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Global Agenda Council on Global Trade and FDI

Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: The Case for a Multilateral Agreement on Investment

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Contents

Abbreviations

AD	Anti-Dumping
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BITs	Bilateral Investment Treaties
BRICS	Brazil, Russia, India, China and South Africa
CNOOC	Chinese National Offshore Oil Company
CSR	Corporate Social Responsibility
CVM	Countervailing Measures
DIIME	Declaration and Decisions on International Investment and Multinational Enterprise
DPW	Dubai Ports World
EPA	Economic Partnership Agreement
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GE	General Electric
GNP	Gross National Product
GVC	Global Value Chains
ICC	International Chamber of Commerce
ICFC	In Country, For Country
IIA	International Investment Agreement
IMF	International Monetary Fund
IPR	Intellectual Property Rights
LOC	Letter Of Credit
MAI	Multilateral Agreement on Investment
MFN	Most Favoured Nation
MNC	Multinational Corporation
NAFTA	North America Free Trade Agreement
NGA	National Governors Association
OECD	Organisation for Economic Co-operation and Development
OPIC	Overseas Private Investment Corporation
P&O	Peninsular and Oriental Steam Navigation Company
R&D	Research and Development
RTA	Regional Trade Agreement
SCM	Subsidies and Countervailing Measures
SEZ	Special Economic Zone
SME	Small and Medium Enterprises
SOE	State Owned Enterprise
SPS	Sanitary and Phytosanitary Measures
SWF	Sovereign Wealth Fund
TAP	Trans-Atlantic Partnership
TBT	Technical Barriers to Trade
TPP	Trans-Pacific Partnership
TRIMS	Trade-Related Investment Measures
TTIP	Transatlantic Trade and Investment Partnership
UCP	Uniform Customs and Practice
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organization

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Executive Summary

Anabel González

The World Economic Forum Global Agenda Council on Global Trade and FDI concentrated its work in 2012-2013 on Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: The Case for a Multilateral Agreement on Investment. The Council built on prior work to identify ways to encourage more foreign direct investment (FDI) in both developed and developing countries as a means of enhancing prosperity worldwide.

The Council reached two main conclusions during its discussions: **1) different barriers and distortions are preventing the realization of the full potential of FDI** and **2) the current fragmented governance of FDI contributes to the confusing landscape faced by investors and governments.** Council Members hence make a strong case for negotiating a multilateral agreement on investment (MAI).

This report makes the Council's case for an MAI. It is organized into seven sections, each of which was drafted by a different Council Member. Each section is briefly summarized below.

Section 2. Facts and Figures – Gary Clyde Hufbauer and Peter Draper

FDI and international trade have grown significantly over the past two decades to become the twin engines of world prosperity. In the new world of global value chains (GVCs), multinational corporations (MNCs) account for some 80% of world exports. MNCs' unique know-how accounts for their explosion on the world economy and creates gains for their host and home countries alike.

The origin and destination of FDI flows have seen remarkable changes in recent years, such as the increasing participation of emerging countries in global FDI flows, most notably in the 2000s. They now account for more than one-quarter of outflows and almost half of inflows.

However, FDI and trade have been growing slowly, in part due to policy failures associated with official tolerance of creeping protectionism and neglect of fresh liberalization. To recover from its decline in growth, the world economy needs a large dose of new FDI to reach US$ 3 trillion annually (about 4% of world gross domestic product, GDP).

Section 3. The New Relevance of FDI: The GVC Perspective – Richard Baldwin

Trade in manufactured goods in today's world is organized around complex international supply chains that have created a tight supply-side linkage between trade and FDI – what has been called the "trade–investment–services nexus". In the 21st century, trade and FDI are neither complements nor substitutes – they are two facets of a single economic activity: international production sharing.

The linkages between trade and FDI are strong, and vary depending on whether FDI can be categorized as market-seeking, efficiency-seeking, pure "export platform", "tariff-jumping assembly" or pure resource-extraction FDI. This classification, in turn, is associated with different development strategies pursued by countries, including import substitution, outward processing or "moving up the value chain" industrialization.

