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Multilateral Agreement on Investment: A Briefing on the Investment-Related Disciplines and the WTO

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Executive Summary

1. Three years after the OECD abandoned its controversial Multilateral Agreement on investment (MAI), a group of advanced countries, including the EU and Japan are again attempting to establish a similar agreement, this time at the WTO. From the submissions made by these countries at the WTO's Investment and Trade Working Group, it would seem that they would like an agreement which would provide investors with high standards of protection as well as freedom to invest anywhere and in any activity (subject to the usual exceptions for defence, culture etc.). One important difference between the OECD's MAI and the advanced countries' proposed new agreement at the WTO (referred to throughout this paper as PMAI) is that the latter would exclude short-term capital flows and only be concerned with FDI.

2. This paper examines the implications of PMAI particularly from the standpoint of developing countries. It argues that (a) the case against MAI-type agreement is if anything stronger now than before; such a treaty would seriously prejudice economic development. (b) PMAI is not only incompatible with the developmental needs of poor countries, it is also likely to harm the interests of advanced country citizens and workers. (c) A continuation of the status quo in this area (i.e., implementing the bilateral investment treaties) would be preferable for developing countries than the PMAI. The paper outlines at the end the general principles of a development friendly multilateral agreement on investment.

The reasoning behind the propositions (a) to (c) above will be briefly presented in this Executive Summary and more fully explained in the main body of the paper.

3. FDI in the 1990s has become a predominant source of external finance for developing countries. At the same time, these countries need for external finance has for structural reasons become greater than before. This has lead to intense competition among them for attracting FDI. This has shifted the balance of power in the dealings between developing countries and the multinationals towards the latter. An important shortcoming of the PMAI from a developing country perspective is that instead of redressing this imbalance such a treaty would make it worse.

4. The current international distribution of FDI inflows is unsatisfactory for the economic development of poor countries. Such inflows among these countries are largely concentrated in a small number of relatively fast growing nations which already have high savings and investment rates. More generally FDI does not go to low income and Least Developed countries which have low savings rates and require FDI to meet their developmental goals. The PMAI, by giving virtually complete freedom to multinationals would not improve the situation but, if anything, would accentuate these difficulties.

5. A detailed analysis of FDI as a source of long term finance for developing countries indicates that unless it is adequately regulated by their governments, in the particular circumstances of these countries, where they are subject to frequent internal and external shocks, it would lead to short and long-term financial fragility. To avoid this fragility, it is necessary for developing country governments to control (a) the timing of the FDI; (b) the total amount of FDI; as well as (c) the selection of large projects by multinationals. These measures are needed to ensure that there is no mismatch of the time profile of a country's foreign exchange inflows and outflows. Such time inconsistency can lead to a liquidity crisis, which as the experience of Asian economic crisis shows, may degenerate into solvency problems with ultimately devastating consequences for the real economy.

6. These arguments for permitting developing countries to be able to monitor and to regulate FDI flows are further complemented by considerations of technology transfer and spillover benefits. Research shows that both of those occur best when FDI is carefully regulated and fits well into a country's development program.

7. Increasingly, FDI in developing countries other than China is taking the form of mergers and acquisitions (M & As). This raises troubling questions for the PMAI. If FDI is occurring through take-overs, would the PMAI require that an advanced country corporation should be able to purchase any host country corporation on the stock market without any let or hindrance (subject to normal exceptions). If so, such a procedure would have highly negative consequences from a developing country perspective. The paper suggests that under PMAI, if FDI takes the form of acquisition of host country corporations on the stock market, the net result could be that of the

best developing country corporations being acquired by multinationals even though the latter would not be as efficient as the acquired corporations.

8. The current gigantic international merger movement raises another area of serious concern for developing countries in relation to PMAI. Already, the playing fields are tilted against the developing country corporations and favour the large multinationals in a variety of ways. The present merger wave will further accentuate the disparity in size and market power of the multinationals compared even with the largest developing country corporations let alone the small and medium-sized firms.

9. The mechanical application of the WTO principle of 'national treatment' in the above circumstances would clearly lead to perverse results which would both harm economic development in developing countries as well as lead to global economic inefficiency. The remedy in these circumstances may lie in competition authorities in developing countries being exempted from the doctrine of national treatment subject to a safeguard clause such as a rule of reason in the context of promotion of economic development, the latter being a primary goal of the WTO as suggested below.

10. The analysis and proposals presented in this paper run contrary to the cherished WTO 'principles' such as national treatment and market access, as well as seek to reopen agreements already settled such as TRIMS. The main justification for this opposition is that the ultimate goals of WTO, as set out in its Preamble, include economic development and full employment as very important objectives. Experience and analysis show, however, that these goals are being hindered rather than helped by the TRIMS agreement and by the application of the doctrine of national treatment in all cases. It is argued here that in a conflict between the primary objectives and the procedural rules of an international organization, it is the former which should dominate especially as these goals are widely endorsed by the world community as a whole. The right to a decent living is virtually a universal human right while "principles" such as national treatment are no more than procedural rules which cannot have precedence over economic development.

11. It has been suggested above that unfettered FDI as envisaged in PMAI can lead to financial fragility in developing countries and harm their development prospects.

are good reasons to believe that although there are gains to the multinationals and their managers from PMAI as it would give them a license to invest anywhere they like, it does not necessarily greatly benefit the citizens of advanced countries. With the free mobility of capital provided by PMAI, and labour being essentially immobile, the balance of power shifts decisively towards capital in these countries. Apart from its unfavourable implications for the distribution of income between labour and capital, such a shift may also leads to job insecurity and low labour standards. It is, however, suggested here that with appropriate regulation of FDI by *both* developed and developing countries, its results for the two groups of countries could be highly positive. This would, however, involve the abandonment of PMAI and purposeful co-operation between the rich and poor countries.

