



VALE COLUMBIA CENTER
ON SUSTAINABLE INTERNATIONAL INVESTMENT
A JOINT CENTER OF COLUMBIA LAW SCHOOL AND
THE EARTH INSTITUTE AT COLUMBIA UNIVERSITY

FDI PERSPECTIVES

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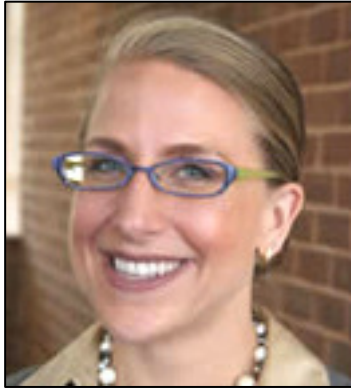
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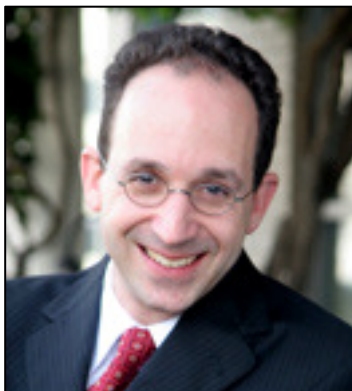
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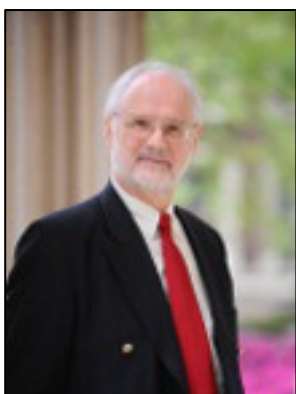
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Foreword

Succinct yet insightful reports are most welcome – especially in our era, distracted as it is by a rising tide of shallow commentary. For those who care about foreign direct investment (FDI), the premier reports are *Columbia FDI Perspectives*, published every few weeks by the Vale Columbia Center on Sustainable International Investment. Since the first issue (here republished as chapter 2) appeared in November 2008, the *Perspectives* have adhered to a format of about two pages, authored by a leading expert, on an FDI question of immediate interest. Consequently, there is no better way to keep abreast of changing trends and emerging themes.

Chapter 2 carries the prescient title, “The FDI recession has begun”; several issues (chapters 9-13) document the ascent and challenges of multinational enterprises based in emerging markets, particularly Brazil, India and China; chapter 6 explores farm deals in Africa with the provocative title, “Land grab or development opportunity?”; chapter 1 reveals that emerging markets would attract more than half of FDI in the midst of the Great Recession; chapters 29 and 30 debate the arbitration featuring environmental claims between Pacific Rim LLC and El Salvador; chapter 22 surprisingly reports that general counsels often know little and care less about bilateral investment treaties.

Fortunately for FDI watchers, these issues of the *Perspectives* and many more – in fact the complete collection through 2010 – are now available in a single eBook. Corporate executives, who always have too much to read, will find this eBook essential for a quick briefing. Scholars, who always want to read more, will find the eBook a great place to start their quest. And policy officials, who want to know how the wind is blowing on hot questions, can find the direction from these *Perspectives*.

Much credit for this collection goes to the editor-in-chief, Karl P. Sauvant, the world’s pioneer in gathering reliable statistical information on foreign direct investment, a lifelong observer of FDI questions and a foremost scholar of multinational enterprises. Together with his team at the Vale Columbia Center, Sauvant has done a great service to those of us who care about FDI trends and emerging themes.

Gary Clyde Hufbauer
Reginald Jones Senior Fellow
Peterson Institute for International Economics

Preface

Foreign direct investment (FDI) has become an increasingly important feature of the globalized economy in the past 20 years. Global FDI inflows more than quintupled from 1990 to 2009, rising from US\$208 billion to US\$1.1 trillion, resulting in a cumulative stock of nearly US\$18 trillion by end-2009. International investment has become roughly twice as important as trade in delivering goods and services across frontiers. The rapid growth of global FDI—which has grown faster than world GDP—reflects major underlying policy changes toward FDI in host and home countries. In addition to widespread liberalization of national investment policies, especially in developing countries and former centrally planned economies, many countries have now also adopted active FDI attraction strategies through a proliferation of investment promotion agencies at both national and sub-national levels.

The rapid growth in the importance of investment flows raises a number of important issues. There is first of all the question of the impact of FDI on host and home countries, particularly the extent to which positive effects can be enhanced and negative effects minimized – largely a policy question. The steep rise in the number of international investment agreements and disputes has generated discussion about the nature of the international investment regime. The proliferation of treaties that govern investment flows has raised questions not only about their utility and importance but also about the suitability of their content, especially (but not only) for developing countries. There are also questions about the ability of international arbitration mechanisms to resolve disputes fairly, affordably and consistently. Increased FDI flows from sovereign wealth funds and state-owned enterprises have raised concerns about the impact of such investment on national security and created a ripple effect of legislation and guidelines to govern sovereign investment. More generally, there is continuing discussion about the balance in the international investment regime between investors' rights and responsibilities on the one hand and host countries' rights and responsibilities on the other, and whether we are heading for a “rebalancing” of the regime. The discussions about these and other issues raised by the global surge in FDI take place in classrooms, boardrooms and legislatures.