Section 4. From Rejection to Hope: Different Perspectives on FDI

4.1 The Emotional Reaction to FDI – Selina Jackson and Jean-Pierre Lehmann

Despite its fundamental dynamic in global economics, FDI can lead to strong – and quite often emotional – reactions. Ideological reasons sometimes underlie opposition to FDI. In the case of developing countries, memories of colonization and the quest for economic independence fuel these reactions. In developed countries, arguments of "national interests" or "strategically sensitive industries" tend to prevail. There are famous cases of rejection of FDI in many countries, from Argentina to India, and from France to the United States.

The People's Republic of China is an interesting case. Inward FDI has been an important component of its economic modernization programme for several decades. In recent years, however, attitudes and policies towards FDI have changed somewhat. Among big economies, the most striking exception to the nationalist trend is the United Kingdom. Smaller, outward-looking economies tend to be genuinely more positive towards FDI, realizing the benefits associated with influxes of capital, technologies and skills.

The driver of negative reactions to FDI is also sometimes related to its form, for example greenfield or brownfield investments, market/resource/efficiency- seeking investments, or mergers and acquisitions.

4.2 Why Countries Say They Impose Barriers to FDI – Susan Schwab

At the national policy level, a variety of different factors may be used to justify limiting inward FDI. These include opposition from (or on behalf of) domestic competitors that fear foreign competition, or various nationalistic and populist motivations, such as those associated with the acquisition of national brands or national champions or the exploitation of finite resources. Disincentives may also include governments' desire to extract the maximum amount of "benefit" for their domestic constituencies. This motivation can lead to policies such as restrictions on foreign equity participation, demands for technology transfer, forced localization/minimum domestic content or value-added restrictions. National security justifications and restrictions based on arguments associated with access to critical infrastructure, sensitive technologies or excessive reliance on imports for an industrial base and sensitive locations have also been used. Finally, there is the catch-all category that involves the fear of losing control to an outside force.

Political and government attitudes tend to differ more on outward FDI flows across countries. Some actively encourage it as a vehicle for exports and global expansion; others demonize it as an act of "exporting jobs".

4.3 Why Countries Constrain FDI: The Political Economy of Asymmetry – Yong Wang

Today represents a new era of economic globalization, with a rising single global market, the political foundation of this global economy is still fragmented. It is still based more on nation state-centred international politics than on a "world government".

Countries and industries benefit from trade in an absolute sense, but at the same time they compete over the relative size of the gain. This mixed perspective of relative and absolute gain is useful in understanding why countries constrain FDI.

Historically, trade and investment have always been intertwined. More recently, in the aftermath of the global financial crisis, old concerns about the loss of control over FDI have revived, mixed with new scepticism about the rise of state-owned enterprises (SOEs). This shift is taking place in the context of a more complicated global political economy, the key elements of which are the rise of emerging economies and new power rivalries, especially between the United States and China. Both of these countries have imposed restrictions on the investment of MNCs and SOEs in each other's territories, justifying them as safeguards of national security and indigenous innovation. The rapidly increasing investment flows from China and other emerging economies into Africa have brought about some concerns about the revival of so-called colonialism, though systemic studies have refuted this argument.

In this new political economy context, the best way to address trade and investment concerns is through the negotiation of a multilateral framework on FDI within the World Trade Organization (WTO). This agreement seems more feasible today, given the participation of emerging and developing economies in inward and outward FDI flows, though it can only prosper if countries enhance their understanding of each other and are determined to compromise.

4.4 A View from Sub-Saharan Africa: Fresh Opportunities for Integration – Salim Ismail

FDI as a driver of trade and development has great resonance in Africa. Though modest, FDI flows to Sub-Saharan Africa have increased over the past decade, and many corporate and academic analysts have identified several African countries as promising investment destinations. Factors cited for this optimism relate to rapid GDP growth, macroeconomic resilience demonstrated during the recent financial crisis, young and increasingly urban populations, and the momentum of regulatory reform in many countries.