12. To attract FDI, developing countries have entered into a large number of bilateral investment treaties (BITs) with developed as well as other developing countries, particularly in the 1990s. These treaties are popular with developing countries because they provide for national treatment to foreign investors in the post-establishment phase only, and do not place any restrictions on host countries in following their own FDI policies.

13. The advocates of PMAI make a number of arguments for replacing BITs by multilateral treaties, none of which is convincing. The paper notes, for example, that there has been an enormous increase in FDI flows to developing countries during the 1990s without there being a multilateral investment treaty in place. Investors obviously regard BITs as adequate protection. Moreover, countries such as China and Malaysia , with illiberal investment regimes, have been among the largest recipients of FDI during the last decade.

14. It is argued that in the absence of a development friendly multilateral treaty, even the small, poor, powerless developing countries would be better off with the BITs than with a multilateral treaty of the PMAI kind.

15. The last part of the paper sets out the basic framework of a development friendly multilateral treaty. It is suggested that the following elements should form the cornerstone of such a treaty

i) permitting countries to be *selective with regard to the timing of FDI and to actual FDI projects,* according to their current development level and needs;

ii) legitimizing *"qualified" market access* so that a potential host country could specify the degree to which it would give national access, in terms of the percentage limit on foreign shareholding, or the total value of individual or aggregate foreign investment;

iii) preventing the abuse of monopoly power by large multinationals, encouraging, as far as possible, level playing fields between large foreign investors and smaller domestic companies so that the latter can continue to operate and flourish;

iv) permitting *limitations to national treatment,* giving governments scope to stipulate performance requirements and similar measures, TRIMs not withstanding, in order to encourage foreign enterprises to contribute to development objectives, including a healthy balance of payments;

v) establishing *rules of conduct for foreign investors* to prevent bribery and corruption and tax avoidance through transfer pricing, among other things;

vi) having neither a negative nor a positive list, but only a requirement for notification from time to time of the exceptions to national treatment;

vii) the inclusion of "developmental reasons" in the category of general exceptions in addition to security, public order or cultural reasons;

viii) freedom from standstill and roll-back obligations;

ix) ground rules for providing a credible and predictable environment for FDI from the investors' perspective including guaranteeing the protection of investment;

x) establishing an appropriate dispute settlement mechanism to take account of developing countries' circumstances.

Multilateral Agreement on Investment: A Briefing on the Investment-Related Disciplines and the WTO

I Introduction

Three year ago when the OECD abandoned its controversial Multilateral Agreement on Investment (MAI) in the wake of wide spread opposition from the civil society, developing countries, and ultimately from advanced countries such as France, it was thought by many that the idea was dead[1]. However, it is being energetically revived at the Working Group on investment and trade at the WTO by advanced countries including the EU, Japan and by the new comer to the rich nations club namely, South Korea. There are however, no substantial new arguments being put forward by the proponents of the 'born-again' MAI. Nevertheless some real, and some not so real, concessions are being made in the direction of civil society and towards developing countries. The real concession is that the proposed agreement would apply only to foreign direct investment (FDI) and not include portfolio investment and other short-term capital flows. The abandoned OECD agreement had a comprehensive definition of investment and included the latter together with FDI (see section II below).

The less tangible concessions are those made in the language used (much more friendly) and the large measure of sympathy expressed for environmental and developmental concerns of the civil society and developing countries, respectively. No specific proposals have however, been put forward to address these issues. This briefing will argue:

[1] Developing countries had no part in the negotiations on the OECD MAI. The expectation was that these countries would be asked to accede to its provisions after the agreement had been established between the OECD member countries. This, of course, was not acceptable to many developing countries and it also led to

1. Firstly, that the case against an MAI-type agreement is if anything stronger now than before. This is in part because of the Asian crisis but is also due to other events in the world economy. Such a multilateral accord would seriously prejudice economic development.

2. Secondly, the paper will suggest that the proposed EU-supported agreement at the WTO would not only act against the developmental needs of poor countries but also most likely harm the long term interests of citizens in developed countries themselves. In other words, contrary to the assertions of its sponsors, the proposed agreement, it will be suggested, would be sub-optimal for both rich and poor countries.

3. A corollary of above conclusions is that continuation of the status quo in this area (i.e. the implementation of the Bilateral Investment Treaties, BITs) will be preferable from a developing country perspective than the proposed multilateral agreement.

4. Nevertheless, if at the end of the day, it is agreed by member countries that multilateral multilateral agreement should in any case be negotiated at the WTO, the paper outlines the general principles which should be incorporated in such an agreement to reflect the developmental concerns of poor countries.

II Proposed MAI and the WTO

It would appear from the Papers and the so called Non- Papers circulated by the European Union, Japan and Korea at the WTO that these countries would like to conclude, subject to the concessions noted above, a comprehensive investment agreement essentially of the same

second half of 1990s. The advanced countries' preference would seem to be to establish a binding treaty at the WTO which would create for foreign investment a regime similar to that of (free) trade in goods. Such a regime would basically provide multinational companies with a license to invest anywhere they like, without significant restrictions. Although industrial countries have made no firm proposals at this stage, to the extent that they choose to follow OECD's MAI model, it would involve the following kind of elements (as noted by Singh and Zammit, 1999).

- the right of establishment for foreign investors;
- the principles of 'most-favoured nation' (mfn) treatment;
- the principle of 'national treatment';
- investment protection, including matters relating to expropriation and the transfer of capital;
- additional disciplines relating to, among other matters, entry, stay, and work of key personnel;
- abolition of performance requirements imposed by host governments on foreign investors in order to secure economic benefits for the country as a whole;
- multilateral rules on investment incentives;
- binding rules for settling disputes.

Thus, it would seem from the papers and discussions being carried out at the WTO Working Group on Investment and Trade that EU, Japan and Korea would like a regime with high standards and strong disciplines against restrictions on free-flow of FDI activity, among WTO member countries. The Unites States agrees with the need for a treaty with high standards, but is sceptical whether this is possible within the WTO. In view of the almost

would be possible only to negotiate there a multilateral agreement with low standards. Nevertheless, the US does not oppose discussions and negotiations on the subject at the WTO, if member countries wish to pursue these.