In late 2008, as financial markets were crashing, the Vale Columbia Center on Sustainable International Investment launched the *Columbia FDI Perspectives*. The first *Perspective*, entitled “The FDI recession has begun”, correctly forecast an FDI recession in the following year. From that first *Perspective* in late 2008 to the end of 2010, the series published thirty-three concise notes on topical FDI-related issues by diverse experts in the field. The purpose of these *Perspectives* is to inform readers about some of the important issues and trends in the contemporary debate on FDI, and to promote a wide-ranging discussion about the policy implications of these trends and events.

The topics of these *Perspectives*, while not an exhaustive list of the issues raised by the global investment regime, capture a dynamic period in the global debate on international

investment and reflect many hot topics and issues of continuing relevance in 2009-2010. Topics ranged from the implications of the financial crisis and recession for major economies, to the changing geography of the international investment regime and policy questions faced by emerging markets; from the implications of sovereign investment for national security and measures taken to restrict such investment, to policy options for countries seeking to increase inward investment flows and trying to stay competitive in a downward market; from investment in land and agriculture, to investment in extractive industries – raising important questions both for national policy and for the international investment regime.

The range of topics reflects the multifaceted, interdisciplinary and rapidly evolving nature of key issues in international investment. This compilation of the *Perspectives* offers snapshots of some of the most topical issues of 2009-2010 and an opportunity to connect the dots, drawing out the interconnections among the various themes addressed in the stand-alone *Perspectives*. It is the collection of these issues and policy considerations that, woven together, forms the changing fabric of the international investment regime. By putting these pieces together in one volume, this e-book allows a clearer picture to emerge.

Two years of these *Perspectives* capture an extraordinary range of topics. Yet some important areas remain underexposed in this volume. We expect that future *Perspectives* (to be posted on www.vcc.columbia.edu) will fill some of these gaps, including, for instance, by addressing the implications of the investment regime for climate change policy, the impact on human rights and mechanisms to maximize the contribution of investment to sustainable development.

The Vale Columbia Center welcomes submissions on these and all other FDI-related topics for future *Perspectives*, to share new and important developments in the field and to continue the generation and discussion of new approaches and policy recommendations to keep apace with the ever-growing importance of foreign direct investment.

Karl P. Sauvant
Lisa Sachs
Ken Davies
Ruben Zandvliet

New York, January 2011

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 and acquisitions

MAI - Multilateral Agreement on Investment

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 - The 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

The global economic crisis and FDI flows to emerging markets

*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 2009.¹ 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.

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 U.S. and U.K., 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-month 2009 data for M&As were not encouraging. According to data provider Dealogic,

* The author wishes to thank Gary Hufbauer and an anonymous reviewer for their helpful comments on this chapter. It 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.

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

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. Sauvart, 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.

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 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.

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.

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 dollars)

	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
<i>of which:</i>			
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.

Table 2: FDI inflows, % of global FDI inflows

	UNCTAD definitions		Economist Intelligence Unit definitions	
	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 2

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

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

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.

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 3

FDI incentives pay – politically

Nathan M. Jensen and Edmund J. Malesky *

Despite broad skepticism about the benefits of globalization, the majority of U.S. states have offered lucrative tax incentives to attract investment.⁹ 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 U.S. 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.¹⁰ 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 U.S. 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 U.S. 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."

* 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. It was first published as a *Perspective* on June 28, 2010.

⁹ 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/>

¹⁰ 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).

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 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 questions¹¹ 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.

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!"

¹¹ 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.

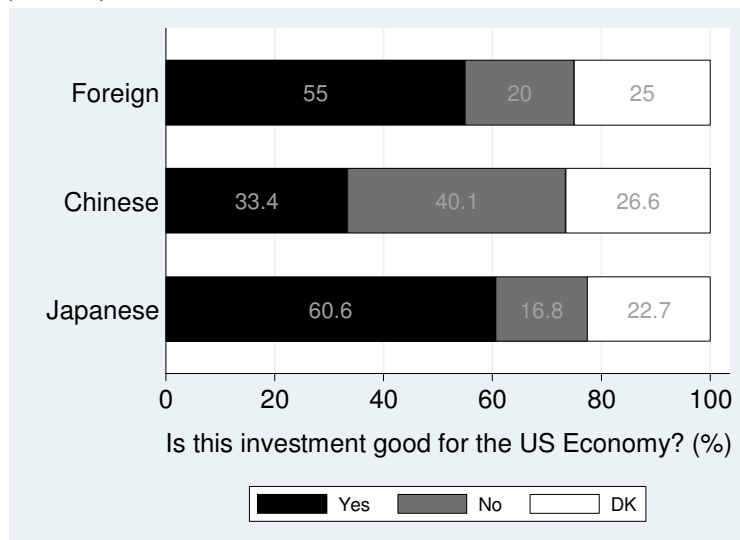
The findings from the survey indicate two clear points related to public policy. First, the tax wars among states, and possibly among countries, are strongly driven by domestic politics. Politicians may be trying to take credit for investment that is going to come anyway and/or trying to minimize blame for investment that does not come. Even without 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.¹² 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

