and damaging environmental fallout.[4] Many food-import-dependent countries have recently acquired large tracts of land to secure their food supplies. This strategy has created some skepticism due to the potential effects of these projects on the local population, which could suffer loss of livelihood despite increases in production. Against this complex backdrop, the challenge lies in promoting sustainable and responsible FDI, permitting private investors to enjoy a reasonable profit while also ensuring that all investment inflows benefit host populations.[5]

The need for such a compromise has been acknowledged by international organizations. The Food and Agriculture Organization (FAO), the International Fund for Agricultural Development (IFAD), UNCTAD, and the World Bank are working together on an initiative aimed at convincing all stakeholders that foreign investment projects in agriculture should consider social and environmental sustainability. The most important

[*] The author wishes to thank Lorenzo Cotula, Olivier De Schutter and Lisa Sachs for their helpful comments on this chapter, which was first published as a *Perspective* on May 23, 2011.

[1] "A special report on feeding the world. The 9 billion-people question*,"* *The Economist*, February 24, 2011, available at: http://www.economist.com/node/18200618.

[2] FAO, "Foreign direct investment: win-win or land grab?,*"* available at: ftp://ftp.fao.org/docrep/fao/meeting/018/k6358e.pdf.

[3] UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Production and Development* (Geneva: UNCTAD, 2009), pp. 96-97.

[4] Lorenzo Cotula, Sonja Vermeulen, Rebeca Leonard, and James Keeley, *Land Grab or Development Opportunity? Agricultural Investment and International Land Deals in Africa* (London/Rome: IIED, FAO and IFAD, 2009).

[5] Olivier De Schutter and Peter Rosenblum, "Large-scale cross-border investments in land: the interaction between foreign direct investment and land rights," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy, 2010/2011* (New York: OUP, 2011).

objective of this joint effort is to recommend a set of voluntary guidelines based on the "Principles for Responsible Agricultural Investment that Respect Rights, Livelihoods and Resources" ("the Principles").[6] Investors are invited to adhere to and abide by the Principles, which include respecting land and resource rights, ensuring food security and assuring social and environmental sustainability. These goals embody desirable objectives, particularly from a public perspective; however, the future success of the Principles will depend more on the support of states and international organizations than on a declaration of good intentions. The implementation and legal effects of the Principles remain in question.

It is frequently noted that international investment agreements lack obligations on the part of the investor, instead focusing mainly on the protection of MNEs and facilitating their operations. Moreover, it is argued that guidelines and voluntary codes constitute a deficient counterbalance because they are not legally binding and thus cannot be enforced. MNEs' main motivation for adhering to the Principles, however, is the improvement of their corporate reputation, as they show their social and environmental commitment to the international community, consumers and their own employees. Nonetheless, despite the non-binding nature of these corporate commitments, the international community should be able to expect MNEs that have agreed to observe the Principles to stick to their promises. This proposition would be consistent with the position in international investment law that representations made by a state, i.e., assurances provided by host countries that were reasonably relied on by an investor, should be respected.[7]

This legal approach could prove positive for the purposes envisaged by the drafters of the Principles. When investors commit to observe the Principles, they do not assume a legal obligation; still, it is worth considering the role the Principles can play in shaping investors' legitimate expectations -- typically one of the most contentious issues in arbitration. If investors in legal dispute argue that their expectations were not met, and these expectations are clearly at odds with the Principles, investment tribunals could not easily find them legitimate. The Principles could contribute to defining the scope of regulatory authority, helping states to pass new regulations, for instance, when there is sound evidence of environmental and social risks. In this manner, the Principles could strike a balance between investors and host country populations' concerns, promoting sustainable FDI in agriculture as a partial solution to the present food situation.

[6] See generally http://www.responsibleagroinvestment.org/rai/node/256.

[7] This position was adopted by the arbitrators in *Waste Management Inc. v. Mexico* (Number 2), ICSID Case No. ARB (AF)/00/3 (NAFTA), award (April 30, 2004), at 98, and has been endorsed by other tribunals.

Chapter 56

Absent from the discussion: The other half of investment promotion

Lise Johnson[*]

As UNCTAD highlighted over a decade ago and again recently in its Investment Policy Framework for Sustainable Development, home-country measures (HCMs), like host-country commitments regarding the protection of foreign investors, are tools of promoting foreign investment.[1] Nevertheless, the vast bulk of investment treaties, which state the promotion of foreign investment as their objective, overlook the potential role of HCMs and focus rather singularly on setting out the obligations of host countries regarding the treatment of foreign investors. Even recent agreements and model investment treaties that should represent "next generation" practices incorporating accumulated learning about the impacts and effectiveness of these treaties remain relatively devoid of any obligation for governments to facilitate or promote the quantity and quality of *outward* investment that many countries want and need for sustainable development.[2]

A few countries (developed and, increasingly, developing) take HCMs to facilitate or promote outward investment. These measures can include such actions as providing information, technical assistance, insurance, and/or financial and fiscal support to domestic firms to encourage and aid them in establishing operations overseas; enhancing coordination among investment promotion agencies; and assisting potential host countries in developing the infrastructure necessary for attracting investment. The dominant approach by home countries has been to formulate and implement these HCMs unilaterally as part of efforts to support FDI by domestic enterprises, and/or as part of international development assistance programs. And although some investment treaties do contain provisions on HCMs, those provisions have generally been limited to hortatory statements regarding FDI promotion and cooperation rather than specific obligations with mechanisms to ensure their implementation. To a great extent, therefore, the HCMs that have been referenced in investment treaties are weak, and lack the stability and predictability to make them the effective tools for sustainable development that they could be.

There is, however, nothing inherent in investment treaties that precludes or is inconsistent with including more obligations on HCMs, making such obligations measurable and enforceable under those agreements and using them to promote the amount and type of

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[*] The author wishes to thank Kathryn Gordon, John Kline, Peter Muchlinski, and Federico Ortino for their helpful comments on this chapter, which was first published as a *Perspective* on September 24, 2012.

[1] UNCTAD, *World Investment Report 2012* (Geneva: United Nations, 2012), pp. 110, 155; UNCTAD, *International Investment Agreements* (New York: United Nations, 2005), ch. 22; UNCTAD, *Home Country Measures* (Geneva: United Nations, 2001).

[2] See, e.g., 2012 US Model BIT, available at: http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf. But see also, e.g., UNCTAD (2005), ibid. 22.

investment that can facilitate sustainable development. Countries could include in their investment treaties commitments on HCMs to allow, encourage and/or promote outward investment, and could craft these provisions to take into account the countries' special and differential obligations; their respective needs, priorities and industrial policies; specific development challenges; and the potential costs and benefits of investment treaties for state parties at the macro- and the micro-levels. Further, they could design the provisions to be flexible or evolve over time as levels of development change.

HCMs, it should be recognized, are not free from controversy. Some argue, for instance, that they raise issues of competitive neutrality, a topic that has recently attracted significant attention from OECD countries. Domestically, HCMs promoting home-country firms' efforts to establish overseas affiliates could potentially exacerbate opposition to investment treaties from constituents concerned about a consequent loss of jobs. Nevertheless, to the extent objections to some HCMs exist and are not assuaged by research or policy responses, home countries have various options for avoiding such objections when, for instance, designing and implementing HCMs that focus on increasing the capabilities of developing host countries to draw in and benefit from FDI. These include HCMs to promote the investment in infrastructure that will help host countries attract FDI, and HCMs that support host countries' development of the absorptive capacity that is crucial for enabling them to reap long-term benefits from such investment.

Home-country efforts to assist with investment promotion activities can truly be win-win measures for home and host countries,[3] helping investment treaties move beyond their arguable current role as mere regulators of the relationship between foreign investors and host countries, to actual tools for encouraging the FDI and economic cooperation that can lead to sustainable development: HCMs can help a home country's investors overcome myriad barriers that make it difficult for them to invest and succeed abroad; the measures can be targeted so as to help scale-up and channel investment into cutting-edge technologies and inclusive business models aimed at solving some of the world's most pressing challenges such as poverty and climate change, while also enhancing the competitiveness of home-country firms; and, more generally, HCMs can serve as catalysts for the type and quantity of international flows of capital that are important for sustainable development, particularly in countries and regions that have struggled to attract such flows. It would thus be a welcome, feasible and overdue departure from traditional practice if new treaties were to contain these commitments, and is an issue policy makers and treaty negotiators should have on their agendas.

[3] Because it is focused on the role of investment treaties as promoting investment for sustainable development, this note primarily envisions HCMs in agreements between developed and developing countries, where the HCMs are used to promote investment into the developing country treaty party.

Chapter 57

Environmental concerns in international investment agreements: The "new era" has commenced, but harmonization still appears far off

Kathryn Gordon and Joachim Pohl[*]

In *Columbia FDI Perspective* No.37, Daniel M. Firger foretells "a new era characterized by profound harmonization" between climate change policy and international investment law,based on what he sees as "unmistakable signs of convergence" in recent investment treaty making.[1] A study just released by the OECD suggests that convergence of investment treaty making toward environmental policy began about a decade ago, but also that "profound harmonization" of investment and climate change policy is still some time away.[2]

Arguably the first of its kind, the study surveys over 1,600 international investment agreements (IIAs) for references to environmental concerns and categorizes these references according to their regulatory purpose. It provides a systematic statistical portrait of how and to what extent governments have dealt with environmental protection in their investment agreements since 1958.

Until relatively recently, references to environmental concerns in investment treaties were exceedingly rare. Indeed, no investment treaty concluded between 1958 and 1985 contained any reference to the environment, and fewer than 10% of treaties concluded in any given year from 1985 to 2001 contained this feature. References to environmental concerns in such treaties have increased sharply since 2002. The share of newly concluded IIAs with explicit environmental references exceeded 50% for the first time in 2005 and reached 89% in 2008. Notably, all free trade agreements (FTAs) included in the sample contain references to the environment in their investment chapters.

Treaty writing practice in this regard still varies considerably: 19 of the 49 countries covered by the study have never used such language in their IIAs, while a few countries have, from a given date onward, systematically included environmental references in their treaties (e.g. Canada, Mexico and the United States since the early 1990s, and Belgium/Luxembourg more recently). Several countries such as Australia and the Republic of Korea appear to have no policy of systematically including such language, but have included such references in some of their treaties.

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[*] The authors wish to thank Daniel Firger, Howard Mann and Benjamin J. Richardson for their helpful comments on this chapter, which was first published as a *Perspective* on August 15, 2011.

[1] Daniel M. Firger, "The coming harmonization of climate change policy and international investment law," *Columbia FDI Perspectives*, No. 37, May 9, 2011, p 1.

[2] Kathryn Gordon and Joachim Pohl, "Environmental concerns in international investment agreements: A survey," OECD Working Papers on International Investment, No. 2011/1, (2011) available at: http://www.oecd.org/dataoecd/50/12/48083618.pdf.

The environmental language in IIAs shows significant variation across time and across countries. The details of the language, even within specific subject areas, vary and identical language across treaties is rare. However, almost all references to environmental concerns appear to develop a limited number of themes (e.g. general environmental references in preambles, right to regulate in the environmental policy area, and not lowering environmental standards for the purpose of attracting investment).

A few treaties in the sample go beyond generic references to environmental concerns and deal with more specific environmental subject matter. These more specific references mainly use language derived from the 1948 General Agreement on Tariffs and Trade, repeating the concepts underlying the environmental policy agenda that prevailed at that time. These references include 45 treaty clauses that deal with protection of human, animal or plant health and 25 dealing with protection of exhaustible natural resources. Almost without exception, more recent concerns, such as climate change and biodiversity, have not yet penetrated the limited set of environmental issues addressed in investment treaties.

The statistical analysis of treaty writing practice says little about the legal effects and policy implications of references to environmental concerns in IIAs. Whether such clauses enable governments better to integrate investor protection and environmental policy objectives is an open question. Given the large stock of IIAs in force, the political and practical limitations on renegotiations of IIAs, and the slow penetration of concepts of international environmental law into IIA negotiations, it would seem that changing or adding to the explicit environmental content of investment treaties will be a long, slow process.

Other avenues for clarifying states' political and legal intent in treaty writing appear promising, but require further reflection and dialogue by both the investment and environmental policy communities.[3] This reflection could start by exploring systematic variations of clauses in the treaty sample -- e.g. the fact that all FTAs with investment chapters in the sample, but only 6.5% of BITs, contain references to the environment. Further legal analysis could shed light on the influence of international environmental law on the interpretation of investment law and ultimately contribute to the "profound harmonization" between climate change policy and international investment law.

[3] OECD, "Harnessing freedom of investment for green growth, Freedom of Investment Roundtable 14 April 2011" (April 14, 2011), sets forth findings by participants in the OECD-hosted *Freedom of Investment* process on the role of international investment in supporting the realization of countries' green growth objectives.

PART V

INTERATIONAL INVESTMENT TREATIES AND ARBITRATION

Chapter 58

Attracting FDI through BITs and RTAs: Does treaty content matter?

Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy [*]

It may appear all too obvious that the extent to which foreign direct investment (FDI) is attracted by bilateral investment treaties (BITs) and regional trade agreements (RTAs) depends on the strength of key investment provisions. Still, BITs and RTAs have typically been treated as black boxes in prior empirical literature, ignoring two important legal innovations: investor-state dispute settlement (ISDS) and pre-establishment national treatment (NT) provisions.[1]

An assessment of the impact of different classes of BITs and RTAs on bilateral FDI flows between up to 28 home and 83 developing host countries (covering the period 1978-2004[2]) yields strong evidence that liberal admission rules promote bilateral FDI. For instance, a host country could increase its share in total FDI flows by almost 30% in the hypothetical case of switching from RTAs without pre-establishment NT provisions to RTAs with such provisions in relation to all possible partner countries. In conducting our analysis, we used a wide range of control variables, employed different estimation methods to test the robustness of our findings, and also found that the results are not due to reverse causality. Like other similar studies, however, our model did not given data limitations or account for unilateral changes in the admission of FDI. Compared to NT provisions, ISDS mechanisms appear to play a minor role.

Also in contrast to what one might expect, the impact of similar investment provisions on bilateral FDI depends on whether these provisions are contained in RTAs or BITs. RTAs offering nothing specific to foreign investors, in terms of liberal admission or effective dispute settlement, leave bilateral FDI unaffected or may even induce a substitution of home-country exports for FDI. By comparison, foreign investors respond to BITs rather indiscriminately regardless of the strength of dispute settlement or market access

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[*] The authors wish to thank Andrew Guzman, Lauge Poulsen and Jeswald Salacuse for their helpful comments on this chapter, which was first published as a *Perspective* on July 30, 2012.

[1] Recent efforts to code BITs and RTAs help overcome this gap. Jason Yackee classified BITs according to ISDS provisions. (Jason Yackee, "Do BITs really work? Revisiting the empirical link between investment treaties and foreign direct investment," in Karl P. Sauvant and Lisa E. Sachs, eds., *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (Oxford: OUP, 2009), pp. 379-394.) We supplemented Yackee's work and coded BITs and RTAs with respect to NT provisions in the pre-establishment phase. (Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy, "Do trade and investment agreements lead to more FDI? Accounting for key provisions inside the black box," International Economics and Economic Policy (April 2012).) The inclusion of such provisions guarantees market access for multinational enterprises (MNEs). As regards pre-establishment NT provisions, we classified BITs and RTAs in four types: the most liberal and transparent type adopts a negative-list approach and lists existing non-conforming measures; the second adopts a negative-list approach but with less transparency regarding non-conforming measures; the third adopts a positive list approach which is limited to services sectors; and the fourth does not contain any NT provisions on pre-establishment.

[2] Ibid.

provisions. This may be surprising given that some recent BITs are no longer restricted to investor protection and extend to FDI liberalization. The low profile and rather technical nature of BIT negotiations provide a possible explanation; foreign investors may tend to regard BITs as agreements containing a similar set of rules, without checking their legal intricacy. Clearly, further qualitative studies are needed better to understand how investors take into account BITs and RTAs when making investment decisions.[3]

Our findings suggest that governments seeking to attract FDI may put greater emphasis on providing comprehensive and transparent admission guarantees. It is primarily the market access guarantees provided by NT at the pre-establishment phase that appears to lead to more FDI. NT provisions using negative list modalities improve legal security and predictability at the admission phase. Specifically, signaling effects appear strongest if pre-establishment NT provisions cover all sectors, precisely list non-conforming measures and generally bind access conditions at the currently level of openness. More restrictive approaches of limiting NT provisions to selected sectors do not appear to be effective.

Concerns the choice between BITs and RTAs, policymakers seeking to attract FDI may face a dilemma. The negotiation and ratification of RTAs tend to be highly politicized. This may help alert foreign investors and increase FDI. However, rule setting in RTAs typically covers a much wider area than in BITs and could impose additional costs. Policymakers should know that RTAs tend to be ineffective in promoting FDI if the focus is exclusively on trade liberalization. On the other hand, the technical nature of BIT negotiations may have the effect that foreign investors are hardly aware of more favorable features that BITs may contain. Investment promotion agencies bear major responsibility to convince foreign investors that it is worthwhile checking the small print of BITs.