The original MAI was all embracing in its definition of investment. As OECD (1997) noted, the scope of the proposed Treaty went "beyond the traditional notion of FDI to cover virtually all tangible and intangible assets which applies to both pre-establishment and post-establishment". The abandoned OECD agreement therefore included, among other things, intellectual property as well as portfolio investment.

The present motivation of advanced countries for confining their proposed MAI type agreement at the WTO (*hereafter referred to throughout this paper as PMAI*)[2] to just foreign direct investment are not difficult to surmise. In the aftermath of the Asian crisis, it has been widely recognised that the volatility of short-term capital flows often leads to serious economic and financial problems for developing countries. There is therefore an emerging consensus that it may be prudent for governments of these countries to restrict such flows. Indeed, one of the world's leading advocates of free trade Professor Bagwati of Columbia University takes the IMF severely to task for encouraging developing countries to liberalise their capital accounts before they were adequately prepared for it. The IMF has in response changed its stance and is willing to countenance leading emerging countries' use of capital controls for the management of short-term capital flows. Moreover, although there is some controversy as to how successful capital controls have been in Malaysia and Chile, hardly anybody argues that these have done harm to these economies. [see further Rodrik (2001); Krugmann (1998)].

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[2] To distinguish the OECD MAI from the similar agreement which advanced countries are putting forward at

Advanced countries are therefore, wise to lower their sights and exclude short term and other controversial capital flows from the preview of the PMAI, and seek agreement only on FDI. It is widely believed on the basis of the experience of the debt crisis in the 1980's and the subsequent Mexican, Asian and other crises in the 1990s that compared with debt and portfolio investment, the FDI, apart from its other merits, is the safest source of funds for developing countries. It is thought to neither add to a country's debt, nor (being bricks and mortar) can it be quickly withdrawn from the country. The proponents therefore, expect that an MAI, concerned only with FDI would be much more acceptable to developing countries. This issue however is more complicated than might appear at first sight, and will therefore be discussed more fully below.

Developing countries are a diverse and heterogeneous group in terms of their economic conditions and needs, but a number of them (including India) are trying to find common ground so as to be able to defend their developmental interests. In relation to the proposed investment agreement their greatest difficulties are with the questions of the right of establishment and national treatment, both pre and post-establishment. As the following sections will show there are very good analytical reasons as well as substantial empirical evidence to support developing countries' reservations.

III Changing Pattern of International Capital Flows, FDI and Developing Countries

There have been enormous changes in the amounts and the pattern of capital flows from industrial countries to emerging economies in the 1980s and the 1990s compared with the

1960s and 1970s. At the same time, there has also been a sea-change in developing countries' perspective on, and attitude towards, FDI. In the earlier period, developing countries were often hostile towards multinational investment and sought to control multinational companies' activities through domestic and international regulations. However, during the last two decades emerging countries have been falling over themselves to attract as much multinational investment as they can. It will be suggested below that this enormous shift in developing countries stance toward multinational investment is closely related to the changes in the pattern of capital flows. The former is both the cause and the consequence of the latter. It will further be argued that developing countries find the new profile of international capital flows profoundly unsatisfactory from a developmental perspective. Their opposition to PMAI stems in part from the fact that it would, instead of improving this pattern of capital flows, further accentuate its negative features in relation to economic development.

The rest of this section will summarise the main changes in the capital flows from industrial to developing countries which have occurred in the 1980's and the 1990's. It will also comment on the apparent paradox of developing countries being positive about FDI and yet opposed to the PMAI.

III.I International Capital Flows in the 1980s and 1990s and Developing Countries.

The most important characteristics of international capital flows to developing countries during the last two decades include the following. (The relevant tables are given in the Appendix).

(1) There has been an enormous increase in resource flows to developing countries during the last three decades as the world economy has liberalised and become financially more integrated. World Bank figures indicate that net resource flows to all developing countries rose from a mere US $11b or so in 1970 to more than US $80b in 1980 and to just over US $100b in 1990.

Net resources flows to developing countries recorded a quantum jump between 1990 and 1995, rising to nearly US $240 billions in the latter year. There was a further sharp increase in the next two years until the Asian crisis. There have been reduced net resource flows subsequently (Appendix Table 1).

(2) Appendix Table 1 also provides information on the changing sources of the external resource flows to developing countries during the last three decades. The table suggests that in the 1970s, long term debt was the predominant source of finance. In the 1980s, as a consequence of debt crisis, this source became relatively less important compared with before and the significance of FDI as well as that of government grants rose. In the 1990s FDI has emerged as a predominant source of external finance for developing countries. Although the rate of growth of Portfolio Equity flows was faster during that decade, these started at a much lower level than FDI at the beginning of the 1990s.

(3) The IMF data reported in Table 2 in the Appendix enables us to distinguish between private and official flows[3]**.** The important point which emerges from this table is that most of the increase in capital flows to developing countries between the 1980s and

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[3] The categories used and the countries included in the composite " developing countries" differ

the 1990s has been due to private rather than official flows. Between 1990 and 1996 private flows were on average, nearly 8 times as large as official flows.

(4) Appendix Table 3 reports data from the World Bank on developing countries shares in global FDI, in capital market flows, and for a comparative perspective, it also reports these countries share in global output and international trade for each of the years 1991 to 2000. The table indicates that developing country shares both in global FDI and capital market flows have become much smaller since the Asian crisis. However, these countries shares in global output and trade in the corresponding period have not declined but remain much the same.