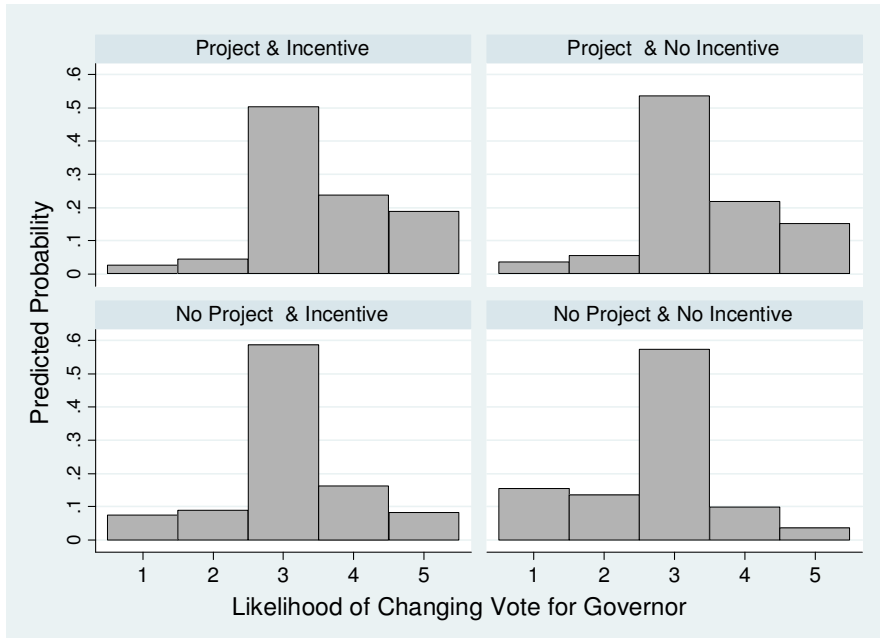
Figure 1. FDI incentives: is this investment good for the U.S. economy?^a
(Percent)



^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 U.S. Economy?” (Options randomized into three groups)

¹² 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).

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 4

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 U.S.-based multinationals by restricting the deductibility of interest expense that is allocated to deferred income. Under current law, U.S.-based MNEs that earn foreign source active business income through their foreign affiliates (CFCs) can defer U.S. 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 U.S.-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 U.S. 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 U.K. 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 U.S.-based MNEs at a competitive disadvantage.¹³

* The author wishes to thank Karen Brown, Lorraine Eden and Jeffrey Owens for their helpful comments on this chapter. It was first published as a *Perspective* on February 11, 2010.

¹³ Matthew J. Slaughter, "How to destroy American jobs: Obama's proposals for increasing the tax burden on U.S.-based multinationals would harm our most dynamic companies," *Wall Street Journal*, Feb. 3, 2010.

However, in my opinion such a view is mistaken, for three reasons. First, there is no evidence that U.S. taxation of the foreign source income of U.S. multinationals puts them at a disadvantage. Second, our FDI partners tax foreign source income more than we do, and that will still be true if the Obama proposals are adopted. Third, even if we want to go further and tax U.S. 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.

U.S. 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, U.S. multinationals dominated the world. General Motors (GM), to take a painful example, had over 40% of the U.S. car market. Since then, other countries have grown, and U.S. multinationals face more competition. But there is absolutely no empirical evidence that any of the myriad changes to our taxation of foreign profits of U.S. multinationals since 1961 has made any difference to their ability to compete. U.S. 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 U.S.-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, U.S. 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, U.S.-based MNEs were the only ones subject to FCPA and were at a competitive disadvantage).

U.S. 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 U.S. multinational profits have an effective tax rate of less than 10%. The Obama proposals represent a very cautious first step toward making U.S. multinationals pay their fair share of the tax burden, and toward leveling the playing field with small U.S.

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 5

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.¹⁴ 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 multinational enterprises 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 U.S. 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.¹⁵ Moreover, the prospects for the near future are also worrisome; only four EU countries appear among the 15 most attractive FDI locations in 2009-2011.¹⁶ The most attractive country is China, followed by the U.S.; the first EU country is the U.K., in sixth position. Besides the

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

¹⁴ 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: Oxford University Press, 2010).

¹⁵ For a detailed review, see chapter 5 above, Laza Kekic, "The global economic crisis and FDI flows to emerging markets."

¹⁶ UNCTAD, *World Investment Prospects Survey 2009-2011* (Geneva: UNCTAD, 2009).

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.

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 U.S.’ 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 multinational enterprises.

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 6

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.¹⁷

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.

* The author is grateful to Howard Mann, Ruth Meinzen-Dick and Herbert Oberhaensli for their comments on earlier drafts of this chapter. It was first published as a *Perspective* on June 22, 2009.

¹⁷ “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 foreign direct investment 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.¹⁸ 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 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

¹⁸ "Fixing the Land Deals", *Financial Times*, Editorial, 27 May 2009.