[3] Various econometric studies on the subject are not in line with recent survey evidence which suggests that MNEs rarely take BITs into account while deciding where and how much to invest. Similar discrepancies between surveys and econometric evidence exist when assessing the relative importance of cost-driven versus market-driven motives for FDI.

Chapter 59

Different investment treaties, different effects

Clint Peinhardt and Todd Allee[*]

The proliferation of investment treaties is perhaps exceeded only by academic studies of those treaties. Legal scholarship has long been attentive to the evolution in international investment agreement (IIA) content -- but until recently, quantitative assessments of IIAs have tended to treat them as interchangeable: the only measure of investor protections encoded in IIAs is whether a treaty had been signed and/or entered into force. Thankfully, the United Nations Conference on Trade and Development has been at the forefront of capturing not just IIAs' proliferation but also the evolution in their content. Its work shows that treaties apply for differing durations, have conflicting procedures for termination and include varying definitions of even basic terms, such as "investors" and "investment." Other quantitative studies have begun to measure these variations, focusing initially on differences in dispute resolution.[1] Some IIAs demand that investors choose between domestic and international dispute resolution; some provide explicit consent of both parties to international arbitration; and some designate a particular forum for arbitration, whereas others specify multiple options. Of course, IIAs vary across many dimensions, but our initial examination of dispute resolution provisions alone demonstrates the importance of examining IIA content.

Importantly, the variations across IIAs are systematically related to characteristics of the governments negotiating them. Even powerful countries' model investment treaties are rarely enacted in full, and treaties enact language that reflects carefully balanced bargaining positions. For example, treaties between countries with great power disparities provide stronger international arbitration provisions; treaties between relative equals tend to be less stringent.[2]

Most published quantitative studies find a correlation between IIAs and FDI -- but, increasingly, this relationship appears more complex than the simple "IIAs increase FDI" story. The earliest studies found little evidence of this story, but in recent years a number of studies have found correlations between the number of IIAs a country signs and its inward FDI. Other research finds that IIAs and FDI between signatories move together as well. Both approaches have elicited criticism on methodological grounds, since previous FDI can influence which countries get IIAs.[3] Also, the FDI effects of IIAs depend on

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[*] The authors wish to thank Emma Aisbett, Andrew Newcombe and Jason Yackee for their helpful comments on this chapter, which was first published as a *Perspective* on February 20, 2012.

[1] Jason Webb Yackee, "Bilateral investment treaties, credible commitment, and the rule of (international) law: Do BITs promote foreign direct investment?," *Law & Society Review*, vol. 42 (December 2008), pp. 805-32.

[2] See, Todd Allee and Clint Peinhardt, "Delegating differences: Bilateral investment treaties and bargaining over dispute resolution provisions," *International Studies Quarterly*, vol. 54 (March 2010), pp. 1-26.

[3] See, e.g., Emma Aisbett, "Bilateral investment treaties and foreign direct investment: Correlation versus causation," in Karl P. Sauvant and Lisa Sachs, eds., *The Effect of Treaties on Foreign Direct Investment* (New York: OUP, 2009), pp. 395-437.

compliance: states that sign IIAs but appear more often (or lose) in international arbitration will not gain new FDI, and in fact may jeopardize the investment stocks they already possess.[4]

New research on IIAs simultaneously examines how the characteristics of their individual state parties, the relationship between those parties, and treaty content affect investment. IIAs do appear to have differing effects on FDI due to their varying levels of investor protection.[5] After taking into account which states sign stronger treaties, the specific language in dispute resolution clauses can impact FDI; for example, treaties that omit any reference to local dispute resolution options appear more likely to increase FDI between the signatories.

For policymakers, this implies that not all countries are likely to gain FDI as a result of IIAs. Only countries on the cusp of establishing good investment climates may benefit, for example by signing more comprehensive investment treaties than their peers. Countries already unattractive to foreign investors are unlikely to become more so as a result of a typical IIA. Likewise, those already viewed as safe investment hosts may only stand to lose ground if they sign weak treaties. Overall, the actual investment effects of investment treaties depend greatly on context. Lastly, our findings do not imply that investors pay great attention to all treaties; instead, where BITs contribute especially critical information, such as in newly independent countries, treaties that commit states more credibly to investor protections can attract FDI.[6]

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[4] Todd Allee and Clint Peinhardt, "Contingent credibility: The impact of investment treaty violations on foreign direct investment," *International Organization*, vol. 63 (July 2011), pp. 401-432.

[5] Clint Peinhardt and Todd Allee, "Devil in the details? The investment effects of dispute settlement variation in BITs," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy* 2010-2011 (New York: OUP, 2011).

[6] Axel Berger, Matthias Busse, Peter Nunnenkamp, and Martin Roy. 2011. "More stringent BITs, less ambiguous effects on FDI? Not a bit!" *Economics Letters*, vol. 112 (September 2011), pp. 270-72.

Chapter 60

Reconciling IMF rules and international investment agreements: An innovative derogation for capital controls

Elizabeth Broomfield[*]

There is currently no universal framework governing capital controls. As a result, a conflict has arisen due to the different approaches taken by various international organizations and many international investment agreements (IIAs). In particular, the International Monetary Fund (IMF) -- established to manage the international financial system -- preserves national autonomy over capital controls when such measures are deemed necessary; in contrast, IIAs, and especially bilateral investment treaties (BITs) -- crafted primarily to protect investors -- typically do not allow for the imposition of restrictions on capital outflows associated with foreign investments for balance-of-payments reasons.

More specifically, countries that significantly limit the policy space for capital controls in their IIAs (that is, do not allow for a balance-of-payments derogation) can potentially come in direct conflict with the IMF. For instance, a senior IMF lawyer, expressing concern that this approach might be contrary to a request by the Fund that a government adopt capital controls, observed that there is a risk that, "in complying with its obligations [under Free Trade Agreements] … a member could be rendered ineligible to use the Fund's resources under the Fund's articles."[1] Recent volatile capital flows to developing countries, as well as the greater acceptance of capital controls today, make it likely that this issue will stay on the international agenda. This dilemma has been recognized in the international community, as demonstrated by several attempted solutions.[2]

In response to this issue, IIAs should incorporate derogations for countries when treaty obligations conflict with IMF recommendations. More specifically, if and when the IMF suggests that a government employ capital controls for a limited time to respond to severe economic hardship, the employing country would have a complete defense against investor lawsuits under IIAs incorporating such derogations.

This recommendation may be more politically palatable than other proposed derogations that might afford greater discretion to treaty parties in the implementation of capital

[*] The author would like to thank Sergey Ripinsky, Diana Rosert, Manfred Schekulin and two anonymous reviewers for their helpful comments on this chapter, which was first published as a *Perspective* on September 10, 2012.

[1] Deborah E. Siegel, "Using free trade agreements to control capital account restrictions: Summary of remarks on the relationship to the mandate of the IMF," *International Law Student Association Journal of International and Comparative Law*, vol. 10 (2004), p. 301.

[2] E.g., some IIAs state that in exceptional cases restrictions to the transfer of funds provisions are allowed when they conform with relevant WTO agreements and IMF regulations. Furthermore, more recent IIAs increasingly incorporate balance of payments exceptions. However, in contrast, the new 2012 US Model BIT does not allow for capital controls.

controls and therefore should be the most politically feasible. Moreover, the IMF has the preeminent role in international economic rule-making on this issue; the General Agreement on Trade in Services defers to IMF authority on the question of transfer restrictions and some countries have already demonstrated a willingness to rely on IMF judgment on this subject: the North American Free Trade Agreement's balance-of-payments derogation relies upon IMF statistical information and recommendations. US Treasury Secretary Timothy Geithner has even advocated a greater role for the IMF in policing international capital flows.[3]

This proposal could be especially useful for US IIAs and the US Model BIT; the US has been particularly reluctant to incorporate any derogation for capital controls into its IIAs. This plan offers several advantages over the potential balance-of-payments derogation currently debated by the US State Department. First, an IMF exemption could allow controls to prevent a crisis from escalating, rather than addressing problems purely retrospectively; this problem has already occurred regarding the NAFTA balance-of-payments exception. Though permission to use capital controls in this manner would likely be extremely rare, the possibility may prevent a costly and potentially unnecessary buildup of reserves, as occurred in Mexico.[4] The requirement of an IMF recommendation to use controls would also limit abuse of the flexibility by host countries. It is also more objective and therefore promotes legal predictability, as the existence of a balance-of-payments crisis can be subjective. A country may be threatened with lawsuits even if it believes capital controls are needed to respond to a clear balance-of-payments dilemma; IMF permission to impose capital controls would remove this uncertainty. If the IMF states that capital controls are needed to address a financial difficulty, a country may proceed without fear of lawsuits.

Most importantly, this proposed derogation would directly address the IMF's concern that its authority to recommend capital controls could be undermined by IIAs. While rules of international institutions are carefully designed to ensure that they do not create conflicting obligations, this is not the case for most treaties crafted in the investment area. Currently, it is possible that a country in crisis will have to face two potentially conflicting international obligations: an IMF recommendation to employ capital controls, and IIAs that allow investors to sue if controls are imposed. A simple derogation in IIAs would remove this risk and enhance the compatibility of such agreements with international rule-making.

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[3] Statement by the United States Secretary of the Treasury Timothy Geithner in the twenty-third meeting of the International Monetary and Financial Committee, April 16, 2011, available at: http://www.imf.org/external/spring/2011/imfc/statement/eng/usa.pdf.

[4] Manuel Perez-Rocha, "Mexico's hot money challenge," *The Epoch Times*, March 6, 2011, available at: http://www.theepochtimes.com/n2/opinion/mexicos-hot-money-challenge-52467.html.

Chapter 61

Political risk insurance and bilateral investment treaties: A view from below

Lauge Skovgaard Poulsen[*]

Many of the risks covered by bilateral investment treaties are also covered by political risk insurance (PRI). Although there are important differences between PRI and BITs, both in terms of coverage and underlying purpose, the considerable overlap between the two instruments suggest that PRI providers should take BITs into account when assessing the risk of investment projects. But while the relationship between BITs and PRI has often been alleged to be considerable,[1] in practice there is practically no publicly available evidence to sustain this assumption. This Chapter reviews evidence from a recent survey of officials in private and public (or mixed private-public) PRI providers.[2]

Government-sponsored agencies

Several governments provide their investors abroad with insurance against political risks, and a few of these, such as those of Germany and France, make their guarantees contingent on investments being covered by BITs. This is notable because practically all BITs allow government-sponsored PRI agencies to "subrogate" insured investors' claims against host countries, thereby providing a legal basis for the government's insurance agency to recover benefits paid out to investors. These programs are an exception, however, in that most public investment guarantee programs do not incorporate BITs as a precondition for coverage. And while BITs may at times provide comfort when PRI agencies of capital-exporting states issue guarantees in risky jurisdictions, interviews with officials from nine of them indicate that it is exceptionally rare that the treaties have a decisive impact on either coverage or pricing.[3]

The Multilateral Investment Guarantee Agency (MIGA)

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[*] The author would like to thank Geza Feketekuty, Mark Kantor and Michael Nolan for their helpful comments on this chapter, which was first published as a *Perspective* on August 2, 2010.

[1] See e.g., United Nations Centre on Transnational Corporations, "Bilateral arrangements and agreements related to transnational corporations," Official Records of the Economic and Social Council, 1986, p. 23 ("the existence of a bilateral agreement with the respective host country is very often a pre-condition for political risk insurance by the investor's home country."); UNCTAD, "UNCTAD hosts bilateral investment treaty negotiations by group of fifteen countries," press release, January 7, 1999 ("In many cases, they [BITs] have become a sine qua non for the availability of political-risk insurance."); Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff, 1995), p. 156 (BITs "reduce the 'risk profile' of a covered investment to a level where it can be prudently insured by the investor's Home state …."); Jenifer M. DeLeonardo, "Note: are public and private political risk insurance two of a kind? Suggestions for a new direction for government coverage," *Vanderbilt Journal of Transnational Law,* vol. 45 (2005), p. 753 (BITs "increase insurers' abilities to offer favorable insurance terms to investors.").

[2] Further details and discussion can be found in the full study.

[3] Covered countries are, Austria, Denmark, Finland, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

For MIGA insurance, a foreign investment has adequate legal protection if covered by a BIT, and the treaties are relevant for other parts of MIGA's operational regulations as well. But whereas BITs may thereby make the underwriting process easier within MIGA, the treaties are often not crucial. A BIT is a sufficient, but not necessary, condition for coverage. And with respect to the pricing of expropriation risk, MIGA has to consider no less than 57 rating factors when determining the underwriting premium rates. Only one of these relate to the existence of an "investment protection agreement" -- a rather broad term which covers trade agreements with investment chapters, for instance, the Energy Charter Treaty. Suffice it to say that, if countries engage in conduct that signals a scale-back of investor protections -- such as withdrawing their consent to submit investment disputes to international arbitration -- that would naturally be factored into MIGA's underwriting decisions. But for developing countries that remain committed to foreign investment and the rule of law, past and current high-ranking officials confirm that the absence of a BIT rarely impacts pricing or coverage, and is never in itself a sufficient reason for MIGA to withhold a guarantee.

Private providers

As an alternative to public investment guarantee schemes, private companies have offered PRI for the past three decades. The survey summarized here included feedback from underwriters and senior managers from firms and Lloyds' syndicates accounting for around 50% of the total "confiscation, expropriation and nationalization" capacity of most PRI providers. Their feedback may appear surprising to those convinced that BITs are crucial for the PRI industry. A few providers incorporate BITs into their products (for instance by insuring treaty-based arbitration award defaults), and some occasionally use the treaties as a guiding tool when assessing investment risks, but most private firms find BITs largely irrelevant for the underwriting process. Naturally, if cancelling or failing to honor existing BITs can be taken as signals that a host country plans to weaken its investor protections, this will be noted and taken into account (as with MIGA). But for developing countries that treat foreign investors fairly and in a non-discriminatory way, BITs very rarely provide a "positive return" in the private industry's underwriting process.

Conclusion

Naturally, what has been discussed here is only one out of several possible links between BITs and PRI. An additional -- and obviously related -- question is the relevance of BITs when PRI providers resolve claims with host governments. This remains almost entirely unexplored in the literature due to the short supply of information about the PRI industry. The conclusion is nevertheless notable: While BITs are basically aimed at reducing the risk of investing abroad, many agencies that price the risk of foreign investments rarely take them into account. Why might that be? If the reason is ignorance about the potency of BITs among some PRI providers, then the treaties should increase in importance once more underwriters realize their potential. But even among those well informed about BITs, major providers remain skeptical about their practical relevance as a risk-mitigating tool. Ultimately, however, it remains to be studied exactly why BITs may be decisive for some underwriting decisions, but have nevertheless not had a transformative impact on the global market for PRI.

Chapter 62

How much do US corporations know (and care) about bilateral investment treaties? Some hints from new survey evidence

Jason Webb Yackee[*]

A remarkable number of countries have recently entered into bilateral investment treaties as a means of protecting and promoting inward FDI. But do the treaties "work"? In exchange for giving up some measure of regulatory autonomy, host countries hope to receive increased flows of investment. Scholars have devoted substantial energy to examining whether this so-called "grand bargain" has in fact been realized. Most studies follow a common research design. The number of BITs that a country has signed are counted up, with the resulting independent variable regressed against country-level FDI flow data. Unfortunately, the results of these various and increasingly complex statistical exercises are inconsistent.[1] Some studies show that BITs can have massive positive impacts on foreign investment; others show modest positive impacts; others show no impact at all, or even a negative impact.

A small handful of scholars are attempting to move past this econometric stalemate by returning to the older, less sophisticated, but potentially more enlightening methodologies of surveys and interviews.[2] In a recent working paper, I presented results from a mail-based survey of general counsels in large US corporations. General Counsels were targeted because it is unlikely that busy non-legal senior executives will be in a position to monitor or evaluate the highly technical and relatively inaccessible evolution of BIT jurisprudence. If investment treaties meaningfully impact FDI, that influence is likely to flow into the corporation's decision-making process through the General Counsels' knowledge or appreciation of BITs as risk-reducing devices.

The survey was mailed to General Counsels in the top 200 US corporations on the Fortune 500 list. 75 surveys were returned, a relatively respectable response rate given the nature of the respondents, who are, undoubtedly, exceedingly busy. Given the modest sample size, and given that I was able to focus only on General Counsels in US corporations, the survey's results should be viewed as preliminary rather than definitive. Responses were received from corporations across the top 200, including four in the top ten, and included corporations from all major economic sectors.

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[1] For a valuable collection of the main studies, see Karl P. Sauvant and Lisa E. Sachs, eds. *The Effects of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (New York: OUP, 2009).

[2] See, e.g., Lauge Skovgaard Poulsen, "The importance of BITs for foreign direct investment and political risk insurance: revisiting the evidence," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy, 2009-2010* (New York: OUP, 2010), ch. 14.