(5) Inward FDI flows accounted on average for 5% of advanced countries gross fixed capital formation during the late 1980s and for most of the 1990s. However, there was a sharp increase in this share in 1998: inward FDI's contribution in these countries rose from 6.2% in 1997 to 10.9 % in 1998. For developing countries inward FDI, during the 1990s was relatively more important in relation to the gross fixed capital formation than for developed countries (See Table 4 in Appendix).

(6) FDI flows to developing countries are highly concentrated. Ten countries accounted for nearly three-quarters of the total FDI flows in 2000 (World Bank 2001, page 38).

III.2 Implications for Developing Countries

This pattern of capital flows including that of FDI has important substantive implications for developing countries. The decline of grants and other official flows has meant that private capital, particularly in the form of FDI has become a major source of external finance for these countries. At the same time, analysis and evidence suggest that developing countries' need for external finance has greatly increased. This is in part due to the liberalisation of trade and capital flows in the international economy. UNCTAD (2000) suggests that because of these structural factors, developing countries have become more balance of payments constrained than before: the constraint begins to bite at a much slower growth rate than was the case previously in the 1970's and 1980's. In these circumstances it is not surprising that developing countries have radically changed their attitude towards FDI. There has also, therefore, been intense competition among these counties for attracting FDI.

Turning to the paradox of developing countries' favourable view of FDI and nevertheless, of their opposition to PMAI, it is important to observe that from the perspective of developing countries the present pattern of external resource flows is very unsatisfactory. As seen above FDI flows are concentrated in a few countries. These are normally countries, particularly the ones in East Asia, which already have very high savings and investment rates. On the other hand, low income and the Least Developed countries which have small saving rates because of their meagre levels of GDP per capita, do not get FDI or other external resources they need. Indeed, in broader terms, contrary to text book neo-classical economics, world resources do not go from the rich to the poor countries but instead are predominantly allocated to the rich countries including the richest among them, i.e., the US. Developing countries oppose PMAI because it would do nothing to change this unsatisfactory pattern of resource flows; instead it is likely to accentuate these negative features.

Moreover, as suggested above there has developed fierce competition between developing countries for FDI and as was noted there are good reasons for it. This has however, resulted in a shift in the balance of power towards multinationals in their dealings with developing countries. The latter fear, if PMAI were to be approved, it would instead of, redressing this imbalance make it worse than before.

IV PMAI and FDI as a Major Source of External Finance

As indicated above, an important characteristic of FDI today is that it has become a prominent source of external finance for developing countries. Table 4 suggests that during 1996-1998 FDI accounted for about 10% of typical developing country's gross fixed capital formation. In this section leaving aside other characteristics of FDI (to be discussed later), we shall consider it simply as a source of finance, and examine its implications for balance of payments and for macroeconomic management of the economy. In orthodox analyses, FDI apart from all the other supposed advantages, is regarded as a stable source of finance (UNCTAD 1999; Lipsey 1999). In contrast to portfolio investments, FDI by definition is supposed to reflect a long term commitment as it involves normally a stake of 10% or more in a host country enterprise together with managerial control.[4] In view of the latter element, the presumption is that the inflow of foreign capital in this form will be more stable than portfolio investments. The latter are easier to liquidate and following an internal or external shock, investors may quickly withdraw such funds from the host country.

There are, however, important arguments to suggest that the presumption of stability in *net* FDI inflows may not be correct. First, the distinction between FDI and portfolio investment has become very much weaker with the growth of derivatives and hedge funds. As

Claessens *et al*., (1993) observe in their World Bank study, even at a more elementary level it is easy to see how a long-term "bricks and mortar" investment can be converted into a readily liquid asset:

> "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows."

Another reason why FDI may be volatile is because a large part of a country's measured FDI according to the IMF balance of payment conventions usually consists of retained profits. As profits are affected by the business cycle, they display considerable volatility. This also prevents FDI from being anti- cyclical and stabilising unless the host and home county economic cycles are out of phase with each other. That may or may not happen.

Further, there is evidence that like other sources of finance FDI flows can also at times come in surges. Apart from their contribution to volatility, these FDI surges, as those for example of portfolio investment can lead to equally undesirable consequences such as exchange rate appreciation and reduced competitiveness of a country's tradable sector.

The World Bank paper referred to above came to the conclusion that: "long-term flows are often as volatile as short- term flows, and the time it takes for an unexpected shock to a flow to die out is similar across flows."[5] However, a more recent study, UNCTAD 1998 found

that between 1992 and 1997, FDI was relatively more stable than portfolio flows, but there were important exceptions. The latter included Brazil, South Korea and Taiwan.

Quite apart from the question of the comparative volatility of FDI and other flows, there are other important implications of FDI for a host country's balance of payments. These derive from the fact that an FDI investment creates foreign exchange liabilities not only now but also into the future. This characteristic leads to the danger that unfettered FDI may create a time profile of foreign exchange outflows (in the form of dividend payments or profits repatriation) and inflows (e.g., fresh FDI) which may be time inconsistent. Experience shows that such incompatibility, even in the short run may easily produce a liquidity crisis. The evidence from the Asian crisis countries with the latter suggests that it could in turn degenerate into a solvency crisis with serious adverse consequences for economic development.[6] Professor Kregel (1996) sums up the balance of payments implications of FDI in the following terms:

> "…while portfolio flows may have a more direct impact on short-term reserve management and exchange rate policy, FDI may have both a short and a longer-term structural influence on the composition of a country's external payment flows. While financial innovation allows FDI to have an impact in the short run which is increasingly similar in terms of volatility to portfolio flows, the more important aspect is the way it may mask the true position of a country's balance of payments and the sustainability of any particular combination of policies … accumulated foreign claims in the form of accumulated FDI stocks may create a potentially disruptive force that can offset any domestic or external policy goals." (Kregel, 1996).