Chapter 7

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 foreign direct investment. 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 multinational enterprises' 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 multinational enterprises (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.

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,

* The authors wish to thank Agnès Bénassy-Quéré and Jack Mutti for their helpful comments on this chapter. It was first published as a *Perspective* on June 3, 2009.

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 (U.S.), 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, U.S.: 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 21.7.¹⁹ 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.

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

¹⁹ Source: AMECO database, available at:
http://ec.europa.eu/economy_finance/ameco/user/serie/SelectSerie.cfm.

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.

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Chapter 8

Can the United States 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 U.S.'s much needed industrial competitiveness and employment – and, more specifically, how this new policy will affect the U.S. 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. U.S. 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 U.S. 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 U.S. Postal Service has been endeavoring to adopt flexible techniques in its efforts to raise efficiency and to serve customers better.

Auto FDI in the U.S. (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

* The author wishes to thank Mark Barenberg and Hugh Patrick for their helpful comments on this chapter. It was first published as a *Perspective* on October 26, 2009.

transplants in particular thrive on Toyota-style management and production. They are known for their workplace “democratization” where the supervisory structure is flattened 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 U.S. 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 U.S. 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\$ 63,538.²⁰ 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 U.S.’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

²⁰ “What is an ‘American’ car?” by Matthew J. Slaughter, *Wall Street Journal*, May 7, 2009.

to the U.S. and encourages the U.S.'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 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.

PART II

THE RISE OF EMERGING MARKET INVESTORS

Chapter 9

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,²¹ 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

* The authors are grateful to Harvey Arbeláez, Jerry Haar and Beatriz Nofal for their suggestions. This chapter was first published as a *Perspective* on August 17, 2009.

²¹ In 2008, Latin America and the Caribbean achieved its sixth consecutive year of positive economic growth (see ECLAC 2008).

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, 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 years²² 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.²³ 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.

²² 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).

²³ For more details about the different measures taken by the governments of the region to confront the crisis, see ECLAC, 2009c.

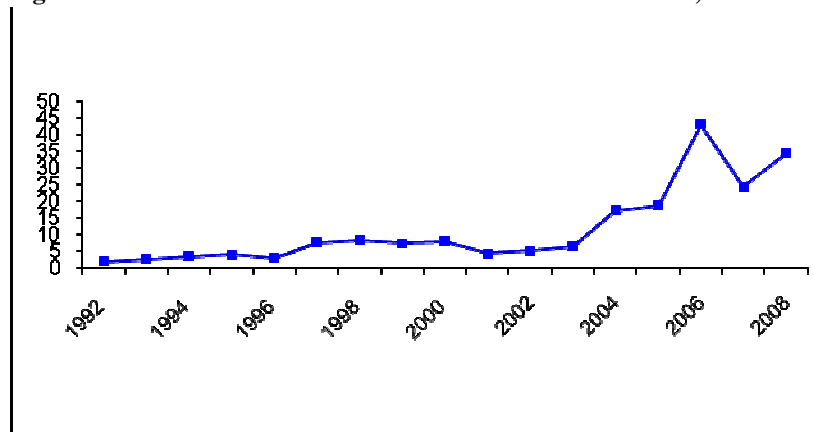
All this said, it should nonetheless be emphasized that there are no guarantees that outward investment by Latin American firms will continue growing or will outpace investment by firms from other regions. Whether that happens depends largely on the particular circumstances of a relatively small number 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 table 2).

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.).²⁴ In this, Latin America and the Caribbean is far behind the policy initiatives of many Asian developing countries.

Annex

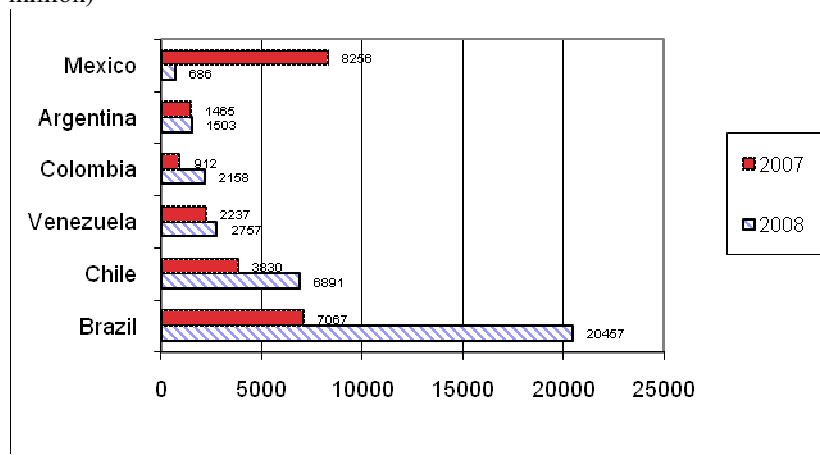
Figure 1. Latin America and the Caribbean: net OFDI flows, 1992-2008 (US\$ billion)



Source: ECLAC (2009a).

²⁴ For further discussion of these points, see UNCTAD, 2006.