The basic story is a somewhat surprising one given some claims in the existing empirical literature that BITs matter a great deal to foreign investors. General Counsels reported that they personally were relatively unfamiliar with BITs. On a five-point scale, ranging from "1" ("not at all familiar") to 5 ("very familiar"), the median response for General Counsels was only a "2," with only about 21 percent indicating high familiarity ("4" or "5").[3] General Counsels reported an identical median level of unfamiliarity with BITs by non-lawyer senior executives.[4] General Counsels did not view BITs as providing particularly effective protection against expropriation (median response of "3" on a 5-point scale where "5" means "very effective" and "1" means "not at all effective"), with only about 21 percent rating BITs as highly effective ("4" or "5").[5] They were even less impressed with BITs as an effective shield against adverse regulatory change (median response of "2," with no respondents selecting "5" and only 10 percent selecting "4").[6]

This latter result is intriguing, because classic expropriation has become an exceedingly rare phenomenon. If BITs have an important role to play in reducing investment risk (and thus in encouraging FDI), it is probably by reducing the risk of adverse regulatory change -- so-called "regulatory expropriation." In fact, General Counsel's skepticism about the ability of BITs to protect against regulatory change is consistent with the jurisprudence of arbitral tribunals, which have so far refused to read an ambitious regulatory takings doctrine into the treaties. General Counsels also indicated that, on average, BITs are not an important consideration in the "typical" FDI decision (median response rate of "2" on the five-point scale, where "1" is "not at all important"),[7] and only four respondents reported that their company had declined to invest in a specific project because of the absence of BIT protections.[8] Interestingly, those four companies that said that a BIT had impacted a specific project spanned the Fortune 200 (two are in the top 10, one is in the 60s, and one is in the 170s) and included a variety of sectors. One is a defense-industries corporation; one is a natural resources company; one is a large manufacturing conglomerate; and one is a financial services company.

Given the small and geographically non-diverse sample, the survey results should certainly not be understood as saying that BITs never matter to investors when they decide whether and where to invest. Nor do they prove that BITs will not matter more to investors at some time in the future, as knowledge of BITs and confidence in the strength of their protections grow. BITs may indeed influence certain investment decisions. But my survey results suggest that they are unlikely to influence many others.

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[3] The question read, "How familiar are lawyers in your office with the basic provisions of Bilateral Investment Treaties (BITs)?"
[4] The question read, "How familiar are nonlawyer senior executives in your corporation with the basic provisions of BITs?"
[5] The question read, "In your view, how effective are international treaties like BITs at protecting foreign investments from expropriation by a foreign government?"
[6] The question read, "In your view, how effective are international treaties like BITs at protecting foreign investments from adverse regulatory change in the foreign country?"
[7] The question read, "How important is the presence or absence of a BIT to your company's typical decision to invest in a foreign country?"
[8] The question read, "To your knowledge, has your company ever declined to invest (or to consider investing) in a particular foreign project specifically because of the absence of a BIT?"

Of course, there are serious methodological challenges with surveys such as this one. But econometric studies of the links between BITs and FDI inflows have reached the point of diminishing returns. In order to provide a more certain answer to the question of whether BITs "work," researchers should re-focus their energies on exploring in more depth and with more sophistication how and why corporate knowledge and appreciation of BITs does -- or does not -- actually enter into the corporation's foreign investment decision-making process.

Chapter 63

US BITs and financial stability

Kevin P. Gallagher[*]

Almost immediately after taking office, the Obama administration charged the US Department of State's Advisory Committee on International Economic Policy with reviewing the US Model bilateral investment treaty (BIT). The group established a sub-committee of business groups, labor and environmental organizations, and a handful of academic experts and tasked it to make official recommendations for reforming US investment treaties. When completed, the Obama administration hopes to proceed with official negotiations with China, India, Vietnam, and possibly Brazil.

In light of the global financial crisis, one of the specific issues that the administration asked the subcommittee to address was the potential impact of BIT provisions on the ability of governments to prevent and mitigate financial crises. Financial stability was one of the few areas in which a consensus recommendation was reached -- the subcommittee asked the administration to undertake a legal review of the prudential measures exception (Article 20 of the US Model BIT).[1] In most recent US treaties that exception states that parties to the treaty should "not be prevented from adopting or maintaining measures … to ensure the integrity and stability of the financial system." However, the paragraph ends with the following sentence: "Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party's commitments or obligations under this Treaty." Some on the subcommittee thought the language was vague and in need of clarification. Others echoed the concerns of legal scholars who argue that the sentences were self-canceling and in need of deletion.[2] Given the high degree of contention among committee members, the report includes an annex in which individual members or subgroups provided additional arguments. A group of sub-committee members (that included myself) recommended that the administration conduct a legal review of the potential that any of the measures implemented or under consideration in response to the financial crisis might be inconsistent with the 2004 Model BIT, and made three specific recommendations that should be implemented by the US in a revised Model BIT:

1. Codify the State Department's position in Glamis Gold Ltd. v. United States regarding the standard of proof for identifying principles of customary international law and the minimum standard of treatment.

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[*] The author wishes to thank Stephen Canner, Thea Lee and Theodore Posner for their helpful comments on this chapter, which was first published as a *Perspective* on February 23, 2010.

[1] Advisory Committee on International Economic Policy, *Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment Treaty* (September 2009). Available at: http://www.state.gov/e/eeb/rls/othr/2009/131098.htm (see annexes for individual comments).

[2] See Congressional testimony by Georgetown Law Professor Robert Stumberg: http://waysandmeans.house.gov/Hearings/Testimony.aspx?TID=2163.

Financial bailout measures, or future preventative measures that create "too big too fail" regulations, could be challenged under the 2004 BIT on the grounds that they deny a foreign investor's right to fair and equitable treatment and a minimum standard of treatment. Indeed, a Dutch subsidiary of a Japanese bank recently argued that the Czech Republic had violated its rights by extending its bailout program only to "too big to fail" Czech banks, excluding a small bank in which the Dutch subsidiary had invested.[3] In addition to ensuring that the prudential exception is broad enough, codifying the *Glamis* position, which prevailed with a narrow interpretation of customary international law and minimum standard of treatment, will set a better standard for preventing and mitigating crises.

2. Include a safeguard provision for balance-of-payments crises that is not subject to investor-state dispute settlement.

US investment treaties essentially force nations to liberalize their capital accounts, regardless of their institutional capacity -- or be prepared literally to pay the consequences. This stands in stark contrast with economic science and most other global treaties. Ayhan Kose of the IMF, Eswar Prasad of Cornell University and Ashley Taylor of the World Bank confirm that capital account liberalization is not correlated with economic growth in developing countries. These authors expand such findings to show that capital account liberalization only works for those nations above a certain threshold of economic and institutional development.[4] Capital controls have been shown to be an effective measure to prevent or mitigate a crisis and such a safeguard mechanism leaving governments room to impose capital controls under certain circumstances can be found in virtually every other form of international economic law, such as the WTO, OECD codes (and the draft MAI), and the BITs of most other capital exporting nations.

3. Exclude "sovereign debt" from "definitions" of an investment.

The US Model BIT does not explicitly exclude sovereign debt from the definition of covered investments, as NAFTA does. It should. The US government is the largest issuer of sovereign debt, and countries across the world have taken on much debt to get out of the financial crises and could risk default. As noted in the full subcommittee report, the IMF and others have raised concerns that efforts to restructure sovereign debt may give rise to investor-state claims. New model investment provisions should not obstruct global efforts to set up adequate facilities for sovereign debt restructuring that could be undermined if bondholders are able to circumvent such mechanisms by filing claims under BITs. At minimum, the model BIT should codify US-Peru FTA-like provisions that limit an investor's ability to bring an investor-state claim based on a debt

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[3] See Saluka Investments BV v. The Czech Republic, UNCITRAL, Award (March 17, 2006), available at: http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf.

[4] See Ayhan Kose, Answar Prasad and Ashley Taylor, "Thresholds in the process of international financial integration," NBER Working Paper No. 14916 (April 2009). Available at: http://www.nber.org/papers/w14916.pdf

restructuring where holders of 75% or more of the outstanding debt have agreed to the restructuring.

Ensuring that the US model is in tune with global efforts to prevent and mitigate financial crises benefits both the US and its investment partners. Making sure that ample prudential exceptions exist can buffer the US from liabilities for prudential regulations. What's more, stability among our investment partners helps US investors and exporters have more certainty for markets. Crises could lead to defaults and large losses to US assets and export markets. And, crises can cause contagion that spreads to other US investment and export destinations. Trade and investment treaties should not prevail over regulations for financial stability in the US and abroad.

Chapter 64

The new Dutch sandwich: The issue of treaty abuse

George Kahale, III[*]

Years ago, international tax lawyers introduced us to the term "Dutch sandwich." The concept was to sandwich a Dutch company between an investor from country A and its investment in country B. The combination of the extensive network of Dutch tax treaties and investor-friendly domestic Dutch tax law meant that country A's investor could reduce withholding tax on dividends out of country B and perhaps eliminate capital gains tax altogether by structuring its investment through a Dutch company.

A different type of Dutch sandwich has emerged over the past fifteen years, this time not related to taxes. It is the product of the extensive network of Dutch bilateral investment treaties (BITs). Companies from all over the world having little if anything to do with The Netherlands seek to acquire Dutch nationality to take advantage of the protections offered by Dutch BITs.

This type of nationality planning has been championed by many in the field of investor-state arbitration, but it is giving BITs a bad name. It does not take much to form a Dutch company. No real offices or employees are necessary, and visiting the country is optional. The benefits sought are not only the substantive treaty protections, but access to ICSID, the forum for dispute settlement specified in most Dutch BITs.

Many states on the receiving end of foreign investment are getting upset at what they see as treaty abuse. They are reexamining treaties they entered into over the past twenty years, often without appreciation of the consequences. There are a number of reasons for this, not the least of which is the expansive interpretation given by some tribunals to terms such as "fair and equitable treatment."[1] But the issue of who gets in the door is an obvious source of annoyance to those who never imagined that a treaty with one country could open the gates to potentially a whole world of investors.

The subject of treaty abuse has received heightened attention recently due to a number of cases involving the restructuring, rather than the structuring, of investments. Restructuring can take place for any number of legitimate business reasons, but often it is done simply for the purpose of moving into a treaty jurisdiction and gaining access to ICSID. The effectiveness of restructuring to achieve that goal becomes most questionable when its timing indicates that it was done in anticipation of litigation.[2] The basic issue is whether there are any limits to the ability to restructure into a treaty jurisdiction or, put another way, whether there is such a thing as treaty abuse. Decisions such as *Phoenix*

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[*] The author wishes to Alejandro Faya Rodriguez, Matthew Skinner and Felix Alberto Vega Borrego for their helpful comments on this chapter, which was first published as a *Perspective* on October 10, 2011.

[1] See "Public statement on the international investment regime," August 31, 2010, available at: www.osgoode.yorku.ca.

[2] See Zachary Douglas, *The International Law of Investment Claims* (Cambridge: Cambridge University Press, 2009), at 551.

Action Ltd. v. Czech Republic[3] and *Mobil Corp. v. The Bolivarian Republic of Venezuela* indicate that there is.[4]

Although several tribunals prior to *Phoenix* had discussed the circumstances that might constitute treaty abuse, the issue gained momentum with *Phoenix*, where the tribunal dealt with an intra-family transaction apparently intended to shift an investment into a treaty jurisdiction in the midst of a dispute with the host state. The tribunal rejected that maneuver, using strong language to underscore the need to guard against abuse of the ICSID system:

> The Tribunal is concerned here with the international principle of good faith as applied to the international arbitration mechanism of ICSID. The Tribunal has to prevent an abuse of the system of international investment protection under the ICSID Convention, in ensuring that only investments that are made in compliance with the international principle of good faith and do not attempt to misuse the system are protected. . . . It is the duty of the Tribunal not to protect such an abusive manipulation of the system of international investment protection under the ICSID Convention and the BITs. [5]

The *Mobil* tribunal quoted language from *Phoenix* in holding that transfers into a treaty jurisdiction did not confer ICSID jurisdiction over pending disputes.[6]

These decisions have already been the subject of much discussion in the international arbitration community, but there is more to come. Other tribunals will soon have the opportunity to define further the concept of treaty abuse, undoubtedly generating more commentary and controversy on what has become a hot issue in investor-state arbitration. In the future, the issue of treaty abuse may be addressed in the terms of new BITs (assuming that BITs continue to proliferate), but in the meantime tribunals will have to work out for themselves the limits of restructuring into treaty jurisdictions. Merely satisfying the technical requirements of nationality at the time of filing a request for arbitration does not suffice under the *Phoenix* and *Mobil* formulations, and it should not.

[3] Phoenix Action Ltd. v. Czech Republic, ICSID Case No. ARB/06/5, *award* (April 15, 2009).
[4] Mobil Corporation and others v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/07/27, *decision on jurisdiction* (June 10, 2010).
[5] Phoenix Action Ltd. v. Czech Republic, op. cit., at 113 and 144 (internal citation omitted).
[6] Mobil Corporation and others v. Bolivarian Republic of Venezuela, op. cit., at 205.

Chapter 65

International investment law and media disputes: A complement to WTO law

Luke Eric Peterson[*]

The recent high-stakes dispute between Google and China over censorship and cyber-security has spawned renewed discussion of the international trade law protections that Internet and media companies may enjoy.[1] Less recognized, however, is a perhaps more powerful legal tool in the arsenal of Internet and media companies engaging in cross-border investments, namely international investment law.[2]

A vast architecture of international treaties has been established to protect flows of FDI from discriminatory or arbitrary treatment, (uncompensated) expropriation, and other forms of mistreatment by host country governments. Legal disputes under these investment protection treaties are on the rise, with foreign investors often taking advantage of dispute settlement mechanisms that permit them to sue a host government for cash damages in case of alleged breach of treaty obligations. Moreover, a small but growing number of international arbitrations taking place between foreign investors and governments arise out of disputes over the treatment of media enterprises. These cases offer tantalizing hints as to the broad potential impact of investment protection treaties to advance freedom of expression and freedom of the media -- as well as some hints as to the limitations of these international investment pacts.

Uses of BITs by media organizations

Where media actors are wholly or partially foreign-owned, there may be scope to challenge a wide range of government actions as breaches of investment protection treaties. Such treaties provide specific legal protections for failure by the host state to compensate for direct or indirect expropriations or for breach of international investment law standards such as “fair & equitable treatment,” “full protection & security” or “national treatment.” Similar legal protections are also found in a growing number of Free Trade Agreements, including the North American FTA (NAFTA), Central American FTA (CAFTA) and numerous bilateral FTAs (including US-Peru and US-Singapore). While not directly aimed at the protection of expressive rights, those standards may protect foreigners and foreign-controlled organizations from government actions

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[1] “Clinton urges global response to internet attacks,” *New York Times*, January 22, 2010, at: http://www.nytimes.com/2010/01/22/world/asia/22diplo.html?emc=eta1.

[2] See, however, the work of Columbia University President Lee C. Bollinger for a discussion of the protections afforded by international human rights, trade and investment law. Lee C. Bollinger, *Uninhibited, Robust, and Wide-Open: a Free Press for a New Century* (New York: OUP, 2010).

designed to limit freedom of expression. For example, if a host state shuts down a foreign-controlled media company in reaction to the company's broadcasting of a speech by an opposition leader, a foreign owner might argue that these actions constitute expropriation or breach of other international investment law protections such as "fair and equitable treatment." Similarly, if a state refuses to provide a foreign-owned media operation with protection from a mob reacting violently to news reporting by that company, the foreign owners might argue that the state has breached its obligation to provide "full protection and security" to the investment. Foreign-owners of newspapers, radio stations, television outlets, and publishing houses have already begun to sue host countries on the international playing field for alleged mistreatment.[3] Although most of these disputes are commercially-oriented and relate to tax, licensing or regulatory matters,[4] others have touched on politically-motivated expropriations of media outlets during military coups or alleged discrimination against publishers who publish political opposition literature.[5]

Challenges and opportunities

The growing potential for media enterprises to rely on the protections of international investment treaties is likely to prompt debate as to the limits of such protections, and the discretion afforded to governments to regulate expression so as to uphold public morals, national security or other state interests. In a related vein, we may see further debate as to the relationship and overlap of investor protection law and human rights law. Already, international arbitrators have consulted human rights law for inspiration and guidance when dealing with certain investment disputes that touch upon questions of due process or denial of justice. It seems likely that, as arbitrators are asked to grapple with disputes arising out of alleged censorship or crack-downs on the media, they may look at how such matters are handled by human rights courts, and perhaps national courts such as the Supreme Court of the United States, even if the rulings of such bodies are not decisive for international arbitrators. In particular, arbitrators may look for guidance to the approach of human rights adjudicators with respect to permissible limits on freedom of expression, for reasons of national security, public safety or other considerations. While not strictly binding in the context of investment treaty disputes, human rights law may provide useful analogies or insights.