These considerations suggest that in order to avoid financial fragility which is likely to follow from unfettered FDI, the government would need to monitor and regulate the amount

and timing of FDI. Since the nature of large FDI projects (whether or not for example these would produce exportable products or how large their imports would be) can also significantly affect the time profile of aggregate foreign exchange inflows and outflows, both in the short and long-term, the government may also need to regulate such investments. To the extent that the PMAI would not permit such regulation of FDI, it would subject developing economies to much greater financial fragility than would otherwise be the case.

It could in principle, be argued that even if the financial fragility point is conceded, a PMAI may still benefit developing countries by generating greater overall FDI which could compensate for the increased financial fragility. However, this proposition is of doubtful validity. We saw earlier, that there has been a huge increase in FDI in the 1990s. This occurred without any MAI and was clearly a product of a number of other factors.[7] Similarly, there does not seems to be any connection between regulatory constraints on FDI and the total amount of FDI which a country may be able to attract. Malaysia (see further US, 1996) and China, (see Braunstein and Epstein, 1999), to illustrate, are large recipients of FDI despite having significant control and regulation over FDI projects.

V. FDI, Technology Transfer, Spill-over and PMAI

Apart from FDI as a source of finance two of the most important ways in which a developing country may benefit from such investments is through (a) transfer of technology and (b) from spill-overs. The latter refer to the affect of FDI on raising productivity in local firms. These firms may be helped by foreign investment in a variety of ways, including the demonstration effect of the new technology and the enhancement of the quality of inputs which such investment may promote. On the other hand there may be few positive or even

negative spill-overs, if FDI leads to local firms being forced out of the market because of greater competition.

Both issues of technology transfer and spill-overs have been widely studied and there exists on these subjects a large and controversial literature. The main lesson which however comes from these writings is that a country is more likely to benefit from multinational investment if it is integrated into its national development and technological plans (see further Dunning (1994), Freeman (1989), Milberg (1999), South Centre (2000). This is the reason why, other than Hong Kong, most successful Asian countries (including China and Malaysia as seen above) have not allowed unfettered FDI but have extensively regulated it.

An interesting recent study by Agosin and Mayer (2000) investigates an important aspect of the spill-overs issue by asking the question whether FDI in a host country "crowds in" further investment by local firms or "crowds out" existing investments of these firms as a consequence of increased competition and hence lower profits. The two author's research covered the period 1970-1996 and included host countries from all three developing regions, Africa, Asia and Latin America. The results of the econometric exercise suggest that over this long period there was a strong "crowding in" in Asia, "crowding out" in Latin America and more or less neutral effects in Africa. Agosin and Mayer conclude:

> "The main conclusion that emerges from this analysis is that the positive impacts of FDI on domestic investment are not assured. In some cases, total investment may increase much less than FDI, or may even fail to rise when a country experiences an increase in FDI. Therefore, the assumption that underpins policy toward FDI in most developing countries - that FDI is

> always good for a country's development and that a liberal policy toward MNEs is sufficient to ensure positive effects - fails to be upheld by the data."

They go on to note:

> "…the most far-reaching liberalizations of FDI regimes in the 1990s took place in Latin America, and that FDI regimes in Asia have remained the least liberal in the developing world… Nonetheless, it is in these countries that there is strongest evidence of CI (crowding in). In Latin America, on the other hand,…liberalization does not appear to have led to CI."

The policy implications of this analysis of FDI in relation to technology and spill-overs reinforce the message of the last section: developing countries need to regulate FDI closely in order for it to promote economic development and not to hinder it.

Market Failures

In broad analytical terms, the case for such government interventions in the FDI process lies in various kinds of market failures. Co-ordination problems abound in relation to investment, including foreign investment, and in the presence of non-existent or incomplete markets typical in a developing economy, governments need to intervene to address co-ordination failures. As the UNCTAD Secretary General R. Ricupero (1999) observed:

> "Significant market failures characterise the TNC investment process in its relationship to developing countries. The first (kind of market failures) arise from information or co-ordination failures in the investment process, which can lead a country to attract insufficient FDI, or the wrong quality of FDI. The second arises when private interests of investors diverge from the

Milberg (1999) calls attention to another kind of market failure in relation to FDI which again calls for government intervention. He observes:

> "Location decisions of firms may deviate from those predicted by comparative advantage for a number of reasons. Firms may put national characteristics ahead of relative cost considerations. Also, to the extent that heightened capital mobility has coincided with growing global excess capacity, trade liberalization may not bring the price adjustment necessary to convert a relative productivity advantage to an advantage in terms of absolute money costs. When currency values do not respond to trade imbalances in the expected fashion, then the price adjustment implied by the theory of comparative advantage may also be inoperative."

Government Failures

It may be argued that these markets failures may turn out to be less important than government failures. That is certainly true in some cases, but it must be remembered that the developing world also contains a large number of highly successful governments, the so-called 'developmental states' in the newly industrializing countries (NICs). If developing countries are to attract the right kind of FDI, in the right amounts, and to be able to obtain the maximum benefit from these, they need to guide the process and therefore, must have effective states (see further Amsden, 2001). For otherwise, they will not receive sufficient FDI and may be more harmed than helped by what they get.

VI International Merger Movement , the FDI and Developing Countries[8]

The world economy has been undergoing a gigantic merger movement over the last decade, probably the largest ever.[9] An outstanding characteristic of this merger wave is the high incidence of cross border mergers and acquisitions (M & As). Indeed, such mergers and corporate take-overs are an important vehicle for FDI flows between industrial countries. However, cross border merger activity, although quite small by the standards of advanced countries, has greatly expanded in developing countries as well during the last three years. (See Table 5 in the Appendix for the sales and purchases of cross border M & As for the 1990s.) The data in Table 5 are, however, at an aggregate level - for the world as a whole and for the main regions. UNCTAD (1999) carried out a more detailed analysis of the incidence of cross border M & As in developing countries. It found that if China (which among developing countries has not only been the largest recipient of FDI but most of its investment has also been "green field") is excluded, the share of M & As in the accumulated FDI rises from 22% during 1988 to 1991 on average to 72% in the period 1992 to 1997.