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



Source: ECLAC, 2009a.

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	Gerda	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).

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.

^aReported OFDI for Brazil covers the period January to May 2009.

Table 3. Main acquisitions by Trans-Latins outside their countries of origin, announced or concluded in 2009 (USD million)

Company or assets acquired	Country of company or assets acquired	Acquired by	Country of origin of acquiring company	Seller	Country of seller	Announced 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/McAllen 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 (Government)	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.

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Chapter 10

How BRIC MNEs deal with international political risk

*Premila Nazareth Satyanand**

Hitherto, political risk has worried developed country multinational enterprises 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.²⁵ 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.²⁶ 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

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

²⁵ 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 (VCCI).

²⁶ 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.

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.

BRIC firms, like global counterparts, are confident about their ability to assess political risk and implement existing mitigation strategies.²⁷ 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 U.S. 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

²⁷ 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>.

agreements with overseas insurers. As yet, few emerging market insurers have 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 11

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 foreign direct investment (IFDI), which plays such a crucial role in China's economic development, and its outward FDI (OFDI), which is receiving increased attention worldwide.²⁸

China has been the developing world's largest recipient of IFDI since the mid-1990s, attracting US\$ 95 billion in 2009.²⁹ 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,³⁰ 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.³¹ China's OFDI doubled from US\$ 12 billion in 2005³² to US\$ 27 billion in 2007, and then doubled again the following year, to reach US\$ 56 billion.³³ 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

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

²⁸ 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.

²⁹ UNCTAD FDI statistical database <http://stats.unctad.org/>.

³⁰ Figure for the first eight months of 2010 from MOFCOM website: <http://www.fdi.gov.cn/>.

³¹ 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.

³² Not including financial FDI.

³³ Ministry of Commerce, *2009 Statistical Bulletin of China's Outward Foreign Direct Investment* (2010).

government policy have been the main drivers of this surge. The 20% revaluation of China's currency against the U.S. dollar in 2005-2008 undoubtedly provided a favorable condition facilitating this in the case of host countries whose currencies did not also appreciate against the U.S. dollar. There is ample evidence in the academic literature that a weaker exchange rate induces increased IFDI.³⁴

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%.³⁵ 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.³⁶ Japan's OFDI tripled from US\$ 6.5 billion in 1984 to US\$ 19.5 billion in 1986, peaking at US\$ 48 billion in 1990.³⁷

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 or abroad. Already more than 700 Chinese affiliates have been established in Vietnam.³⁸ Revaluation would push even more in that direction.

Suspicious 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.

³⁴ 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 Kathy L. Dewenter, "Do exchange rate changes drive foreign direct investment?", *The Journal of Business*, vol. 68, (1995) 3, pp. 405-433.

³⁵ Invest in China website: <http://www.fdi.gov.cn>

³⁶ 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.

³⁷ JETRO, Japanese Trade and Investment Statistics, JETRO website: <http://www.jetro.go.jp/>.

³⁸ *China Daily*, August 31, 2010, p. 14.

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 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 12

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.³⁹

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.⁴⁰ 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

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

³⁹ 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).

⁴⁰ See, *inter alia*, Deborah Brautigam, *The Dragon's Gift: The Real Story of China in Africa* (New York: Oxford University Press, 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 multinational enterprises 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 million⁴¹ – 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 U.S.'s African Growth and Opportunity Act (AGOA) may nudge China to invest more in democratic and market-based economies.

Conclusion

⁴¹ "World Bank unit to finance Chinese Africa venture," *Financial Times*, April 22, 2010.

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 13

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 multinational enterprises 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.

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

* The author would like to thank John Cantwell, Torbjörn Fredriksson and Robert Pearce for their thoughtful comments on a draft of this chapter. It was first published as a *Perspective* on April 29, 2009.

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 U.S.-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 skilful 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 U.S. 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 U.S. 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 U.S. and Europe and lower the inclination to perceive this development in the frame of a long-term win-win scenario.

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PART III

NATIONAL POLICIES

Chapter 14

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 U.S. Emergency Economic Stabilization Act authorizes

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purchase of distressed assets (especially mortgage-backed securities) in financial institutions if they have “significant operations” in the United States. Early reports suggest that domestic U.S. 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 U.S., may be self-executing as a matter of U.S. constitutional law giving investors of a state-party the ability to initiate claims before U.S. courts.⁴²

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

⁴² *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.⁴³

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

⁴³ 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 15

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 2008.⁴⁴ At that time, the authors, Anne van Aaken and Jürgen Kuntz, 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.⁴⁵ 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.⁴⁶ 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

* The authors wish to thank Anne van Aaken, Ted Posner, and an anonymous reviewer for their helpful comments on this chapter. It was first published as a *Perspective* on June 17, 2010.

⁴⁴ See chapter 1, Anne van Aaken and Jürgen Kurtz, “The Global Financial Crisis: Will State Emergency Measures Trigger International Investment Disputes?”.

⁴⁵ The reports are available at www.oecd.org/daf/investment/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.

⁴⁶ 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>

for a few emerging markets, almost all countries in the OECD inventory established such 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,⁴⁷ 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

⁴⁷ 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.