[3] Newspapers: Victor Pey Casado and President Allende Foundation v. Republic of Chile, ICSID Case No. ARB/98/2, (September 25, 2001); Radio: Joseph C. Lemire v. Ukraine, ICSID Case No. ARB/06/18, (September 18, 2000); Television: CME v. Czech Republic, UNCITRAL, (September 13, 2001), Ronald Lauder v. Czech Republic, UNCITRAL, (September 13, 2001), and European Media Ventures v. Czech Republic, UNCITRAL, (July 8, 2009); Publishing: Tokios Tokeles v. Ukraine, ICSID Case No. ARB/02/18, (July 26, 2007).

[4] Media licensing disputes under investment treaties can bear close resemblance to claims lodged under human rights adjudicative mechanisms. Compare, the investment treaty arbitration, Joseph Charles Lemire v. Ukraine, where Ukraine was held liable for certain breaches in relation to its handling of radio licensing applications, and an ECHR case where similar broadcast licensing actions were framed as breaches of human rights law: Meltex Ltd and Mesrop Movsesyan v. Armenia, Application No. 32283/04, Judgment (June 17, 2008).

[5] See Pey Casado v. Chile and Tokios Tokeles v. Ukraine, op. cit.

Although there are clear signs that media organizations may enjoy some protection under international investment treaties, these agreements are not a panacea for the range of challenges posed to freedom of expression. Not only are the protections of such treaties limited to *foreign* investors, the structure of such agreements -- including the provision of costly international arbitration -- mean that they are of most use in disputes where large sums of money are at stake.[6]

Indeed, in an unfortunate twist, arbitration of disputes between media companies and governments can sometimes play out in confidence -- away from the prying eyes of journalists and the public -- thanks to the confidentiality that is the default position under certain arbitration rules. Thus, whatever its potential value to media enterprises, it should be noted that the international law protecting foreign investment could have broader impacts upon freedom of expression that need to be closely monitored. Foreign investments outside of the media sector, particularly in extractives or energy sectors, can be controversial and lead to serious conflict, particularly in developing countries. MNEs sometimes bring pressure to bear upon host countries to crack down on local activists or campaigners. At times, foreign investors may argue that governments are legally obliged to provide "full protection and security" against local critics or campaigners. In such cases, arbitrators will need to ensure that the security-interests of foreign-owned investments are not permitted to undermine basic norms of free dissent and expression.

Conclusion

There are growing signs that investment treaty protections -- while rarely discussed in media or human rights law circles -- may be surprisingly useful in some cases of repression or censorship of foreign-owned media. While there is growing debate as to the uses of World Trade Organization agreements to combat certain forms of state repression of media actors, less attention has been paid to the potential of international investment law to combat certain forms of state censorship and repression. With the US Department of State now signaling that Internet freedom should be advanced through US foreign policy, it remains to be seen whether the US negotiating position on international investment treaties will shift so as to embrace this foreign policy objective. Ongoing investment treaty talks between the US and China could provide the obvious forum for this issue to be raised and debated.

[6] While effective as a bulwark against expropriation or arbitrary license cancellations, these international investment agreements may offer less value in situations where media repression is targeted at particular journalists or their reporting methods. See for example the recent battle at the ECHR between the *Financial Times* and the United Kingdom over the protection of confidential journalist sources, which appears to be a battle over a principle, rather than over large sums of damages incurred by the media organization.

Chapter 66

Is a model EU BIT possible -- or even desirable?

Armand de Mestral C.M.[*]

The Treaty on the Functioning of the European Union (TFEU), which entered into force on December 1, 2009, extends the Common Commercial Policy (CCP) articles 206 and 207 to embrace "foreign direct investment." This raises the question of whether the EU is now in a position to adopt a model BIT articulating a common policy on FDI. An EU policy on FDI could replace the disparate efforts of the 27 member states, complementing and reinforcing their efforts and presenting a stronger image to the world, especially at a time when the EU appears to have lost ground to other jurisdictions as a preferred destination for FDI.[1]

Suggesting the preparation of an EU model BIT for treaty relations with third states assumes that the EU is empowered to do so and has the competence to negotiate and ultimately to implement any such agreement. However, despite the expansion of the CCP to include FDI, there remain many doubts as to the capacity of the EU to embark on such a course alone. The obstacles are at once political (the reluctance of member states to abandon their authority here) and legal (the limited competence under the CCP to regulate the internal market). In this context, three models can be envisaged: (1) a BIT binding all EU member states and concluded by the EU alone; (2) a BIT concluded as a mixed agreement (signed by both the EU and each member state); or (3) a BIT relating to EU action alone. Given the circumstances, the negotiation and implementation of a model BIT may only be possible as a mixed agreement with the willing concurrence of member states.

EU competence over the CCP is exclusive, which has led some to suggest that member states must cease to negotiate BITs now that TFEU articles 206 and 207 are in place.[2] However, it is by no means clear what the new CCP competence embraces. The CCP has been read by the European Court of Justice to focus essentially outward, seemingly giving the EU authority to set the conditions for admission of foreign investment into the internal market, including the types of FDI and investors allowed and the conditions at the point of entry. But it is not clear that the CCP covers regulation of the standards of treatment of FDI in the internal market, as well as guarantees against performance requirements and expropriation. The TFEU does not define "foreign direct investment," and the definition seems to exclude portfolio investment. It is also uncertain that the EU

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[*] The author wishes to thank Marc Bungenberg, Jan Winter, Joern Griebel, and Thomas Eilmansberger for their helpful comments on this chapter, which was first published as a *Perspective* on March 24, 2010.

[1] See chapter 9 above, José Guimón, "It's time for an EU investment promotion agency."

[2] Marc Bungenberg, "The politics of the European Union`s investment treaty making," in Tomer Broude, Marc L. Busch and Amy Porges, eds., *The Politics of International Economic Law* (Cambridge University Press, 2011), at 17, working paper available at: http://www.asil.org/files/ielconferencepapers/bungenberg.pdf; Christian Tietje, "Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon," *Beiträge zum Transnationalen Wirtschaftsrecht*, vol. 83 (2009), p. 19.

could commit to all forms of investor state arbitration. Certainly it could not commit to ICSID procedures, as it is not a state. A further complication, which it shares with several federal states, is that it may not be able to recover the damages that it might be condemned to pay on behalf of member states' peccadilloes.

Given these limitations, a unilateral EU BIT would not be the equivalent of the standard BITs between member states and third states: hardly an attractive negotiating position from which to start. Further questions remain: Would an EU BIT protect only against EU action or against the acts of all member states? If MFN and national treatment are offered, what will be the comparator -- the EU or member states' action? Would the EU seek to renegotiate the hundreds of BITs with third states? If this were attempted, there are many pitfalls in renegotiating BITs, at least with those countries that are already actively seeking to get out of their existing BIT obligations. In this regard it should be noted that hundreds of "outdated" air transport bilateral agreements still remain in place due to inertia and the difficulties of renegotiation.

A related legal issue is posed by the 191 existing BITs between member states. Are they to disappear as did air transport bilateral agreements when EU competence over air transportation was exercised after 1989? So far, only the Czech Republic is willing to abandon its intra-EU BITs -- perhaps because it has been an unsuccessful respondent in several investor-state claims?

One should note that there is already a partial model EU BIT: the *Minimum Platform for Investment for the EU FTAs.* This is a curious document prepared by the Directorate General for Trade in 2006,[3] focused primarily on establishment and trade in financial services providing investment services. It provides guidance to negotiators of EU trade agreements who may have a mandate to include provisions related to investment. It does not read like a standard BIT, and it would have to be considerably amended and expanded to serve as a genuine model BIT.

Surely a common legal standard regulating FDI in the EU is an eminently sensible goal: it would replace 27 competing jurisdictions with one high standard of protection; it would allow the EU to present a common face to the world on FDI issues; and it would serve as a powerful incentive to promoting global standards. But it would be foolish to minimize the obstacles that lie in the path of this laudable goal.

[3] Council of the EU, Brussels 6 March 2009, 7242/09, Limited; first issued as *Minimum platform on investment for EU FTAs – Provision on establishment in template for a Title on "Establishment, trade in services and e-commerce,"* Note to The 133 Committee, European Commission DG Trade, Brussels, 28 July 2006, D (2006) 9219. It must be noted that this document, although available on several NGO websites, has never been officially issued. Requests under freedom of information have been denied.

Chapter 67

International investment arbitration: Winning, losing and why

Susan D. Franck[*]

We know several things about foreign investment. First, foreign investment matters, reaching US$ 1.7 trillion in 2008. Second, we know that foreign investors have new international law rights to protect their economic interests. Third, we know that those rights are now being used. So since we now know that the international legal risk is not illusory, the real questions are: who wins, who loses and why? While various commentators have asserted a variety of answers to those questions, many have done so without reference to valid and reliable data.[1] In its most benign form, these observations create misinformation, but perhaps more troublingly, might also lead to policy choices based upon unrepresentative anecdotal evidence, supposition or political rhetoric. To help alleviate these possible outcomes, this Chapter reviews recent empirical research[2] in order to provide basic information to fundamental questions about investment treaty arbitration (ITA) to create a more accurate framework for policy choices and dispute-resolution strategies.

So who does win and lose international investment treaty arbitration? The answer is: both foreign investors and host states win and lose.[3] The data suggest, however, that they lose in reasonably equivalent proportions. Not including the disputes that ended with an award embodying a settlement, respondent governments, for example, won approximately 58% of the time. Meanwhile, investors won 39% of the cases.[4]

Winning and losing, however, is not just about whether there is a breach of the underlying investment treaty. The amount awarded is also critical. Despite the fact that

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[1] See, e.g., Press Release, Food and water watch, World Bank court grants power to corporations (April 30, 2007), available at: http://www.foodandwaterwatch.org/press/releases/world-bank-court-grants-power-to-corporations-article12302007.

[2] See Susan D. Franck, "Empirically evaluating claims about investment treaty arbitration," *North Carolina Law Review*, vol. 86 (2007) 1, pp. 16-23 [hereinafter *Evaluating Claims*] (describing the method of gathering data from publicly available arbitration award to identify 102 public awards from 82 disputes that resulted in 52 final determinations); Susan D. Franck, "Development and outcomes of investment arbitration awards," *Harvard International Law Review*, vol. 50 (2009) 2, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1406714 [hereinafter *Development and Outcomes*] (conducting chi-square and analyses of variance tests at significance levels of $\alpha = .05$).

[3] This Chapter defines "winning" and "losing" using quantitative measures: (a) a binary yes/no answer about whether a government breached a treaty, or (b) a scaled quantitative variable of damages awarded. Qualitative approaches might assess experiences with ITA and measure "success" differently. Subjective approaches could consider how parties, with varying levels of familiarity with ITA, and other situational differences understand success.

[4] Approximately 4% of the cases were settlement agreements. Figures do not add up to 100% due to rounding.

investors claimed US$ 343 million in damages on average, that is not what they received. Rather, tribunals awarded investors only US$ 10 million on average. This US$ 333 million difference is not insubstantial, and it may give investors a basis for some reflection about the value of arbitration -- particularly given the need to pay the arbitral tribunal and the other legal costs associated with bringing a claim.[5]

Knowing which parties actually win and lose begs a further question -- namely: why are parties successful? This question is critical given suggestions that ITA is potentially biased.[6] There has been some debate about whether respondents' development status or whether arbitrators come from the developing world improperly affects outcome. If these development variables cause particular results, this would raise issues about the integrity of investment treaties and arbitration.

To address this critical issue, recent research considered whether there was a reliable statistical link between the level of development and ITA outcomes. The results suggest that development variables did not generally cause particular outcomes. One study found that there was no relationship between a government's level of development and the outcome of ITA.[7] A second study then showed that -- at a general level -- outcome was not reliably associated with the development status of the respondent, the development status of the presiding arbitrator, or some interaction between those two variables. This held true for both: (1) winning or losing investment treaty arbitration, and (2) amounts tribunals awarded against governments. Follow-up tests in the same study showed, however, that there were two statistically significant effects -- found in one sub-set of potentially non-representative cases -- that suggest arbitration must be used carefully in certain situations. Only where the presiding arbitrator was from a middle income country, the data showed that high income countries received statistically lower awards than: (1) upper-middle income respondents, and (2) low income respondents. Nevertheless, in other circumstances involving middle income presiding arbitrators or all cases involving presiding arbitrators from high-income countries, the amounts awarded were statistically equivalent.[8] In other words, in limited circumstances, tribunals with presiding arbitrators from middle-income countries made awards that tended to favor developed countries and were different than one might expect from chance alone.

The overall results cast doubt on the arguments that: (1) ITA is the equivalent of tossing a two-headed coin to decide disputes, (2) the developing world is treated unfairly in ITA,

[5] Franck, *Empirically Evaluating Claims*, op. cit., pp. 49-50, 64.
[6] See e.g., Third World Network, *Finance: Bias Seen in International Dispute Arbiters*, June 22, 2007 (JUN07/02), available at: http://www.twnside.org.sg/title2/finance/twninfofinance060702.htm ("A little-known entity closely affiliated with the World Bank that mediates disputes between sovereign nations and foreign investors appears to be skewed toward corporations in Northern countries"); Gus Van Harten and Martin Loughlin, "Investment treaty arbitration as a species of global administrative law," *European Journal of International Law*, vol. 17 (2006). ("No matter how well arbitrators do their job, an award will always be open to an apprehension of an institutional bias against the respondent state").
[7] Susan D. Franck, "Considering recalibration of international investment agreements: Empirical insights," in José E. Alvarez, Karl P. Sauvant and Kamil Gerard Ahmed, eds., *The Evolving International Investment Regime: Expectations, Realities, Options* (New York: OUP, 2009).
[8] Franck, *Development and Outcomes*, op. cit.

and (3) arbitrators from the developed and developing world decide cases differently. The evidence creates a basis for cautious optimism about the integrity of ITA and suggests radical overhaul, rejection or rebalancing of these procedural rights is not necessarily warranted. While the follow-up tests and limitations of the data suggest optimism must be tempered properly, a sensible approach would involve creating targeted solutions to address particularized problems and enacting targeted reforms to redress perceived concerns about the international investment regime.

Ultimately, the data suggest that investors and governments won and lost in relatively equal measure, but governments won a bit more. While the data show also that, when they did win, investors ended up with substantially less than they requested. Moreover, the data do not establish that a respondent's development status was a reason why investors or governments were successful in pursuing arbitration. This suggests that why a party wins or loses arbitration may ultimately have more to do with factors other than development, such as the merits of a particular claim or defense. Other factors may also be linked with outcome, such as the business sector involved, the amounts claimed or the type of host state government, but they may not necessarily cause particular results. This suggests that although there are risks in pursing arbitration, there will be times when it is warranted and, ultimately, parties should think carefully about why arbitration is in their interests.

Chapter 68

Thinking twice about a gold rush: *Pacific Rim v El Salvador*

Gus Van Harten[*]

Whether it concerns oil drilling or gold mining, sometimes a government, facing new circumstances, must change its mind. This reality creates a tension in law between encouraging stability and allowing adaptation to new information and new situations. The "gold rush" CAFTA lawsuits against El Salvador reveal this tension.

Pacific Rim, a Canadian-based mining firm, has brought one of two gold mining lawsuits against El Salvador under CAFTA.[1] Since the early 2000s, Pacific Rim has spent money looking for gold in El Salvador. It did so under exploration (but notably not exploitation) licences that were issued in 1996 and that Pacific Rim acquired in 2002. A few years later, after Pacific Rim decided where it wanted to dig, the government had adopted a more cautious position on gold mining. So, Pacific Rim has invoked its privilege -- uniquely available to foreign investors under international law, via investment treaties -- to sue El Salvador. It argues that the government should have allowed it to mine for gold; the government responds that Pacific Rim failed to satisfy steps in the approvals process, including an acceptable environmental assessment. Pacific Rim seeks at least US$ 77 million for its costs and hoped-for profits.

El Salvador is a small, poor country with precariously few water resources. It lost 20% of its surface water in the past 20 years, and 95% of the rest is reportedly contaminated.[2] Industrial gold mining is a recent prospect for the country, and there are serious concerns about the risks it poses to people's health and livelihoods, especially their access to clean water.

How should the tension here between stability and change be resolved?

On the one hand, it seems unfair that a company that put money into exploration should be frustrated when applying for permission to exploit what it has found. On the other hand, all mining companies must be aware that a government might change its approach over time to health and environmental risks of mining. If taxpayers had to compensate everyone who lost out in bets on the social or environmental feasibility of a project, this would disadvantage those who are more prudent, patient, or environmentally conscious. The question of how the arbitrators in PacRim Cayman LLC v. El Salvador might resolve

[*] The author wishes to thank three anonymous reviewers for their helpful comments on this chapter, which was first published as a *Perspective* on May 24, 2010.

[1] The second lawsuit is by US-based Commerce Group Corporation. I focus on the Pacific Rim case here because there is more information publicly available about it.

[2] Richard Steiner, "El Salvador: gold, guns, and choice," Report for the International Union for the Conservation of Nature and the Commission on Environmental, Economic, and Social Policy (February 2010).

this tension is challenging to answer. Although not the fault of the arbitrators, it raises some important concerns.