This preferred mode of entry of FDI raises troubling questions in relation to its costs and benefits for developing countries. It also raises difficult questions for PMAI. When FDI takes the form of green field investment, it represents a net addition to the host country's capital stock. However, FDI entry via an acquisition may not represent any addition at all to the capital stock, output or employment. In the medium term there may be more investment by the acquiring firm if the acquisition is deemed successful. How beneficial FDI is to developing countries in the long term, if it takes predominantly the form of cross border take-overs of domestic firms by foreign corporations, is ultimately an empirical question on which there is so far little hard evidence.

Nevertheless, cross border take-overs raise difficult issues for PMAI. If FDI is occurring through take-overs, would the PMAI require that an advanced country corporation should be able to purchase any host country corporation on the stock market without any let or hindrance (except in relation to firms protected by national defence or other similar considerations)? This important issue does not appear to have been directly addressed in PMAI. However, going by the analogy with the green field investment where essentially the PMAI would permit any home country corporation to invest in any activity in a host country (subject to the usual caveats), it would follow that a foreign company should be able to acquire any domestic company as a form of FDI. From a developing country perspective such a procedure would have very negative consequences. There is a large literature which suggest that corporate take-overs take place only to a limited extent on the basis of performance, but largely on the basis of size. Research for the U.S. and the U.K. shows that in the market for corporate control, the large, relatively unprofitable companies have a much greater chance of survival than the small, profitable ones.[10] Thus, under PMAI, if FDI takes the form of acquisition of host country corporations on the stock market, the net result could be that of the best developing country corporations being acquired by the much larger multinationals even though the latter would not be as efficient as the acquired corporations.

The international merger movement raises another important area of concern for developing countries. This relates to the question of unequal competition between large multinationals and big domestic corporations in these countries. Even the largest developing country corporations tend to be much smaller than the industrial country multinationals. The current large merger wave is likely to make this disparity even bigger. By means of these world-wide mergers and tie-ups, the advanced country corporations are able to integrate their international operations. This may be a source of genuine technical economies of scale, but

evidence indicates that in most industries average cost curves are L-shaped, that is to say, after a threshold size which is relatively small and which most of these giant corporations would already have achieved even before mergers, costs do not fall as the size of the firm increases. The economies which nevertheless the multinationals are able to achieve through integration are those relating to bulk buying of inputs, reduced cost of capital due to large size as well as economies achieved in advertising and other marketing activities on a large scale. To the extent that these economies depend on the market power of the multinationals in relation to inputs, the cost saving measures are not necessarily welfare enhancing; furthermore, these "pecuniary economies" create barriers to entry which makes the markets less contestable.[11]

During the last 50 years, Japan, as well as many NICs in Asia and Latin America, were able to foster the development of big businesses to the advantage of these countries' overall economic development. This has usually been achieved through various kinds of state support. These large domestic corporations, which are privately owned, have often been the leaders in the diffusion of new technologies and the adaptation of imported technologies to domestic circumstances.[12] However, in the current international economic environment these firms are likely to be handicapped in three significant ways:

1) through the limiting of state aid as part of WTO disciplines;
2) through the increased size and market power both in the product and input markets of large multinationals;
3) through increased barriers to entry and contestability which the merger boom is creating.

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literature see Singh (1992); Hughes (1994).

It is normal for multinationals to complain that there is no 'level playing field' between themselves and national corporations which are government supported; hence, the multinationals' demand for "national treatment". However, the actual situation is quite the opposite; the playing fields are tilted in favour of multinationals who have considerable market power. The current international merger movements is making these fields more unequal even from the perspective of the *large* developing country corporations.

The mechanical application of the sacred WTO principle of 'national treatment' in the circumstances set out above would clearly lead to perverse results which would both harm economic development in developing countries as well as lead to global economic inefficiency. The remedy in these circumstances may lie in competition authorities in developing countries being exempted from the doctrine of national treatment subject to a safeguard clause such as a rule of reason in the context of promotion of economic development, the latter being regarded as a primary goal of the WTO. (On the last point, see the following section.)

To provide a simple illustration, it should be perfectly legitimate for a developing country competition authority to allow large domestic firms to merge so that they can go some way toward competing on more equal terms with multinationals from abroad. Even if the amalgamating national firms are on the horizontal part of the L-shaped static cost curve, bigger size may still promote dynamic efficiency for the reason that firms need to achieve a minimum threshold size to finance their own R & D activities. The competition authority may therefore quite reasonable deny national treatment to the multinationals and prohibit their merger activity (because they are already large enough to achieve either static or

doctrine of national treatment is likely to be beneficial both to economic development and to competition.

Section VII The Right to Economic Development and PMAI

It may be argued against the analysis and proposals outlined above that these run contrary to the cherished WTO 'principles' such as national treatment and market access, as well as attempt to reopen agreements already settled such as TRIMS. This is certainly one side of the ledger. There is, however, the other side which unfortunately is completely ignored by the proponents of PMAI. This concerns the ultimate goals of the WTO and their relationship to that organisation's procedural rules such as national treatment.

The Preamble to the WTO notes that "trade and economic endeavour should be conducted with a view to raising the standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand". It is further stated that "there is need for positive efforts designed to ensure that developing countries, and especially the least-developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development". Full employment and economic development are not only the ultimate goals of the WTO but these have also been repeatedly endorsed by the international community. In 1995, 117 Heads of State or Government attending the Copenhagen Social Summit endorsed the Copenhagen Declaration, which put primary emphasis on the promotion of full employment and poverty reduction. More recently similar declaration have been made at the Millennium Summit at the UN and other fora. Indeed, the right to a decent living has virtually acquired the status of a universal human right.

If experience and analysis show that the primary goals of WTO are being harmed rather than helped by specific measures such as TRIMS, or the equal application to all countries of a particular procedural principle such as national treatment, it is the latter which should be changed. It is the primary goals rather than the procedural rules of an international organization which should dominate especially as the former are widely endorsed by the world community as a whole.