Chapter 16

Are sovereign wealth funds 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 sovereign wealth funds (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 multinational enterprises accounted for 40% of all FDI inflows.⁴⁸

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 U.S. 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.⁴⁹ 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.⁵⁰ Whereas observers once feared an excessive push toward the regulation of foreign investment and a consequent stifling of FDI inflows into OECD

* The authors are grateful to José María Serena Garralda and April Knill for their comments on earlier drafts of this chapter. It was first published as a *Perspective* on July 21, 2009.

⁴⁸ Karl P. Sauvants, "Driving and countervailing forces: a rebalancing of national FDI policies," in Karl P. Sauvants, ed., *Yearbook on International Investment Law and Policy 2008-2009* (New York: Oxford University Press, 2009), pp. 239-240.

⁴⁹ William Miracky et al., "Sovereign wealth fund investment behavior: analysis of sovereign wealth fund transactions during Q3 2008," Monitor Company Group Publications (2008).

⁵⁰ 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).

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 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.⁵¹ 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.

⁵¹ Bernardo Bortolotti, Veljko Fotak, William Megginson, and William Miracky, “Sovereign wealth fund investment patterns and performance,” Fondazione Eni Enrico Mattei Working Paper, mimeo (2009).

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 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 17

Sovereign wealth funds: much ado about some money

*Charles Kovacs**

The first sovereign wealth fund was established by Kuwait in 1953,⁵² and was followed by many others from 1973-1974, after the first oil crisis.⁵³ 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,⁵⁴ 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 2009.⁵⁵

These investments brought SWFs not only increased attention, but also their name, adopted by the *Financial Times* in May 2007.⁵⁶ 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.⁵⁷

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⁵² 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).

⁵³ Singapore was the exception to this rule; it established in Temasek Holdings in 1974, and the Government of Singapore Investment Corporation in 1981.

⁵⁴ 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.

⁵⁵ BFMM, op. cit., p. 1.

⁵⁶ BFMM, op. cit., p. 50.

⁵⁷ 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).

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 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 foreign direct investment, 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.⁵⁸

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.

⁵⁸ UNCTAD, *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge* (Geneva: UNCTAD, 2008), p. 20.

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 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 18

The revised national security review process for FDI in the United States

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

On December 22, 2008, new regulations setting forth the U.S. government's national security review process for foreign mergers and acquisitions of U.S. 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).⁵⁹

CFIUS administers the so-called Exon-Florio statute, which provides the U.S. President with the authority to review mergers, acquisitions and takeovers that may result in foreign control over a U.S. 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 U.S. national security in a manner that cannot be mitigated or that is not, in the President's judgment, otherwise addressable through other U.S. 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 U.S. 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 U.S. 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 U.S. parties. The

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

⁵⁹ 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 U.S. 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.

timeframe for CFIUS review – and Presidential action, when necessary – can be summarized as follows:

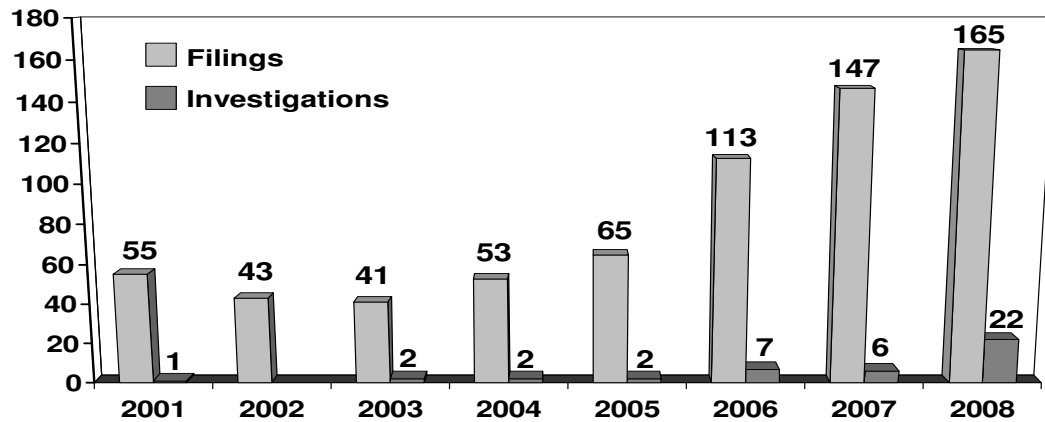
- CFIUS conducts an initial 30-day review following receipt of a voluntary notice filed jointly by the foreign acquirer and the U.S. business. The vast majority of CFIUS cases are concluded following this initial 30-day review.
- For transactions deemed to require additional review following the initial 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 U.S. 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 U.S. 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 U.S. 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 U.S. 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.

Table 1. CFIUS Filings and Investigations, 2001-2008



Source: U.S. Treasury Department.

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 U.S. 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 U.S. parties alike by assuring greater transparency and stability in the CFIUS review process.