First, under CAFTA and other investment treaties, the constraints put on governments are both exceptionally potent and highly malleable. This makes it very important, and yet very difficult, to assess the legal standards that will apply in particular cases. In numerous awards to date, tribunals have interpreted provisions on expropriation, national treatment and fair and equitable treatment in starkly divergent ways. In turn, they have fuelled high-stakes uncertainty in the evaluation of policy space and litigation risk.

Second, investment treaties rely on the remedy of damages in cases often stemming from difficult judgment calls by governments in complex areas of policy. This can put arbitrators in a bind. Do they order a state to pay damages after finding that it violated an unclear rule? Or do they dismiss the claim, leaving the investor reeling after a long, expensive arbitration? Compared to other forms of public law judging, the system gives few options to respond to government conduct that is characterized, well after the fact, as unlawful.

Third, the use of arbitrators instead of judges to decide basic tensions in public policy makes it essential that the process be credible and independent. However, investment treaty arbitration lacks key safeguards of independence that apply to courts, including security of tenure, an objective method of assigning judges to specific cases, and checks on income-earning activities outside of the judicial role.

This invites unsavoury questions. What are the business interests of the arbitrators chosen to decide a case? With whom might they have a common outlook at the International Chamber of Commerce, ICSID and others that wield key powers over arbitrator appointments? By allowing the arbitration industry to make final decisions in matters of public law, investment treaties remove longstanding safeguards that protect judges from economic and financial entanglement and that ensure public confidence in the courts.

How should governments respond? One option is to re-introduce a mediating role for domestic courts, including perhaps the courts of neutral states not involved in a specific dispute. Another is to look for ways to re-introduce safeguards of judicial independence, such as by designating a roster of eminent jurists, drawn from outside the commercial arbitration industry, from which arbitrators would be chosen.

On the rules, governments could clarify that investment treaties are designed to offer an exceptional remedy in cases of serious abuse or targeted discrimination against a foreign investor, but not a wide-ranging opportunity to challenge general laws and policies. Nearly all government measures harm some people while helping others, not because this is the aim of the regulation but because all general decisions, by definition, have ripple effects across the economy and society. Requiring public compensation for those foreign investors who are “harmed” by a general measure skews markets, as well as regulation, by inappropriately privileging one group of private interests over all others.

There are various ways to address the lack of independence, fairness and coherence in investment treaty arbitration. But the root questions are familiar. How should the tension in law between stability and change be resolved, and by whom?

Chapter 69

Mining for facts: *PacRim Cayman LLC v El Salvador*

Alexandre de Gramont[*]

In the above chapter, Professor Gus Van Harten uses the *PacRim v. El Salvador* arbitration, pending at the International Centre for Settlement of Investment Disputes (ICSID), as the basis for asserting a number of criticisms against the overall system of arbitration under investment treaties.

The problem is that Van Harten has embraced a version of the facts that is very similar to that promulgated by the Government of El Salvador (GOES), without even acknowledging the allegations made by PacRim. The one-sided presentation of the facts contributes, in part, to a critique of the system that is off-target.

I must disclose that I serve as counsel for the claimant in the *PacRim* case. Given that Van Harten has effectively presented only El Salvador's side of the case, I will briefly present the claimant's side here. The juxtaposition of PacRim's version of the facts against El Salvador's helps demonstrate why the issues posed by these cases are often more complex than presented in the above Chapter -- and why a neutral, independent system to resolve these disputes is so important.

Van Harten's premise is that GOES had to act against PacRim because of environmental concerns that GOES did not previously recognize when it invited PacRim to invest in the country, and when GOES enacted the mining and environmental laws under which PacRim carried out its activities in El Salvador. According to Van Harten, the issue is simply whether and how an investor should be given redress when a government has acted reasonably to safeguard its environment. But according to PacRim, GOES did not act reasonably, rationally or fairly. PacRim's project would have set new standards for environmentally clean gold mining in the Americas.

PacRim -- led by a group of geologists who are dedicated to green mining and sustainable development -- searched throughout Latin America before choosing this location in El Salvador. PacRim chose the site in large part because its geology allows for extremely clean, underground mining, with very limited surface disturbance and virtually no possibility of ground water contamination. The project would easily meet the regulatory requirements of any developed country where gold is mined (including, for example, Sweden, Canada, and the United States), while also bringing enormous economic benefits to an especially impoverished region of an already poor country.

But El Salvador's regulators never ruled on PacRim's application. Nor have any of the laws and regulations under which PacRim invested in El Salvador been changed. Rather,

[*] The author wishes to thank Todd Arena, Jan Paulsson and Gus Van Harten for their helpful comments on this chapter, which was first published as a *Perspective* on September 8, 2010.

in the midst of a difficult election campaign, then-President Saca -- attempting to outflank his opposition on the left -- announced that his administration would not grant any more mining permits. The only "changed circumstances" here involve a highly-charged political situation, where wildly inaccurate information and accusations against PacRim have made any rational, informed or balanced discussion of the issue impossible. The real question posed by these circumstance is: in what forum are both sides most likely to receive a fair, neutral and objective hearing on their respective cases?

Van Harten is critical of the system's use of independent arbitrators. He suggests that it would be better for government appointed judges to hear these cases, or that it would be preferable to select arbitrators from "a roster of eminent jurists, drawn from outside the commercial arbitration industry." But governments like El Salvador's agreed to have these cases heard by independent arbitrators, who are not selected by states or governmental organizations, to remove any appearance of governmental influence or pro-government bias.

Van Harten's suggestion that the "business interests" of the independent arbitrators who hear these cases are unknown -- possibly raising conflicts of interest -- is inaccurate. Each side typically picks an arbitrator, and the chair is usually appointed upon agreement of the parties. The arbitrators and their backgrounds are well known to the parties. Indeed, the parties and lawyers who use the system have effectively created a *de facto* list of arbitrators with significant experience in these cases. It includes former judges and government officials, law professors and private lawyers. In the *PacRim* case, the three arbitrators (an Argentine lawyer, a French law professor and an English barrister) not only have diverse backgrounds; they have collectively served as arbitrators in over twenty investor-state cases.

While Van Harten is correct that there have been some inconsistent and contrary rulings issued by tribunals in these cases, the same is true for virtually any court and any legal system. For the most part, the arbitrators are acutely aware of their obligation to create a consistent, transparent and predictable body of investment laws. Van Harten is also correct that there is room for improvement. But much has been accomplished and improved in a system that was hardly used ten years ago. The drafters of CAFTA (which, along with El Salvador's Investment Law, provides the basis for PacRim's claims) and other so-called "new generation" treaties have attempted to address various critiques of earlier treaties. Among other things, CAFTA provides for great transparency, in which all of the pleadings and briefs, as well as the hearing, are public. In *PacRim*, the hearings have been broadcast live via the Internet (and can still be watched on ICSID's website). It is difficult to envision a better way to resolve the factual (and legal) dispute between PacRim and El Salvador -- and perhaps to improve the system through a candid, open and balanced debate concerning both its strengths and weaknesses.

Chapter 70

The public law challenge: Killing or rethinking international investment law?

Stephan W. Schill[*]

At the heart of the so-called "legitimacy crisis" of international investment law, prominently reflected in the *Public Statement on the International Investment Regime*,[1] is what I call the public law challenge. It builds on the observation that one-off appointed arbitrators, instead of standing courts, review government acts and reach far into the sphere of domestic public law by crafting and refining the standards governing investor-state relations. Arbitrations against Uruguay and Australia concerning cigarette packaging are the most recent examples of genuinely public law disputes now settled in arbitration. The disputes about Argentina's emergency legislation and Canada's ban on pesticides are others. These arbitrations create friction with domestic public law as arbitrators, having little democratic legitimacy, often operate in non-transparent proceedings and produce increasing amounts of incoherent decisions.

Many domestic public lawyers, and also some international lawyers, therefore view investment treaty arbitration as a threat to public law values, such as democracy and the rule of law.[2] Comforted by the recent trend among states to recalibrate their investment treaty policies, or even to withdraw from the ICSID Convention, some demand a return to domestic law and domestic courts.[3] This, however, is not desirable when domestic systems do not offer sufficiently independent and effective protection against undue government interference. Notwithstanding, international investment law will continue to face calls for increased transparency and for leaving states sufficient policy space -- precisely because of the impact of investment treaties on domestic public law. Unless international investment law and investment arbitration allow public law values to thrive, the present system may succumb to the public law challenge. That is why international investment law should tackle this challenge by enculturating public law thinking.

We should thus explore how public law can help rethink rather than kill investment arbitration, namely by expanding public law thinking into international investment law.[4] Along these lines, investment treaty standards should be understood as standards of public law that can be further concretized by comparative law methods. Investment tribunals, in turn, should understand themselves as exercising a form of, albeit

[*] The author wishes to thank José Alvarez, Giorgio Sacerdoti, Michael Waibel and André von Walter for their helpful comments on this chapter, which was first published as a *Perspective* on January 30, 2012.

[1] "Public statement on the international investment regime," August 31, 2010, available at: http://www.osgoode.yorku.ca/public_statement.

[2] See Gus Van Harten, *Investment Treaty Arbitration and Public Law* (Oxford: OUP, 2007); David Schneiderman, *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (Cambridge: Cambridge University Press, 2008).

[3] See supra note 1.

[4] See Stephan Schill, ed., *International Investment Law and Comparative Public Law* (Oxford: OUP, 2010).

internationalized, judicial review, similar to that of administrative or constitutional courts, and as being engaged in public law adjudication rather than pure commercial arbitration. After all, investment arbitration is not only about settling individual disputes under the principle of party autonomy, but about implementing principles of good governance and the rule of law for international investment relations.

Given that the global nature of international investment law prohibits solutions tied to singular national laws, arbitral tribunals should draw on comparative public law, both domestic and international (for example, WTO law, human rights law, EU law), and on that basis develop general principles of public law applicable as a recognized source of international law.[5] This should promote the use of proportionality analysis to balance investors' rights and host states' regulatory interests, and help to relate investment law concepts, such as the protection of legitimate expectations, to principles of public law. Similarly, comparative public law can help rethink investment arbitration procedure, for example, by outlining appropriate public law standards of review, or by developing a convincing conceptual basis for transparency and third-party participation.[6] All this should reinject legitimacy into investment law by stressing parallels with domestic public law.

The utility of such an approach has already fallen on fertile ground in practice. The tribunals in *Total v. Argentina*[7] and *Lemire v. Ukraine*[8] interpreted the fair and equitable treatment standard by drawing on domestic and international public law. As these decisions show, comparative public law is a useful tool because traditional methods of treaty interpretation and recourse to customary law face limits in concretizing investment law principles for the modern regulatory state. Taking the public law challenge seriously, therefore, does not mean killing international investment law. What is needed is not so much institutional change of the present system nor a return to domestic law, but a change in the mindset of those active in the field. Arbitrators, to start with, should draw more extensively on comparative public law concepts when applying and refining investment treaty standards and should reconsider their own role, and their responsibilities, as public law adjudicators who have an impact not only on the dispute before them but on the entire system of international investment protection.

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[5] See Article 38(1)(c) of the Statute of the International Court of Justice.
[6] These issues, amongst others, are explored in the book referred to supra note 4.
[7] Total S.A. v. Argentina, ICSID Case No. ARB/04/1, *decision on liability* (December 27, 2010), at 111 and 128-134.
[8] Lemire v. Ukraine, ICSID Case No. ARB/06/18, *decision on jurisdiction and liability* (January 14, 2010), at 506.

Chapter 71

The pernicious institution of the party-appointed arbitrator

Hans Smit[*]

As arbitration has grown by leaps and bounds, so has the role of the party-appointed arbitrator. Surprisingly, this has not led to increased inquiry into the appropriateness of having arbitrators appointed by the parties in general, or in arbitrations against states in particular. In my judgment, party-appointed arbitrators should be banned unless their role as advocates for the party that appointed them is fully disclosed and accepted. Until this is done, arbitration can never meet its aspiration of providing dispassionate adjudication by those with special skills and experience in a process designed to combine efficiency with expertise.

The incentive of the party and its counsel is to appoint an arbitrator who will win the case for them. That incentive will be particularly strong when its case, on its merits, is not particularly strong. It may well be argued that it is a lawyer's duty to appoint someone who is most likely to obtain the best result for the client, regardless of whether, objectively, the law and the facts favor its case. Once selected, an arbitrator's personal incentive is to secure reemployment by providing his or her party with a favorable outcome. This is not necessarily bad. In US domestic arbitration, a party-appointed arbitrator is exactly that: an advocate on the panel. If that is clear, fully disclosed and accepted, it adds another option to the arbitral process. But in international arbitration, the party-appointed arbitrator is expected to be objective and impartial. I believe the reality is that many, if not most, of those party-appointed arbitrators respond to their personal incentives and become to a certain extent party advocates within a system that expects them to behave objectively. The subject of repeat arbitrators, irrespective of who appoints them, poses additional difficulties to the international arbitrations system that cannot be discussed in this short article.[1]

I believe true objectivity is possible only if all arbitrators are prepared to rule against the party that appointed them exactly as if they had been sitting as sole arbitrators. In my experience, that condition is not met in most cases. I have personally encountered this pressure. While I made clear to the lawyer who selected me that I would decide the case on its merits, I could not help feeling influenced by the knowledge that the lawyer who appointed me had done so because he had judged that that would best serve his client's interests. While Alexis Mourre argued that party-appointed arbitrators are selected for their reputation of impartiality,[2] I disagree. I believe that lawyers feel that their duty to

[*] The author wishes to thank Ed Kehoe, Jan Paulsson and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on December 14, 2010.

[1] For further discussion of repeat arbitrators see Fatima-Zahra Slaoui, "The rising issue of 'repeat arbitrators': a call for clarification," *Arbitration International*, vol. 25, no. 1 (2009), pp. 103-119.

[2] Alexis Mourre, "Are unilateral appointments defensible? On Jan Paulsson's moral hazard in international arbitration," *Kluwer Arbitration Blog*, Oct. 14, 2010, http://kluwerarbitrationblog.com/blog/2010/10/05/are-

advocate for their clients' interests takes precedence over institutional concerns.

Even if arbitrators are willing to rule against the party that appointed them, there are still ways in which they can influence the final outcome of a case to favor their party. For example, they may try to persuade the other panel members to reduce the award in favor of their party in return for joining them in a unanimous award. This compromise will ordinarily be attractive to the chair of the panel, for his or her reputation for obtaining unanimous awards may increase the likelihood of being appointed to future panels. Even if the award is not affected, the party-appointed arbitrator may bargain for not awarding counsel fees. The panel has a great deal of leeway in that regard, and party-appointed arbitrators may save the parties that appointed them a great deal of money by eliminating counsel fees or reducing the size of the awards.

It might be argued that these are relatively minor disadvantages, that there is virtually always reason for compromise and that this is an acceptable price to be paid. But it is not only untoward compromises that the institution of party-appointed arbitrators promotes. The presence of a partisan arbitrator on a panel will normally reduce, if not eliminate, the free exchange of ideas among the members of the panel. The chair will be less receptive to arguments that appear to be moved by partisan considerations or may join one of the arbitrators, with the result that the other party-appointed arbitrators feel excluded from the deliberations. The *Lauder* arbitration against the Czech Republic provides an excellent example of these dynamics. In that case, a party-appointed arbitrator stated that he had been excluded from the panel discussion. I believe it was the response of a party-appointed arbitrator to these structural incentives that caused one of the great failures of international arbitration, the *Multinovic* arbitration.

This conflation of personal and professional incentives is particularly inappropriate in international investment disputes, in which arbitral decisions can affect the state and its people. Decisions binding them should not be rendered by privately selected arbitrators, but by arbitrators selected by truly neutral institutions. The drafters of the ICSID Convention realized this by reserving for the ICSID Secretariat the power to appoint the members of the panels that review first-instance decisions. In my judgment, all arbitrators sitting in investment disputes should be appointed by a neutral institution; bilateral investment treaties should be amended to achieve this. International investment arbitration would thus set a potent example for general emulation in international arbitrations.

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unilateral-appointments-defensible-on-jan-paulsson%E2%80%99s-moral-hazard-in-international-arbitration/

Chapter 72

Is the party-appointed arbitrator a "pernicious institution"? A reply to Professor Hans Smit

Giorgio Sacerdoti[*]

Some readers of the *Columbia FDI Perspective* No. 33 of December 14, 2010 may have been surprised to read Hans Smit's contribution against party-appointed arbitrators. The opening of his *Perspective* could not be expressed in more sweeping terms: "In my judgment, party-appointed arbitrators should be banned unless their role as advocates for the party that appointed them is fully disclosed and accepted. Until this is done, arbitration can never meet its aspiration of providing dispassionate adjudication..."