Section VIII PMAI, FDI, and Advanced Economies

It has been suggested above that unfettered FDI as envisaged in PMAI can lead to financial fragility in developing countries and harm their development prospects. However, what would be its implications for the citizens of advanced countries? It would be useful to discuss these briefly, even if the main focus of this paper is on developing countries.

There are good reasons to believe that although there are gains to the multinationals and their managers from PMAI as it gives them a license to invest anywhere they like, it does not necessarily greatly benefit the citizens of advanced countries. With the free mobility of capital provided by PMAI, and labour being essentially immobile, the balance of power shifts decisively towards capital in these countries. Apart from its unfavourable implications for the distribution of income between labour and capital, such a shift may also leads to job insecurity and low labour standards. The employers in a high-waged, high- labour standards countries may simply threaten to take their investments to a low- waged, low-labour standard host country. Large multinational corporations may be able to achieve much of their cost saving objectives without actually having to carry out the threat, as long as the

threat was credible in the first place. There is a growing analytical and empirical literature on this subject which broadly confirms this intuition.[13]

More broadly, the footloose FDI is not helpful in establishing harmonious co-operative relations between labour and capital in advanced economies. However, developing countries, by their efforts to control the process of FDI in order to increase their gains from it and to reduce losses, also indirectly do service to citizens and workers in advanced countries. Essentially, these measures amount to throwing the proverbial 'sand in the wheels' of too much capital mobility. This probably helps to slightly re-address the balance between capital and labour in advanced countries.

In a series of papers this author has suggested that in the present circumstances of the world economy, there would be enormous gains for both the North and the South from purposeful economic co-operation, as that could lead to faster global economic growth. The application of that analysis to the case of FDI would suggest that with its appropriate regulation by both developed and developing countries, within a broader framework of other North/South co-operation policy measures, could greatly increase the net gains from FDI to each group of countries. This would however, involve the abandonment of PMAI and establishing institutional arrangements for active co-operation between nation states in a number of different spheres, including FDI.[14]

IX Bilateral and Multilateral Investment Treaties

To attract FDI, developing countries have entered into a large number of bilateral investment treaties (BITs) with developed as well as other developing countries. Ganesan (1998)

reports that by January 1997 there were 1,330 such treaties in over 162 countries. This compares with less than 400 at the beginning of the 1990s. Ganesan notes that these treaties were popular with developing countries because they provided for "national treatment to foreign investors in the post-establishment phase only, and do not place any restrictions on host countries in following their own FDI policies. This is because the aim of BITs is the protection and equitable treatment of FDI after the investment has taken place in consonance with the host countries' laws and regulations."

The advocates of PMAI make a number of arguments for replacing BITs by multilateral treaties which it may be useful to examine. The first is a transactions costs argument which suggests that everybody would gain from the lower transaction costs involved in a multilateral agreement. This suggestion is essentially one of bureaucratic neatness and centralisation, and is not convincing. As Hoekman and Saggi (1999) note in their World Bank paper:

> "Regarding the costs imposed by the multitude of BITs on multinational firms, it seems that the major proportion of the transactions costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country. Familiarising oneself with the investment laws of a country seems trivial in contrast to these more daunting challenges that exist regardless of whether the country is a signatory to a multilateral or a bilateral investment agreement."

The second, in some ways related argument made by PMAI enthusiasts, is to suggest that a multilateral agreement would provide a more secure framework for multinationals and thereby lead to greater FDI than now. This argument has already been briefly examined earlier although in a different context, but that analysis remains relevant. As was noted,

the regime of BITs. Investments protection is normally provided in these treaties by provisions for private international arbitration. Evidence suggests, however, that this has seldom been resorted to with the parties usually settling their disputes prior to arbitration. A central point is that investment protection for investors is also essentially guaranteed by the fact that there is enormous competition between developing countries for FDI and no country would wish to acquire a poor reputation with investors. There is nothing to suggest that a multilateral agreement would provide more protection which would translate into more overall FDI. The main determinants of FDI, a wide range of research suggests, are the level of a country's per capita income, its rate of growth, and its physical and human capital infrastructure.[15] As noted earlier, countries such as China and Malaysia have been able to attract enormous amounts of FDI despite their illiberal investment regimes. The protection to investors provided by the BITs as well as the reputational concerns of developing countries has clearly been regarded as adequate.

One argument in favour of multilateralism which has more validity is that of unequal power between advanced countries and some very poor developing countries which may lead the latter to having to agree to onerous terms in their BITs. The suggestion is that such countries would gain from a multilateral treaty where they would collectively have more influence. This, however, presupposes that a multilateral treaty on investment which is finally negotiated would be development friendly. If it is not, and there can not be any assurance that such a treaty would necessarily emerge from the WTO process, the poor developing countries would be better off with the BITs than with a multilateral treaty of the PMAI kind.

X Multilateral Investment Treaty: A Development-friendly Framework

The previous section suggested that a development-friendly multilateral investment treaty could be superior to BITs for some developing countries (which are obliged to accept unfavourable bilateral terms because of their lack of economic, political or strategic strength). It may therefore be useful to outline the main elements of such a treaty, not least in order to clarify developing countries' thinking on this subject. Whether or not such a treaty is ever negotiated and the fora where such negotiations may take place are tactical matters which are best left to developing country diplomats.