Chapter 19

Foreign direct investment and U.S. 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 U.S. 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.⁶⁰ In 2008, CFIUS reviewed 155 cases; CFIUS reviewed fewer than half as many transactions in 2009.⁶¹ 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

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

⁶⁰ 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>.

⁶¹ 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.

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.

Second, the Foreign Investment and National Security Act of 2007 (FINSAs), 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 FINSAs 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 U.S. acquirers.

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 FINSAs become more routine, and the internal precedent under FINSAs 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 20

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.⁶² 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.⁶³ 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.⁶⁴

At a time when many jurisdictions, including the U.S. 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.⁶⁵

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

* The author wishes to thank Anthony Baldanza and Ed Safarian for their helpful comments on this chapter. It was first published as a *Perspective* on July 30, 2009.

⁶² 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).

⁶³ 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).

⁶⁴ The link for the Extended Note is: <http://vcc.columbia.edu/pubs/documents/ICAextendednote-Final.pdf>.

⁶⁵ 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).

security.⁶⁶ 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 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.⁶⁷ 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.⁶⁸ 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 U.S. 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 U.S.

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

⁶⁶ 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.

⁶⁷ Mostaghel, “Dubai Ports World under Exon-Florio: a threat to national security or a tempest in a seaport?”, *op. cit.*, p. 608.

⁶⁸ 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.

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.⁶⁹

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.⁷⁰ 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.

⁶⁹ Competition Policy Review Panel, *Compete to Win: Final Report* (Government of Canada, June 2008).

⁷⁰ "Teck Resources announces C\$1.74 billion private placement," News Release (July 3, 2009), available at: www.teck.com.

PART IV

INTERNATIONAL INVESTMENT TREATIES AND ARBITRATION

Chapter 21

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 foreign direct investment (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.⁷¹

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.⁷² 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

* The author wishes to thank Marc Bungenberg, Jan Winter, Joern Griebel and Thomas Eilmansberger for their helpful comments on this chapter. It was first published as a *Perspective* on March 24, 2010.

⁷¹ See chapter 9 above, José Guimón, “It’s time for an EU investment promotion agency”.

⁷² Marc Bungenberg, “The politics of the European Union’s investment treaty making,” in Tomer Brode, Marc L. Busch and Amy Porges, eds., *The politics of international economic law* (Cambridge University Press, forthcoming), 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.

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 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 2006,⁷³ 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.

⁷³ 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 22

How much do U.S. 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 foreign direct investment. 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.⁷⁴ 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.⁷⁵ In a recent working paper, I presented results from a mail-based survey of general counsels in large U.S. 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 U.S. 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 U.S. corporations, the survey’s results should be viewed as preliminary rather than definitive.

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⁷⁴ For a valuable collection of the main studies, see Karl P. Sauvant & Lisa E. Sachs, eds. *The Effects of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows* (New York: Oxford University Press, 2009).

⁷⁵ 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: Oxford University Press, 2010), ch. 14.

Responses were received from corporations across the top 200, including four in the top ten, and included corporations from all major economic sectors.

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”).⁷⁶ General Counsels reported an identical median level of unfamiliarity with BITs by non-lawyer senior executives.⁷⁷ 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”).⁷⁸ 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”).⁷⁹

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”),⁸⁰ and only four respondents reported that their company had declined to invest in a specific project because of the absence of BIT protections.⁸¹ 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

⁷⁶ The question read, “How familiar are lawyers in your office with the basic provisions of Bilateral Investment Treaties (BITs)?”

⁷⁷ The question read, “How familiar are nonlawyer senior executives in your corporation with the basic provisions of BITs?”

⁷⁸ The question read, “In your view, how effective are international treaties like BITs at protecting foreign investments from expropriation by a foreign government?”

⁷⁹ 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?”

⁸⁰ 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?”

⁸¹ 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?”

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.

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 23

U.S. BITs and financial stability

Kevin P. Gallagher^{*}

Almost immediately after taking office, the Obama administration charged the U.S. Department of State's Advisory Committee on International Economic Policy with reviewing the U.S. Model bilateral investment treaty (BIT). The group established a subcommittee of business groups, labor and environmental organizations, and a handful of academic experts and tasked it to make official recommendations for reforming U.S. 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 U.S. Model BIT).⁸² In most recent U.S. 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.⁸³ 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 U.S. in a revised Model BIT:

^{*} The author wishes to thank Stephen Canner, Thea Lee and Theodore Posner for their helpful comments on this chapter. It was first published as a *Perspective* on February 23, 2010.

⁸² 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).

⁸³ See Congressional testimony by Georgetown Law Professor Robert Stumberg: <http://waysandmeans.house.gov/Hearings/Testimony.aspx?TID=2163>.

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.*

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.⁸⁴ 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.*

U.S. 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.⁸⁵ 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 U.S. Model BIT does not explicitly exclude sovereign debt from the definition of covered investments, as NAFTA does. It should. The U.S. 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 U.S.-Peru FTA-like provisions that limit an investor's ability to bring an investor-state claim based on a debt

⁸⁴ See *Saluka Investments BV v. The Czech Republic*, UNCITRAL, Award (March 17, 2006), available at <http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf>.