Criticisms of the appointment of arbitrators by parties are not novel, but it is surprising to see them raised by such a highly regarded and senior member of the international arbitral community as Professor Smit. I consider his views too negative: appropriate safeguards exist to take care of his concerns. He considers that, while in international commercial arbitration party-appointed arbitrators are expected to be objective and impartial (and not become advocates of the parties appointing them, as he claims is the reality in the US), party-appointed arbitrators "respond to their personal incentives and become to a certain extent party advocates." I do not believe that the responsible, reputable lawyers available for such appointments are amenable to these temptations, especially considering the control that arbitral institutions exercise.

The first argument for retaining the current system is based on the very nature of arbitration that distinguishes this process from adjudication by permanent courts endowed with *ex-ante* jurisdiction on litigants.

By contrast, arbitration remits to the parties the choice of adjudicators. Internationally, this approach is even more attractive. Arbitration allows the parties to agree on such basic issues as applicable laws and jurisdiction, language and seat of the arbitration, avoiding hurdles that hamper the judicial solution of a transnational dispute and its enforcement. The ability to select arbitrators is prominent among the elements favoring arbitration as it reflects the expectations of the appointing party regarding nationality, language, cultural background, and legal and technical expertise. Acceptance of the ultimate result (the award) by the parties is enhanced by their trust in the arbitral process where consent -- including consent regarding the adjudicator -- replaces judicial authority. Various precautionary devices have been introduced, mostly through practice, to ensure that these advantages are not undermined by the parties' abuse of power.

The first such device is the general recognition that arbitrators are not agents of the parties appointing them but rather trustees who have to decide the dispute fairly,

[*] The author wishes to thank Emmanuel Gaillard, Loretta Malintoppi and Catherine Rogers for their helpful comments on this chapter, which was first published as a *Perspective* on April 15, 2011.

according to applicable substantive and procedural rules reflecting the common intention of the parties to resort to arbitration.

Secondly, the rules of arbitral institutions often provide for a monitoring of the selection of arbitrators by the parties. Local courts, or foreign courts under the New York Convention of 1958 where recognition is sought, are empowered to control whether basic rules of due process have been respected.

Thirdly, arbitration rules require that arbitrators be impartial and independent in general, including as regards party-appointed arbitrators toward the parties appointing them. Arbitration rules also require that arbitrators disclose situations giving rise to potential conflicts of interest. The IBA Guidelines on Conflict of Interest in International Arbitration of 2004 are intended to enhance standards as part of the development of uniform best practices. Their first General Principle states that "[e]very international arbitrator shall be impartial and independent of the parties at the time of accepting an appointment and shall remain so until the final award has been rendered."

Prof. Smit fears nonetheless that the lack of impartiality of a party-appointed arbitrator may unduly influence outcomes. Thus, in order to reach a unanimous award, a tribunal might incline toward the argument put forward by one of the parties without proper justification. Empirical evidence from the rejection of most disqualification requests confirms that the great majority of arbitrators are serious professionals who take care and pride in being independent and impartial. If a party-appointed arbitrator is biased he or she will end up in the minority. On the other hand, there is nothing wrong if such an arbitrator shares in good faith the position of the party who has made the appointment.

Finally, one has to consider the alternatives to the appointment of arbitrators by the parties. Who would systematically make all appointments? In *ad hoc* arbitration, the issue would have no easy solution. In administered arbitration, the task entrusted to the institution in charge of the process would be challenging. Lists would have to be kept, transparency requirements for the choices would become paramount and other types of influences and pressures might derail the fairness of the process. More decisively, international commercial arbitration would lose one of its fundamental features, becoming a kind of international quasi-judicial mechanism. Such a system could not be compelled on parties that could migrate to institutions more deferent to their choices.

As to investment arbitration, Prof. Smit's argument that arbitral decisions that can affect the State and its people "should not be rendered by privately selected arbitrators but by arbitrators selected by truly neutral institutions" carries more weight. In selecting an arbitrator in such disputes, parties may wish to look more closely at the general profiles of candidates and at their positions on relevant issues. To avoid a "conflation of personal and professional incentives" in investment arbitration that institutions can detect, it has been suggested that advocates be barred from acting as arbitrators.

So, on balance, let's not throw the baby out with the bath water!

Chapter 73

Starting anew in international investment law

M Sornarajah[*]

The legitimacy of investment arbitration becomes increasingly questioned, with liberal states like Australia moving away from the regime. Defenders seek to ensure the survival of this regime of asymmetric investment protection, using a variety of techniques. The conservation of the gains of property protection has resulted in novel arguments relating to the existence of a global administrative law and standards of global governance.[1] These arguments seek to preserve an approach associated with the failure of market fundamentalism and global economic crises. As long as the inequity contained in regulatory restraints of the system affected only the powerless states, it operated with vigor; but with powerful states feeling the effects of regulatory restraints of investment treaties, there has been movement away from the earlier premises of the established regime.

The idea that international investment agreements (IIAs) had brought about a standard of governance began to recede when the United States, the proponent of strong standards of investment protection, began to retreat, in its own model treaty, by providing that regulatory expropriations are not compensable "except in rare circumstances;"[2] the fair and equitable standard is nothing more than the customary international minimum standard; national security preclusion is a matter for subjective assessment; and measures taken to promote health and welfare of society are justifiable. The US policy and its newer treaty provisions (e.g. in the US-Peru Trade Promotion Agreement) states that the standards of protection are the same in domestic law as well as in its treaties; this is an espousal of the consistently rejected Calvo doctrine. The US Model Treaty (2012) confirms these trends.[3] The uncertainties introduced into US treaties have made the outcome of arbitration less predictable for foreign investors.

These developments are beginning to be replicated in the treaty practices of other states. In this context of change, it is futile to argue that the old neo-liberal system of investment protection can be kept alive through constitutional or public law principles. When the US and Canada, two states sharing a language and culture, cannot agree on the domestic public law standards of property, it would be futile to search for a common universal standard of public law on a subject that attracts many ideological, cultural and even religious divisions. International law must not, as in the past, become the means by which

[*] The author wishes to thank David Schneiderman and two anonymous reviewers for their helpful comments on this chapter, which was first published as a *Perspective* on July 16, 2012.
[1] See generally, Stephan Schill, ed., *International Investment Law and Comparative Public Law* (New York: OUP, 2010).
[2] 2004 US Model BIT, annex B, section 4(b), available at:
http://www.state.gov/documents/organization/117601.pdf.
[3] The text is at http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf.

hegemonic states impose principles on the basis of a pretense such as a higher standard of civilization or better standards of governance.

It is best to start anew in the context of the developments that have taken place, such as the recognition of competing interests of the sustainable use of resources, the pursuance of social interest in the health and welfare of communities, human rights considerations in the conduct of business, and corporate social responsibility. The existing regime suffers from inconsistent awards, allegations of bias against the limited number of arbitrators who are called upon and the efforts of law firms to develop strategies of litigation that states hardly contemplated when negotiating investment treaties.

A truly justice-centered regime that shows concern for the interests of the poor is better than a regime that is geared to promote the narrow interests of the rich. The new regime should not restrict the regulatory space of governments to take measures for the advancement of its people, their environmental and human rights interests and their economic development. A regime must be constructed that gives rights to foreign investors while respecting the needs of the people of the host state of which the foreign investor has, by consent, become a part. The past, prior to the neo-liberal approach, had solutions. In fact, the early treaty regime was in itself such a solution. It could be improved, with states retaining greater control over the interpretation of treaties rather than abdicating that function to arbitrators. There were contractual solutions that, due to greater access to information, can be more transparent than before. Diplomatic protection still remains a possibility. A system of dispute settlement with adequate controls over the interpretation of treaties by the state parties and manned by designated government lawyers could be devised to deal with egregious instances of denial of justice to foreign investors by domestic courts. Foreign investors may be given standing to plead before such a system through a nominated body of lawyers. Contract-based systems in which the rights of foreign investors could be specified are preferable. The parties could then negotiate their own protection subject to rules of transparency and devise their own methods of dispute settlement, subject to constraints in local laws and to the primacy of local courts to first deal with the dispute.

The Osgood Hall Public Statement on International Investment Law makes a good beginning for this venture.[4]

[4] Public statement on the international investment regime, available at: http://www.osgoode.yorku.ca/public-statement/documents/Public%20Statement%20%28June%202011%29.pdf.

Chapter 74

The (lack of) women arbitrators in investment treaty arbitration

Gus Van Harten[*]

Investment arbitration has a remarkably poor record on representation of women. This calls for reform of the appointments process for arbitrators, who make important policy choices in the context of global governance.

In 249 known investment treaty cases until May 2010, there were 631 appointments. Of these, 41 were appointments of women -- just 6.5% of all appointments. Worse, of the 247 individuals appointed as arbitrators across all cases, only 10 were women. Women thus comprised 4% of those serving as arbitrators (annex table).

The story is also almost entirely that of two women, Gabrielle Kaufmann-Kohler and Brigitte Stern, who together captured 75% of appointments of women. In contrast, the two most frequently appointed men accounted for 5% of the 593 appointments of male arbitrators (for more on the data, see below).

Representation of women is important, not because women would necessarily make different choices than men, but because arbitrators who make decisions of public importance should reflect the make-up of those affected by their decisions. Representation of women is among the most obvious components of this principle. Reflecting this, states have well-established obligations to take appropriate measures to ensure equality between women and men and to afford women the same employment opportunities as men.[1]

To their credit, a few states appear to have driven appointments of women arbitrators. These include Argentina (5 women of 29 appointments), Turkey (2 of 6), the United States (2 of 9), Bolivia (1 of 2), and Georgia (1 of 2).

On the whole, though, the system's performance has been abysmal. By comparison, women have been much better represented among international (and many domestic) judiciaries. For example, women made up 32% of European Court of Human Rights appointees (26 of 82 judges) since 1995 and 19% of Appellate Body members (4 of 21 members) in WTO history. Incidentally, on a perusal of the data, the system's record on racial and regional representation also appears poor.

The record thus gives reason to doubt the existing appointments process in international investment arbitration. Based on that process -- which is ad hoc, partly-privatized and conducted under acute litigation pressure -- men have devoured the opportunities.

[*] The author wishes to thank George Bermann, Ken Davies, Anthea Roberts, and Detlev Vagts for their helpful comments on this chapter, which was first published as a *Perspective* on February 6, 2012.

[1] CEDAW Convention, Articles 3 and 11b.

Although not the only option, a direct and practical solution is to adopt a mandatory roster system. This would permit a publicly accountable and deliberative process of appointments, free from the strategic pressures that arise after a dispute has been registered. It would also enable more detached attention by states to representation, including ways to overcome possible barriers to participation by women, such as the concentration of men in major law firms or differential family responsibilities of women.

Likewise, a roster system would improve quality, if based on an open and merit-based process, including consultation with investor organizations and other interest groups. Advice on suitable candidates could be sought from organizations such as the International Association of Women Jurists, the International Federation of Women Lawyers or Arbitral Women. Besides tapping the knowledge and networks of these organizations, involving them directly would help loosen the hold of the boys' club. If the roster itself did not achieve this end, then states could move to mandatory representation of particular groups on the roster.

Importantly, a roster system would enhance the independence and public accountability of the system, especially if all arbitrators had to be selected from the roster (preferably by lottery or rotation). Related to this, the roster would need to be kept to a reasonable size (unlike the ICSID roster) in order to ensure a reasonable distribution of appointments among its members.

Alternative options to enhance representation appear less effective or less comprehensive. For example, one could introduce annual quotas for the appointing bodies under the treaties, but this would require acceptance by a range of public and private bodies or would depend on a claimant's choices of arbitration rules. Also, this alternative would cover only some presiding members of tribunals and very few, if any, party-appointed arbitrators.

On the other hand, a roster could be designed to cover all investment treaty arbitrations based on a separate agreement to clarify or supersede existing investment treaties. An expert advisory body could be charged with recommending candidates based on merit. Further, to avoid possible frustration of the roster by one or a few states, an ultimate decision-maker -- such as the President of the International Court of Justice -- could be designated as the final appointing authority.

To summarize, the reliance on ad hoc appointments by the disputing parties has failed to ensure adequate representation of women. A mandatory roster would permit states to address this directly. It would also enhance public accountability and independence by giving states the responsibility to select those eligible for appointment and by providing a degree of secure tenure for the arbitrators.

Of course, there would be challenges in designing and implementing a roster system. But, as an outside observer, I see no clearer way to address this and other problems plaguing the status quo.

Annex table. Appointments of women arbitrators in known investment treaty cases, to May 2010

Note: Data were collected from all known investment treaty cases that had led, by May 1, 2010, to a confirmed award on jurisdiction or, in the case of the North American Free Trade Agreement, to the filing of a notice of claim. The data track changes in tribunal membership at the stage of the establishment of a tribunal, an award on jurisdiction, an award on the merits, and an award on damages. In some cases, it was not possible to identify who was appointed as arbitrator based on publicly available primary documents.

Arbitrator	**Appointment history**	**Total appointments**
Giuditta Cordero Moss	Bogdanov v Moldova (sole arbitrator)	1
Susana Czar de Zaluendo	Vieira v Chile (investor)	1
Tatiana de Maekelt	LG&E v Argentina (presiding)	1
Merit E. Janow	Mobil v Canada (unconfirmed)	1
Gabrielle Kaufmann-Kohler	Saipem v Bangladesh (presiding) Chemtura v Canada (presiding) Burlington Resources v Ecuador (presiding) Duke Energy v Ecuador (presiding) Noble Energy v Ecuador (presiding) Jan de Nul v Egypt (presiding) Bayinder v Pakistan (presiding) Austrian Airlines v Slovakia (presiding) AWG v Argentina (investor) CGE/ Vivendi v Argentina (No 2) (investor) EDF v Argentina (investor) Suez & InterAguas v Argentina (investor) Suez & Vivendi v Argentina (investor) Mobil v Venezuela (investor) PSEG v Turkey (state) Quiborax v Bolivia (unconfirmed, presumed presiding) Vattenfall v Germany (unconfirmed)	17
Carolyn Lamm	ADF v United States (state)	1
Lucinda Low	CCFT v United States (state)	1
Sandra Morelli Rico	Anderson v Costa Rica (presiding) Sempra v Argentina (state) Camuzzi v Argentina (No 1) (state)	3
Fern M. Smith	Apotex v USA (unconfirmed)	1
Brigitte Stern	Pheonix Action v Czech Republic (presiding) BP America v Argentina (state) El Paso v Argentina (state) Pan American v Argentina (state) Burlington Resources v Ecuador (state) Occidental Petroleum v Ecuador (No 2) (state) Jan de Nul v Egypt (state) Alapli Electrik v Turkey (state) Vannessa Ventures v Venezuela (state) Barmek v Azerbaijan (unconfirmed) Quiborax v Bolivia (unconfirmed, presumed state) Itera v Georgia (unconfirmed, presumed state) Gustav Hamester v Ghana (unconfirmed) AES Summit v Hungary (No 1) (unconfirmed, presumed state)	14
Total appointments: 631 **Men: 590** **Women: 41** (16 state, 7 investor, 13 presiding, 5 unknown)		

Source: Gus Van Harten, www.iiapp.org.

Chapter 75

State-controlled entities as claimants in international investment arbitration: An early assessment

Michael D. Nolan and Frédéric G. Sourgens[*]

State-controlled entities (SCEs) are increasingly important participants in international investment flows and international trade. Cumulative FDI by sovereign wealth funds has reportedly reached US$ 100 billion. SWFs are significant equity investors in, and provide significant debt financing to, every kind of company, from professional sports franchises to container ports. In addition to the role of these funds, national oil companies are growing in regional and international importance. In many countries, other industries are also increasingly government-owned.

Not surprisingly, SCEs already act as claimants in contractual arbitrations, frequently conducted *ad hoc* or under the UNCITRAL arbitration rules. Examples from the 2009 American Lawyer Arbitration Scorecard include arbitrations instituted by the National Property Fund of the Czech Republic against Nomura Bank, as well as by Sonatrach, the Algerian national gas company, against Repsol and British Petroleum.[1] Contractual arbitration thus may sidestep many of the complex issues treaty arbitrations may raise for SCEs. With that said, SCE cases may encounter some unique issues at the enforcement stage. The New York Convention allows the following reservation by member states: "This State will apply the Convention only to differences arising out of legal relationships, whether contractual or not, that are considered commercial under the national law." This reservation has been made by such diverse states as Argentina, China, Cuba, Ecuador, Greece, India, Nigeria, the Philippines, the United States, and Venezuela.[2] Whether a dispute involving an SCE as Claimant would be considered "commercial" under the national law of these states may differ from situation to situation -- leaving some SCE claimants with potential enforcement issues depending upon the case and jurisdiction in which enforcement might be sought.

How and when SCEs can participate in international investment arbitration, as opposed to strictly contractual arbitrations, likely soon will emerge as a complex question. SCEs facing a dispute with a host state government to which an international investment agreement (IIA) could apply may wish to use treaty arbitration as an alternative or additional means of dispute resolution. SCEs may prefer the enforcement mechanisms of

[*] This chapter benefited from the Vale Columbia Center on Sustainable International Investment's *Roundtable on State and State-Controlled Entities as Claimants in International Investment Arbitration* on March 19, 2010 (for the report of that Roundtable, see www.vcc.columbia.edu). The authors also wish to thank Efi Chalamish, Robert Howse and Edward Kehoe for their helpful comments on this chapter, which was first published as a *Perspective* on December 2, 2010.