The analysis of this paper suggests that the following principles should form the cornerstone of a development-friendly treaty.[16]

xi) permitting countries to be *selective with regard to the timing of FDI and to actual FDI projects,* according to their current development level and needs;

xii) legitimizing *"qualified" market access* so that a potential host country could specify the degree to which it would give national access, in terms of the percentage limit on foreign shareholding, or the total value of individual or aggregate foreign investment;

xiii) preventing the abuse of monopoly power by large multinationals, encouraging, as far as possible, level playing fields between large foreign investors and smaller domestic companies so that the latter can continue to operate and flourish;

xiv) permitting *limitations to national treatment,* giving governments scope to stipulate performance requirements and similar measures, TRIMs not

withstanding, in order to encourage foreign enterprises to contribute to development objectives, including a healthy balance of payments;

xv) establishing *rules of conduct for foreign investors* to prevent bribery and corruption and tax avoidance through transfer pricing, among other things;

xvi) having neither a negative nor a positive list, but only a requirement for notification from time to time of the exceptions to national treatment;

xvii) the inclusion of "developmental reasons" in the category of general exceptions in addition to security, public order or cultural reasons;

xviii) freedom from standstill and roll-back obligations;

xix) ground rules for providing a credible and predictable environment for FDI from the investors' perspective including guaranteeing the protection of investment;

xx) establishing an appropriate dispute settlement mechanism to take account of developing countries' circumstances.

XI Conclusion

The main points of this paper have been presented in the Executive Summary. Very briefly, the central conclusion which follows from the analysis of this paper is that PMAI, despite its important concession of confining itself to only one source of external finance namely FDI.

shortcomings are particularly serious with respect to developing countries as it essentially ignores the developmental dimension altogether. This paper outlines a framework for a development-friendly multilateral investment treaty. In the absence of such a treaty, developing countries would be better off with their existing bilateral treaties (BITs) than with a multilateral agreement, particularly of the kind represented by PMAI.

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APPENDIX

Table 1: Net Capital Flows to Developing Countries, 1970 to 1998.
(US$ billions)

	1970	1980	1990	1995	1996	1997	1998
Net flow of long-term debt (excl. IMF)[1]	6.9	65.2	43.4	77.0	87.6	118.7	82.9
Foreign direct investment (net)	2.2	4.4	24.5	95.5	119.0	163.4	155.0
Portfolio equity flows	0.0	0.0	3.7	32.1	45.8	30.2	14.1
Grants (excl. technical cooperation)	2.2	13.2	29.2	32.6	29.2	25.7	23.0
Total net resource flows	11.3	82.8	100.8	237.2	281.6	338.0	275.0

[1] Bank loans, bonds, official (bilateral and multilateral)loans.

Source: IMF, Global Development Finance, 1999; data for 1995 is from Global Development Finance, 1997; and 1996 is from Global Development Finance, 1998.

Table 2: Net Private and Official Capital Flows: Developing Countries 1984–1989, 1990–1996

	1984–1989	1990–1996
Net private capital flows[1]	17.8	129.4
Net direct investment	12.2	57.9
Net portfolio investment	4.9	51.1
Other net investment	0.6	20.4
Net official flows	27.2	16.8
Change in reserves[2]	5.1	–54.8

[1] Because of data limitations, "other net investment" may include some official flows.

[2] A minus sign indicates an increase.
Source: IMF, 1998.

Table 3. Developing Country flows of FDI, Capital Market Flows, Output and Trade. All Relative to Global Totals, 1991-2000.

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
In global capital market	9.7	9.4	9.4	9.0	9.0	9.8	10.8	6.2	4.7	5.5
In global FDI flows	22.3	27.4	29.5	35.2	32.3	34.9	36.5	25.9	18.9	15.9
In global output	19.8	19.2	19.7	20.0	20.7	22.1	23.2	21.6	21.7	22.5
In global trade	26.5	28.3	28.3	28.4	29.5	31.3	32.4	30.7	30.7	33.4

Source: World Bank 2001, table 2.3 page 37, adapted.

Table 4. Inward FDI Flows as a Percentage of Gross Fixed Capital Formtion Developing and Developed Countries 1988-1998.

(Percentage)

	Developed countries	Developing countries
1988-1993 (*Annual Average*)	4.0	4.6
1994	3.5	8.3
1995	4.5	7.6
1996	4.8	9.1
1997	6.2	10.8
1998	10.9	11.5

Source: World Investment Report, Cross-border Mergers and Acquisitions and Development (2000), Annex table B.5. Page 306, adapted.

Table 5. Cross Border M & As: Sales and Purchases, by Region, 1990-1999

(Billions of dollars)

	sales					pur.				
Region/ economy	**1990**	**1995**	**1997**	**1998**	**1999**	**1990**	**1995**	**1997**	**1998**	**1999**
Developed countries	**134.2**	**164.6**	**234.7**	**445.1**	**644.6**	**143.2**	**173.7**	**272.0**	**511.4**	**677.3**
of which:										
European Union	62.1	75.1	114.6	187.9	344.5	86.5	81.4	142.1	284.4	497.7
United States	54.7	53.2	81.7	209.5	233.0	27.6	57.3	80.9	137.4	112.4
Japan	0.1	0.5	3.1	4.0	15.9	14.0	3.9	2.7	1.3	9.8
Developing Countries	16.1	15.9	64.3	80.7	63.4	7.0	12.8	32.4	19.2	41.2
of which:										
Africa	0.5	0.2	1.7	0.7	0.6	-	0.1	-	0.2	0.4
Latin America and the Caribbean	11.5	8.6	41.1	63.9	37.2	1.6	4.0	10.7	12.6	24.9
Europe	-	-	-	-	0.3	-	-	-	-	-
Asia	4.1	6.9	21.3	16.1	25.3	5.4	8.8	21.7	6.4	15.9
Pacific	-	0.1	0.3	-	0.1	-	-	-	-	-
Central and Eastern Europe[a]	**0.3**	**6.0**	**5.8**	**5.1**	**10.3**	**-**	**0.1**	**0.3**	**1.0**	**1.6**
World[b]	**150.6**	**186.6**	**304.8**	**531.6**	**720.1**	**150.6**	**186.6**	**304.8**	**531.6**	**720.1**

Source: UNCTAD, cross- border M&A database on data from Thomson Financial Securities Data Company.