⁸⁵ See Ayhan Kose, Anwar 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 U.S. model is in tune with global efforts to prevent and mitigate financial crises benefits both the U.S. and its investment partners. Making sure that ample prudential exceptions exist can buffer the U.S. from liabilities for prudential regulations. What's more, stability among our investment partners helps U.S. investors and exporters have more certainty for markets. Crises could lead to defaults and large losses to U.S. assets and export markets. And, crises can cause contagion that spreads to other U.S. investment and export destinations. Trade and investment treaties should not prevail over regulations for financial stability in the U.S. and abroad.

Chapter 24

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,⁸⁶ 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.⁸⁷

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.⁸⁸

^{*} The author would like to thank Geza Feketekuty, Mark Kantor and Michael Nolan for their helpful comments on this chapter. It was first published as a *Perspective* on August 2, 2010.

⁸⁶ 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.”); R. Dolzer and M. 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”); J. 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*, 45 (2005), p. 753 (BITs “increase insurers’ abilities to offer favourable insurance terms to investors.”).

⁸⁷ Further details and discussion can be found in the full study.

⁸⁸ Covered countries are, Austria, Denmark, Finland, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

The Multilateral Investment Guarantee Agency (MIGA)

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 25

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.⁸⁹ 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 research⁹⁰ 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.⁹¹ 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.⁹²

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⁸⁹ 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>.

⁹⁰ 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*, 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 $\alpha = .05$).

⁹¹ 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.

⁹² Approximately 4% of the cases were settlement agreements. Figures do not add up to 100% due to rounding.

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 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.⁹³

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.⁹⁴ 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.⁹⁵ 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.⁹⁶ 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.

⁹³ Franck, *Empirically Evaluating Claims*, op. cit., pp. 49-50, 64.

⁹⁴ See e.g., Third World Network, *Finance: Bias Seen in International Dispute Arbiters*, June 22, 2007 (JUN07/02), available at: <http://www.twinside.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*, 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").

⁹⁵ 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: Oxford University Press, 2009).

⁹⁶ Franck, *Development and Outcomes*, op. cit.

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, 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 pursuing arbitration, there will be times when it is warranted and, ultimately, parties should think carefully about why arbitration is in their interests.

Chapter 26

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 U.S. 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.⁹⁷

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

^{*} The author wishes to thank Ed Kehoe, Jan Paulsson and an anonymous reviewer for their helpful comments on this chapter. It was first published as a *Perspective* on December 14, 2010.

⁹⁷ For further discussion of repeat arbitrators see Fatima-Zahra Slaoui, "The rising issue of 'repeat arbitrators': a call for clarification," *Arbitration International*, vol. 25, number 1 (2009), pp. 103-119.

their reputation of impartiality,⁹⁸ I disagree. I believe that lawyers feel that their duty to 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.

⁹⁸ 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-unilateral-appointments-defensible-on-jan-paulsson%E2%80%99s-moral-hazard-in-international-arbitration/>

Chapter 27

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.⁹⁹ 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.¹⁰⁰ 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

^{*} 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. It was first published as a *Perspective* on December 2, 2010.

⁹⁹ Michael D. Goldhaber, *American Lawyer Arbitration Scorecard 2009 – Contracts*, available at <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202431683613&hbxlogin=1>.

¹⁰⁰ 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).

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 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.”¹⁰¹ 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.”¹⁰² 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.¹⁰³

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

¹⁰¹ 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).

¹⁰² 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.

¹⁰³ 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).

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 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 28

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.¹⁰⁴ 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.¹⁰⁵

A vast architecture of international treaties has been established to protect flows of foreign direct investment 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

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¹⁰⁴ “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>.

¹⁰⁵ 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: Oxford University Press, 2010).

protect foreigners and foreign-controlled organizations from government actions 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.¹⁰⁶ Although most of these disputes are commercially-oriented and relate to tax, licensing or regulatory matters,¹⁰⁷ others have touched on politically-motivated expropriations of media outlets during military coups or alleged discrimination against publishers who publish political opposition literature.¹⁰⁸

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.

¹⁰⁶ 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).

¹⁰⁷ 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).

¹⁰⁸ 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.¹⁰⁹

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. Multinational enterprises 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 U.S. Department of State now signaling that Internet freedom should be advanced through U.S. foreign policy, it remains to be seen whether the U.S. negotiating position on international investment treaties will shift so as to embrace this foreign policy objective. Ongoing investment treaty talks between the U.S. and China could provide the obvious forum for this issue to be raised and debated.

¹⁰⁹ 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 29

Thinking twice about a gold rush: PacRim Cayman LLC 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.¹¹⁰ 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.¹¹¹ 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 author wishes to thank three anonymous reviewers for their helpful comments on this chapter. It was first published as a *Perspective* on May 24, 2010.

¹¹⁰ The second lawsuit is by U.S.-based Commerce Group Corporation. I focus on the Pacific Rim case here because there is more information publicly available about it.

¹¹¹ 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).

The question of how the arbitrators in *PacRim Cayman LLC v. El Salvador* might resolve 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 30

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.

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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, 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.