[1] Michael D. Goldhaber, *American Lawyer Arbitration Scorecard 2009 – Contracts*, available at: http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202431683613&hbxlogin=1.

[2] See Status, 1958 - Convention on the Recognition and Enforcement of Foreign Arbitral Awards, (b), available at: http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (last visited September 16, 2010) (listing both the reservation and the states that have made it).

the ICSID Convention. SCEs may consider that host state treatment violated a treaty provision without breaching the underlying contract. Finally, SCEs may seek to invoke access to market provisions in bilateral investment treaties if an investment contract is not concluded or revoked at an early stage in a transaction for the SCEs deems to be improper political reasons.

SCE treaty claims face two different types of jurisdictional hurdles: *first*, a SCE must satisfy the requirements of the underlying IIA; *second*, in the case of ICSID arbitration, the SCE also must fall within the scope of the ICSID Convention. SCEs can invoke IIAs only if they are qualifying "investors." Most definitions of "investors" in IIAs were drafted prior to considerations of SCE claimants. Some refer to "legal entities, including company, association, partnership and other organization, incorporated or constituted under the laws and regulations of either Contracting Party and have their headquarters in that Contracting Party."[3] Others, such as the definition of Saudi investors in the bilateral investment agreement between Saudi Arabia and the People's Republic of China, include expressly "Institutions and authorities such as the Saudi Arabian Monetary Agency, Public Funds, Development Agencies and other similar governmental institutions having their head offices in Saudi Arabia."[4] This issue will have to be parsed on a case-by-case basis. But as the Saudi example shows, treaties may expressly include some SCEs in the definition of investor.

The ICSID Convention may present additional hurdles. The ICSID Convention applies to disputes of host states and nationals of other states and not to disputes between two states. Whether an SCE is a "national" may be subject to a formal or a functional analysis. Many ICSID tribunals have applied a functional test that looks to whether the SCE acted as an agent of the state or performed a state function. This question also must be addressed on a case-by-case basis.[5]

The role of SCEs as claimants in international investment arbitrations likely will evolve in the near future. It can be anticipated that, in some instances at least, these arbitrations will run in parallel to contract arbitrations. A key question in treaty arbitrations will be whether the SCE qualifies as an "investor" under the treaty. Similarly, SCE claims will explore the limits of disputes between two states and disputes between a state and a national of another state under the ICSID Convention. The answer to both questions will

[3] Agreement between the Government of the Republic of Uganda and the Government of the People's Republic of China concerning Reciprocal Protection of Investments, Art. 1(2)(b), IC-BT 525 (2004).
[4] Agreement between the Government of the People's Republic of China and the Kingdom of Saudi Arabia on the Reciprocal Promotion and Protection of Investments, Art. 1(2)(b)(3), IC-BT 462 (1996). SCEs were of particular importance to that agreement.
[5]See *Maffezini v. Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction, (January 25, 2000), paras. 74-79, IIC 85 (2000) (dealing with a SCE as a defendant); *Ceskoslovenska Obchodni Banka AS v Slovakia*, Decision on Objections to Jurisdiction, ICSID Case No ARB/97/4, para. 17, IIC 49 (1999). So far, at least two ICSID cases have been commenced by SCEs. See *Government of the Province of East Kalimantan v. PT Kaltim Prima Coal* (ICSID Case No. ARB/07/3) (the Award rendered in that case is not publicly available); *Tanzania Electric Supply Company Limited v. Independent Power Tanzania Limited* (ICSID Case No. ARB/98/8) (that case is currently subject of an interpretation proceeding).

inform the ongoing global policy debate about the proper role of SCEs in international investment flows.

Given that jurisprudence and scholarship are still in an early stage of development, the challenge may be resolved first at the treaty drafting stage. As the example of the Saudi treaty shows, treaty parties may, if deliberate about the potential issues associated with SCEs acting as claimants, reflect their specific intentions in their negotiated definition of the term "investor." With progress on the treaty front, it is to be expected that the issues faced by tribunals applying IIAs, as well as the ICSID Convention, similarly would become clearer. Until that time, however, each case will have to be examined on its own merits. What can be said at this point is that it is likely that some SCEs would pass muster under both IIAs and the ICSID Convention in some instances. The trick is the question: which instances?

Chapter 76

The standing of state-controlled entities under the ICSID Convention: Two key considerations

Mark Feldman[*]

The ICSID Convention, under Article 25(1), applies only to those investment disputes that are between a contracting state and a "national" of another contracting state. Given that limitation, and in light of the significant and growing amount of foreign investment by state-controlled entities (SCEs),[1] ICSID tribunals likely will need to address one fundamental issue with greater frequency: whether disputes arising from SCE investments constitute investor-state disputes falling within, or state-to-state disputes falling outside of, the scope of the ICSID Convention.[2]

For claims submitted to ICSID arbitration by SCEs, arbitral tribunals consistently have found that such entities meet the "national" requirement under Article 25(1), often without analysis of how investor-state and state-to-state disputes should be distinguished under the provision.[3]

One tribunal, however, has addressed that distinction. In the *CSOB v. The Slovak Republic* case, the tribunal first observed that Article 25(2) defines "National of another Contracting State" to include both "natural" and "juridical" persons, but that neither of those terms is "defined as such in the Convention."[4] The tribunal then turned to "the accepted test" -- formulated by Aron Broches -- for analyzing the "national" requirement with respect to a "mixed economy company or government-owned corporation": whether the entity acts as an agent for the government or discharges an essentially governmental function.[5]

Applying that test, the *CSOB* tribunal concluded that, so long as a state-controlled claimant's activities are commercial in nature, the claim does not give rise to a state-to-state dispute, even if the claimant's activities are "driven by" governmental policies and even if the entity is controlled by the state such that it is "required" to do the state's

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[*] The author wishes to thank Tom Johnson, Bart Legum and Jeremy Sharpe for their helpful comments on this chapter, which was first published as a *Perspective* on April 16, 2012.

[1] See, e.g., Karl P. Sauvant and Jonathan Strauss, "State-controlled entities control nearly US$ 2 trillion in foreign assets," *Columbia FDI Perspective,* No. 64 (April 2, 2012).

[2] For fuller discussion of the issue, see Mark Feldman, "The standing of state-owned entities under investment treaties," in Karl P. Sauvant, ed., *Yearbook on International Investment Law & Policy 2010/2011* (New York: OUP, 2011).

[3] See, e.g., Hrvatska v. Slovenia, ICSID Case No. ARB/05/24, *decision on the treaty interpretation issue* (June 12, 2009); CDC v. Seychelles, ICSID Case No. ARB/02/14, *award* (December 17, 2003); Telenor v. Hungary, ICSID Case No. ARB/04/15, *award* (September 13, 2006).

[4] CSOB v. The Slovak Republic, ICSID Case No. ARB/97/4, *decision on objections to jurisdiction* (May 24, 1999), at 16.

[5] Ibid., at 17.

"bidding."[6] According to the *CSOB* tribunal, the purpose -- as distinguished from the nature -- of a state-controlled claimant's activities is not relevant when determining whether the claimant meets the "national" requirement under Article 25(1).[7]

That finding is in tension with two key aspects of the ICSID Convention. First, the ICSID Convention was intended to apply to private, but not public, foreign investment. Second, the ICSID Convention was intended to respond to a procedural gap that existed between state-to-state disputes (which could be resolved in, among other fora, the International Court of Justice), and disputes between private entities (which could be resolved through domestic courts or commercial arbitration).[8] Each of those factors supports consideration of not only the nature, but also the purpose, of a state-controlled claimant's activities when determining whether the claimant meets Article 25(1) requirements.

First, regarding private foreign investment, the World Bank had considered, prior to the adoption of the ICSID Convention, how to contribute to the investment climate in light of the quantitative and qualitative importance of private foreign investment for development.[9] That contribution ultimately took the form of the ICSID Convention, which opens by recognizing "the need for international cooperation for economic development, and the role of private international investment therein...." Consistent with that preambular clause, "States acting as investors have no access to the Centre in that capacity."[10]

Second, regarding the ICSID Convention's role in addressing a procedural gap between state-to-state and purely private disputes, "there was general agreement" from the outset of ICSID Convention negotiations that state-to-state, as well as purely private, disputes should be excluded from ICSID jurisdiction.[11] That exclusion is reflected not only in Article 25(1), but also Article 27, which prohibits diplomatic protection and thus denies the investor's state of nationality access to the Centre.[12] In addition, a proposal by "a number of governments" to create a limited exception to the state-to-state exclusion -- which would have permitted contracting states to submit subrogation claims to ICSID arbitration -- faced "vigorous" opposition and ultimately "was dropped."[13]

Given the above two factors, the motivations driving the activities of a state-controlled claimant should be considered under Article 25(1). A failure to consider such motivations risks sweeping into ICSID arbitration public foreign investment disputes between states, which would exceed clear ICSID Convention boundaries.

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[6] Ibid., at 20 and 24.
[7] Ibid., at 21.
[8] See Aron Broches, *Selected Essays: World Bank, ICSID, and Other Subjects of Public and Private International Law* (Dordrecht: Martinus Nijhoff Publishers, 1995), p. 167.
[9] Ibid., p. 193.
[10] Christoph Schreuer et al., *The ICSID Convention: A Commentary* (Cambridge: Cambridge University Press, 2009), p. 161.
[11] Broches, op. cit., p. 167.
[12] Schreuer et al., op. cit., pp. 186–187.
[13] Broches, op. cit., p. 167.

Chapter 77

State-controlled entities as "investors" under international investment agreements

Jo En Low[*]

A review of the definition of "investor" and investor-state dispute resolution clauses in 851 international investment agreements (IIAs)[1] reveals that, except in two, state-controlled entities (SCEs) (sovereign wealth funds and state-owned enterprises (SOEs)) have equivalent standing to their purely private counterparts as investors under such IIAs.

In particular, of the 851 IIAs reviewed:[2]

- 691 IIAs do not define "investor" such that it would exclude SCEs as the definition is not based on the nature of ownership but, rather, on whether a legal person was duly constituted, incorporated, established, or organized in accordance with the law of a contracting party. Therefore, if an SCE is established as required under the law of a contracting party, it qualifies as an "investor."
- 81 IIAs define an "investor" to include a "state enterprise" as well as entities that are government owned and controlled, thereby expressly capturing SCEs.
- 52 IIAs explicitly provide that an "investor" includes the government of a contracting party and/or such contracting party itself. Such IIAs do not preclude a contracting party from acting in the capacity of an investor through an SCE.
- None of the IIAs exclude SCEs from the definition of an "investor" on the basis that such entities have not been organized primarily for the purpose of profit or do not carry out investments motivated by pecuniary gain. Thus, the IIAs do not appear to disqualify certain SCEs, such as government institutions, development funds and monetary agencies that may not strictly be established for pecuniary gain.
- Only two IIAs expressly exclude the SOEs of one contracting party.[3] Both IIAs were concluded in 1983 and are otherwise silent on the status of SOEs.
- 33 IIAs do not contain a definition of "investor."

[*] The author wishes to thank Stanimir Alexandrov, Mark Feldman and Thomas Johnson for their helpful comments on this chapter, which was first published as a *Perspective* on October 8, 2012. The author also wishes to thank Loren Anderson, John Coleman, Martin Delaroche, Tomasz Koziel, Rabih Maalouf, and Vera Shikhelman for their assistance in reviewing the non-English IIAs.

[1] The IIAs reviewed include the bilateral investment treaties (BITs) of countries that account for 70% of world foreign direct investment outflows in the period 2008-2010; BITs of certain countries, such as the United Arab Emirates, that are home to the top ten largest SWFs as ranked (by assets under management) by the Sovereign Wealth Fund Institute; the model BITs of Canada, France, Germany, Norway, United States, and United Kingdom; a cross-section of regional free trade agreements (FTAs) with investment chapters, such as the North-American Free Trade Agreement and the Association of South East Asian Nations Comprehensive Investment Agreement; as well as bilateral FTAs to which at least one of the sample states is a party; and multilateral agreements such as the Energy Charter Treaty.

[2] The figures below do not add up to 851 as the IIAs falling in the second and third category below overlap in some cases.

[3] The Panama BITs with Germany and Switzerland.

Therefore, SCEs generally have recourse to the investor-state dispute resolution provisions of IIAs as "investors." In particular, as approximately 78% of the IIAs surveyed allow for investor-state dispute resolution before the International Centre for Settlement of Investment Disputes (ICSID) pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), in most cases, SCEs will have recourse to the ICSID dispute resolution framework as "investors."

There is some debate among scholars regarding whether SCE access to the ICSID framework as investors should be limited if the IIA otherwise covers SCEs in the definition of an "investor." The text and negotiating history of the ICSID Convention do not unequivocally address the standing of SCEs as a diverse class of investors. In addition, the handful of ICSID arbitral decisions which have addressed this issue did not establish clear guidelines regarding the extent to which SCEs are able to initiate claims as investors under IIAs.[4]

We should be mindful that if indeed SCE access to the ICSID framework as investors is somehow limited as suggested by certain scholars,[5] SCEs might well turn to other avenues of dispute resolution. The majority of IIAs that grant SCEs access to ICSID also enable SCEs to elect to refer an investment dispute to an arbitral institution other than ICSID, such as the International Chamber of Commerce, and/or pursuant to arbitral rules other than the ICSID Convention, such as those of the United Nations Commission on International Trade Law.

As the number of treaty-based investment arbitrations is growing alongside increased levels of foreign direct investment by SCEs,[6] it is likely that investment disputes involving SCEs as claimants will occur with greater frequency going forward. Thus, in the long term, any limits on the access of SCEs to ICSID may diminish the institutional significance of ICSID.

[4] See e.g. Československa Obchodní Banka, A.S. v. Slovak Republic, ICSID Case No. ARB/97/4, *decision on objections to jurisdiction* (May 24, 1999).
[5] See e.g. Paul Blyschak, "State-owned enterprises and international investment treaties: When are state-owned entities and their investments protected?," *Journal of International Law and International Relations*, vol. 6 (Spring 2011), pp. 1-52, at 29-34; and Mark Feldman, "The standing of state-owned entities under investment treaties," in Karl P. Sauvant, ed., *Yearbook on International Investment Law and Policy 2010-2011* (New York: OUP, 2011), pp. 615-637.
[6] UNCTAD, *World Investment Report 2011* (Geneva: UNCTAD, 2011) and UNCTAD, *IIA Issues Note*, no. 1 (April 2012).

Chapter 78

The world economic crisis as a changed circumstance

Hermann Ferre and Kabir Duggal[*]

In September 2008, the bankruptcy of Lehman Brothers sent financial markets in the United States into a spin. Credit markets froze as banks began to mistrust counterparties, not knowing the extent of toxic assets in loan portfolios that could lead to another major bank collapse. The crisis quickly spread around the world. Governments were urged to take drastic measures. Experts discussed the possible nationalization of portions of the US banking industry and other sectors. Other countries also considered measures to save key industries.

In the world of investor-state arbitration, many predicted that national measures to combat the economic crisis would result in treaty claims.[1] Commentators also warned states to heed the lessons of Argentina, which was unable to escape its treaty obligations by invoking a state of necessity. Predicted investor claims included violations of non-discrimination, fair and equitable treatment (FET) and expropriation provisions.

There is little evidence that the investment treaty regime anticipated the possibility of a worldwide economic crisis like that of 2008-2010. While claims against states responding to the crisis have yet to materialize, most investment treaties are silent with respect to a limitations period. Such claims may appear long after the crisis. States have, however, another defense: changed circumstances.[2]

The defense typically has arisen in the context of treaty termination, but an unexplored aspect is a temporary suspension of treaty obligations. Different from necessity and force majeure, the defense of changed circumstances, classically known as *rebus sic stantibus*,[3] is tailor-made for this crisis. Its literal meaning -- "things standing thus" -- refers to the expectations of the parties and the circumstances existing at the time a treaty was negotiated. In the context of investor claims arising from governmental responses to the crisis, the crisis itself is a fundamental change, not anticipated under the economic model

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[*] The authors wish to thank Pieter H.F. Bekker, August Reinisch and M Sornarajah for their helpful comments on this chapter, which was first published as a *Perspective* on August 1, 2011.

[1] See Anne van Aaken and Jürgen Kurtz, "The global financial crisis: Will state emergency measures trigger international investment disputes?" *Columbia FDI Perspectives*, No. 3 (March 23, 2009); Joshua Fellenbaum and Christopher Klein, "Investment arbitration and financial crisis: The global financial crisis and BITs," 3(6) *Global Arbitration Review* (2008).

[2] International law has recognized thisdefense; see, e.g., Vienna Convention on the Law of Treaties (VCLT), Article 62.

[3] The portion of the doctrine raised here focuses on the legitimate expectations of the parties, rather than excuses for non-performance. Provisions regarding necessity and *force majeure* are generally addressed in BITs, establishing the parties' risk allocation. BITs rarely address global issues that might impact states at a macro level.

on which the current treaty system is based, i.e., the "circumstances" existing in the 1990s. Some states can argue credibly that they did not cause the crisis, yet their economies were greatly affected. Under these changed circumstances, a state should be able to enact emergency economic measures to sustain critical national industries.

If the investment treaty regime is to remain sustainable, should a state not be permitted to suspend its treaty obligations during exceptional circumstances? Article 62 of the Vienna Convention on the Law of Treaties (VCLT) permits temporary suspension but provides no guidance. The circumstances that have changed must have constituted an "essential basis" of the parties' consent, and the change must "radically transform" the extent of obligations. The VCLT permits the state to terminate the treaty entirely or temporarily suspend its obligations. A temporary suspension -- a more limited response -- logically should require a lower standard. The VCLT uses the same standard for both actions. This is perhaps the reason why Article 62 has been invoked rarely by states seeking to defend against claims relating to measures taken to address unanticipated crises. A mere suspension of treaty obligations would strengthen the treaty system by making it resilient. The standard for suspension, while remaining high, should take into account exceptional circumstances. A workable approach might include: (i) an unforeseen global crisis; (ii) causing considerable hardship to significant populations; (iii) not a consequence of the state's own actions; (iv) suspension is made in good faith with the expectation of resuming obligations; and (v) suspension is reasonable under the facts and circumstances.

As the economic crisis has required many countries to undertake protective measures, the suspension of rights and obligations might be the most desirable option. The risk of not permitting suspension might cause states to consider less desirable alternatives when claims are asserted.[4] Questions regarding the length of suspension, and which rights and obligations are suspended, are subjective. Arbitrators could make such determinations in light of facts and circumstances. Recognition that suspension of treaty obligations might be appropriate under certain circumstances will not weaken the treaty system but strengthen it.

[4] States already have shown skepticism toward this treaty regime. See Osgoode Hall Law School, York University, *Public Statement on International Investment Regime*, (2010); George Kahale, III, "A problem in investor/State arbitration," 6 (1) *Transnational Dispute Management* (2009).

Chapter 79

The global financial crisis: Will state emergency measures trigger international investment disputes?

Anne van Aaken and Jürgen Kurtz[*]

Several developed countries have introduced emergency measures to mitigate the effects of the global financial crisis, including Australia, Germany, Ireland, the United Kingdom, and the United States. Although the measures taken are still undergoing changes by the executive branch and are thus a "moving target," our survey reveals early evidence of differentiation between foreign and domestic actors in the emergency plans adopted by this sample grouping. It is this differentiation that may give rise to liability as breaching guarantees against discrimination of foreign investors under international investment law.

In general, the emergency measures passed to date can be grouped into three broad categories: (1) measures designed to bolster the stability of the financial services industry; (2) measures directed at the financial services industry but structured to increase the availability of credit to other sectors of the economy; and (3) general fiscal measures designed to boost public spending and targeting select and strategic industries (including the automotive industry). Our focus is on the first and second categories, which we regard as presently most likely to engage international investment law.

The emergency measures

The extensive measures undertaken in this first category are designed to increase the confidence of market participants and to ensure the continuation of bank funding. They encompass liquidity support, recapitalization (through share purchases or otherwise), purchase of specific assets (including "toxic" bank assets), inter-bank (wholesale) lending guarantees and increases in retail deposit guarantees.

Australia and Ireland have introduced new insurance schemes for retail deposits, wholesale lending, and, in Ireland's case, guarantees for covered bonds, senior and dated subordinated debt. Both measures triggered flight of wholesale capital from excluded foreign bank branches to domestic guaranteed institutions. Those countries are not alone in building adverse incentives for regulatory arbitrage. The financial stabilization programs in Germany and the United Kingdom cover only financial institutions with their seat in the respective country and also exclude branches of foreign institutions (as authorized deposit takers). In contrast, Switzerland has elected to bail out specific institutions taken to be of systemic importance. To date, the benefits of this program have only been extended to one Swiss bank -- UBS -- with a promise to do the same for another, Credit Suisse. The US Emergency Economic Stabilization Act authorizes purchase of distressed assets (especially mortgage-backed securities) in financial

[*] The authors wish to thank Jose Alvarez, James Mendenhall, and Christoph Schreuer for their helpful comments on this chapter, which was first published as a *Perspective* on March 23, 2009.

institutions if they have "significant operations" in the United States. Early reports suggest that domestic US institutions are the majority if not exclusive recipients of capital injections under the scheme. If this trend continues, there may be differentiation against foreign institutions as a matter of fact, even if not on the face of the law. The second category of emergency measures also targets the finance sector but is designed to directly foster the provision of credit throughout the economy. Both the United Kingdom and Germany have structured their plans so that participants *must* support lending to credit worthy borrowers -- mainly small to medium sized enterprises -- as a condition of the receipt of governmental support. Much again will depend on how this aspect of the scheme is implemented in practice. If this condition leads to the provision of credit solely to national industry, this too will evidence differentiation against foreign actors as a matter of fact, even if not on the face of the law.

Implications under international investment law

There are approximately 2800 bilateral and regional investment treaties (including investment chapters in free trade agreements) in operation across the globe. Except for Ireland, the countries we have surveyed have all entered into multiple investment treaty commitments. Most of the newer investment treaties of the sample grouping have been signed with developing countries and Eastern European states. On first view, this might preclude claims by foreign investors of OECD countries against other OECD countries since there are almost no investment treaties in operation among them, although they are both the source and the target of the major financial transactions. However, treaty shopping might enable investors to make use of an investment treaty by channeling their investment through any other country that has concluded a BIT with an OECD country. Furthermore, older investment commitments -- including Friendship, Commerce and Navigation treaties -- remain in operation across a range of OECD countries (including a number of countries we have surveyed). These treaties usually allow disputes to be brought before the International Court of Justice and, at least in the case of the US, may be self-executing as a matter of US constitutional law giving investors of a state-party the ability to initiate claims before US courts.[1]

Newer investment treaties normally confer direct rights of international dispute settlement on foreign investors of a signatory state. The ability to do so will depend initially on whether the measures in question fall within the scope of a given treaty instrument. Investment treaties commonly structure their operations on an expansive "negative list" system (whereby all government measures including those relating to the finance sector are covered unless specifically exempted). This is in contrast to more conservative scheduling systems such as the "positive list" method of the WTO General Agreement on Trade in Services.

If action is brought, there is a possibility that the measures we have surveyed may attract liability under investment treaty commitments or in certain national courts. In particular, we see a case for breach of the obligation to accord national treatment. These measures may also breach the "fair and equitable" standard, most notably its limitation on

[1] Asakura v. City of Seattle, 265 US 332 (1924).

discriminatory conduct on the part of a signatory state. There is, however, considerable uncertainty both in arbitral jurisprudence and among commentators on the precise outer contours of the "fair and equitable" guarantee. With that in mind, we focus our analysis on national treatment.

National treatment proscribes "less favorable treatment" of a foreign investor that stands "in like circumstances" or "like situations" with a domestic actor. The fact that a measure is temporary and triggers loss but is then removed (as in Australia) does not excuse legal liability, *per se*. Moreover, the obligation to accord national treatment will cover instances of both *de jure* (in law) and *de facto* (in fact) discrimination. The latter covers measures that may not explicitly distinguish on nationality but pose a greater adverse burden on foreign actors in the host state. The non-binding OECD National Treatment Instrument is a relevant source for guidance on the constituent elements of the national treatment obligation. Investor-state arbitral tribunals have drawn on the OECD National Treatment Instrument in looking to competitive interactions as a necessary condition of finding that domestic and foreign investors operate "in like circumstances." They have also, on occasion, interpreted these parameters rather broadly, which might see the whole financial sector (rather than a specific industry grouping) as the basis for comparison between foreign and domestic actors. Ultimately however, the question of breach will come down to whether a tribunal requires evidence of some malign governmental purpose, particularly on claims of *de facto* discrimination. Certain cases have explored -- with different emphases -- whether the distinction is based on legitimate policy grounds and justifiable or solely as a means of conferring protection to domestic actors and thus impermissible. Much will depend here on the *indicia* employed by a tribunal in a test for protectionist purpose. Even on a test requiring evidence of constructed purpose, some of these measures may not withstand scrutiny. Indeed, similar forms of discrimination to those we have surveyed were employed by the Czech Republic -- in response to a domestic financial crisis in the late 1990s -- and were ruled to be in breach its investment treaty obligations.[2]

There are exceptions for host country conduct in the event of a finding of liability for breach of national treatment. Some investment treaties include qualified exemption for prudential measures in the finance sector (modeled on the GATS). But one should keep in mind that the most-favored nation clause in those treaties may afford claimants better treatment if their host country has concluded other treaties without those carve-outs. Older investment treaties typically only exempt measures necessary to maintain "public order" or protect "essential security interests." While newer iterations of these exceptions are self-judging, most of the older formulations clearly contemplate a role for an adjudicator in the application of the exception. Indeed, the scope of this vague exemption was assessed in a range of cases brought against Argentina in the aftermath of its 2001-2002 financial crisis. In those cases, particular tribunals were prepared to find that the adverse societal effects of financial crisis might engage a country's "essential security interests." On the whole though, it is unlikely that the current measures will fall within the exemption. In particular, it will be difficult to make the argument that discrimination directed against foreign bank institutions (with domestic depositors) was indeed

[2] Saluka Investments B.V. v. Czech Republic, UNCITRAL (Partial Award of March 17, 2006).

"necessary" to protect those "essential security interests." Argentina has also been unable to escape its treaty obligations by invoking the customary plea of a state of necessity. We therefore expect similar legal treatment of the current measures.

Conclusion

We draw two tentative conclusions, implicated in our analysis of potential liability under international investment treaties. First, there is clear evidence of widespread discrimination directed at foreign actors in the laws we have surveyed despite the public commitment of state parties to free market principles, including the rule of law, respect for private property, open trade and investment and competitive markets, expressed at the G-20 meetings. This is not confined to any individual state or select grouping; it is a marked characteristic of emergency responses to the financial crisis across a significant proportion of the globe. This then is a timely reminder to revisit the lessons associated with the outbreak of protectionism leading to the Great Depression in the inter-war period. Protectionism is the result of a prisoner's dilemma understood in game theory terms. Cooperation would make every country better off, but it is individually rational for countries to pursue their self-interest (and protect domestic industry) at least in the short term. While protectionist instincts are now more nuanced, it is difficult to escape the conclusion that countries are failing to cooperate in the current crisis, with possible cascading consequences.

This leads to our second, tentative concern, namely whether international law will fulfill a key function in the contemporary period. The framers of the post-Second World War architecture of international economic law were deeply influenced by the lessons of the inter-war period. They had drafted rules hoping to embed a loose form of cooperation and constrain the freedom of countries to resort to short-term protectionist measures. The preparedness and rapidity by which countries are now moving in that direction raise serious questions of whether our existing system is a sufficient check against these problematic tendencies.

Ultimately, these sensitive issues may be addressed -- in less than optimal ways -- in legal rather than diplomatic *fora*. The 2001 Argentine financial crisis triggered a wave of international litigation against that state. If current trends continue, there is no reason to expect any different on existing state responses to the global financial crisis.

Chapter 80

The response to the global crisis and investment protection: Evidence

Kathryn Gordon and Joachim Pohl[*]

The chapter above, first published in March 2009, carried an early analysis of investment policies in response to the financial crisis that began in early 2008.[1] At that time, the authors, Anne van Aaken and Jürgen Kurtz, found "clear evidence of widespread discrimination directed at foreign actors" in the emergency response to the crisis.

One year on, OECD analysis suggests a more nuanced assessment of investment policy making during the crisis. The findings of a series of OECD reports tracking investment policy trends in 49 developed and emerging markets since November 2008 challenge the wholesale claim that investment policy measures taken during the crisis were driven by a protectionist agenda involving significant discrimination against foreign investors.[2] However, in the current context, the OECD inventory of investment measures also shows that crisis response and exit policies (that is, policies that unwind crisis response measures) pose a major threat to the openness of international investment.

Fears of a destructive spiral of investment protection and retaliation have not materialized

As the crisis deepened in 2008, fears took hold of a destructive cycle of protectionist and retaliatory policies of the type experienced in earlier deep crises.[3] In retrospect, these fears proved largely unfounded. General investment measures -- those not covered by national security or crisis exceptions -- taken since the outbreak of the global crisis point, with few exceptions, toward greater openness and transparency for foreign investors. Governments have streamlined investment review procedures, loosened limits on foreign ownership in domestic companies and abolished monopolies that had previously limited foreign investments. The OECD found several dozen general investment measures, of which only a few restrict inward or outward investment.

Crisis measures have pervasive impacts on inward and outward capital flows

While general investment policy changes tended to promote international investment, the many crisis response measures that governments introduced to rescue or support companies bear significant potential for discrimination against foreign investors. Except for a few emerging markets, almost all countries in the OECD inventory established such

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[*] The authors wish to thank Anne van Aaken, Ted Posner and an anonymous reviewer for their helpful comments on this chapter, which was first published as a *Perspective* on June 17, 2010.

[1] See chapter 79, Anne van Aaken and Jürgen Kurtz, "The Global Financial Crisis: Will State Emergency Measures Trigger International Investment Disputes?"

[2] The reports are available at: www.oecd.org/daf/infestment/foi. A series reports on G-20 trade and investment policies jointly produced by the WTO, OECD and UNCTAD are also available at this address.

[3] See "Keeping markets open at times of crisis," OECD Policy Brief (April 2009) for a discussion of protectionist risks and appropriate investment policies during economic crises. Available at: http://www.oecd.org/dataoecd/18/44/42446696.pdf.

schemes since late 2008, and new measures were still being introduced in early 2010. A conservative OECD estimate found that, by September 2009, G-20 governments alone had made combined public expenditure commitments of more than US$ 3 trillion to assist companies in difficulty -- roughly US$ 10 billion per day on average since the dramatic deepening of the crisis in autumn 2008. By early 2010, several thousand companies had received financial support or were expected to benefit from support schemes. The massive support measures influence worldwide capital flows in various ways: by affecting the pattern of entry and exit in globalized sectors such as finance and automobiles or via direct governmental participation in firms' investment decisions by virtue of control rights conferred by shareholdings acquired as part of crisis response policies.

Emergency measures pose a serious threat to open investment

While emergency measures have almost certainly influenced international capital flows, their discriminatory or protectionist intent or effect is less certain. Indeed, the design and implementation of emergency measures varies significantly among countries. In addition, the determination of what is non-discriminatory treatment can be a subtle one, especially in the financial sector. Under OECD investment dialogue, policies such as "fit" and "proper" tests of general application, financial requirements for non-residents' branches equivalent to levels applied to domestic entities, rules for consolidated supervision and the non-extension of emergency lending facilities to non-residents' branches are not necessarily considered discriminatory. Under this approach,[4] the OECD inventory finds that most crisis response schemes are designed to be non-discriminatory (i.e., they are *de jure* designed to be open to participation by foreign-controlled companies).

However, even those support schemes that are *de jure* open to foreign controlled enterprises may be administered in a discriminatory manner. Crisis response poses a dilemma for policy makers -- they need to take action, but most options for crisis response pose grave risks for public sector transparency and market competition. The implementation of most schemes involved significant discretion for the implementing authorities; many governments participated directly in one-on-one negotiations with companies on conditions for rescue or mergers -- over 100 business-government negotiations are recorded in the OECD inventory. While confidential, one-on-one negotiations may have helped protect companies involved in rescue negotiations, they are also inherently non-transparent and may cover discrimination and complicate public scrutiny of such measures.

The risk of discrimination has not abated -- "exit" is the next challenge

[4] The OECD methodology does not assume that prudential measures (and measures taken to safeguard essential security interests) are protectionist -- such measures may be taken to address legitimate concerns, but they may also be used to camouflage protectionist intent. Because these measures exist in a kind of grey zone in terms of motivation, they are subject, under OECD rules, to enhanced scrutiny and to peer review. The OECD treatment of such measures, which differs from earlier studies, may explain some of the differences between the OECD findings and those of other reports such as the van Aaken and Kurtz chapter above.

The “exit” phase of crisis response involves the dismantling of policies and the unwinding of stakes in companies acquired in the course of crisis management. The OECD inventory shows that the introduction of new crisis response schemes has significantly slowed, and exit from emergency measures, especially in the financial sector, has begun in some countries. However, the risks of discriminatory treatment of foreign controlled enterprises have not declined.

Ongoing implementation of rescue and support schemes perpetuates the abovementioned risks, albeit arguably at a smaller scale as rescue operations of most large companies are concluded. New risks arise in the exit phase that is only just beginning: governments that have acquired financial positions will decide on the timing and modalities of divestments and will have to select from among the potential acquirers of the assets. The risks from governments’ discretion in administering the exit process raise concerns similar to those of the rescues of large financial institutions in the early stages of the crisis. Furthermore, until the public financial positions in companies are unwound, governments will also need to manage tensions between their roles as owners of companies and their roles in regulation, taxation and law-enforcement.