Against this background of broadly encouraging dynamics, there are also important challenges to overcome in the region. These include political and macroeconomic instability, narrow markets, weak regional integration, and difficulties involved in the transition away from the focus on natural resources and extractive industries.

FDI can serve as a potent tool of economic development and poverty reduction in Sub-Saharan Africa. To reap the benefits of FDI, countries must establish productive market-state relations that align economic, social and environmental objectives. This is particularly important in this region, as domestic environments are often characterized by weak institutions, some degree of corruption and limited administrative capacity. It is likewise important that companies strengthen the social and environmental integrity of their investment and supply chain strategies, and that they upgrade to higher-value activities.

Section 5. From Barriers to Facilitation Incentives: Different Distortions of FDI

5.1 Barriers to FDI: A Corporate Perspective – Karan Bhatia

In today's world, where the prevailing model of production is "in the world, for the world", rules governing FDI have become increasingly important – and indeed, in some cases, pivotal – in deciding where and how investment occurs. Moreover, the rules affecting investment have effectively become the rules of international trade.

Left to market forces alone, four factors should principally shape investment decisions: size of the market, quality of the enabling physical infrastructure, quality of the human infrastructure, and the regulatory and legal environment. Since the global financial crisis, however, a number of laws, policies and practices have been put in place to distort investment decisions. The investment-distorting rules and conditions fall into six categories: rules or practices that 1) constrain FDI in certain sectors; 2) constrain flows of capital, technology, people or other resources that are necessary to establish successful FDI operations; 3) make investment conditional on technology transfer and the like; 4) make access to local markets conditional on local content requirements or the holding of local assets in country or 5) restrict the availability of certain raw materials to locally invested companies. The last category encompasses subsidies that seek to incentivize investment.

Efforts to address these barriers in various ways, including through dialogue, negotiations and even WTO litigation, have proved largely ineffective. Clearly, this issue demands a multilateral resolution, but today's global rules are insufficient, and provide only uncertain protection.

5.2 Facilitators of FDI: Trade Finance – Christopher Logan

Both trade and FDI depend heavily on trade finance. Trade finance provides the day-to-day funding that supports FDI transactions. Thus the availability and effectiveness of trade finance represents an opportunity for FDI; its absence is an important risk.

Three issues are relevant when examining trade finance. First, the size of and changes to this market must be tracked in a more holistic and systemic manner. Second, there is a need to move beyond the traditional letter of credit to provide alternate financing mechanisms, such as the "supply chain finance solutions" that are becoming available. Third, vigilance must be exercised as to the availability of trade finance, which was significantly affected by the recent global financial crisis and may be further affected by new banking regulations.

5.3 Incentives to Attract FDI – Uri Dadush

Countries engage in a global competition, establish investment promotion agencies and enact policies to incentivize FDI in order to attract the "right" kind of FDI. Incentives may be of a fiscal or financial nature. Authorities naturally compete to attract FDI that creates jobs and helps revitalize the local economy, but incentives do not always succeed. Money spent on incentives can be wasted and, in extreme cases, even drag down the city or region that courted a firm.

Investment incentives reflect a coordination failure among governments and are, like most subsidies, inefficient. They distort markets, promote unhealthy competition, and may divert resources and attention away from the hard decisions needed to improve the business climate and necessary investments in upgrading skills. In extreme cases, they can encourage investments that are inherently unprofitable and ultimately unsustainable. In the longer run, developing countries that become over-reliant on incentives to attract FDI can adversely affect their own development.

Efforts to regulate incentives in the European Union (EU), the United States (US), Canada and Australia have in general had only partial and modest success. At the multilateral level, the WTO Agreement on Trade-Related Investment Measures (TRIMS), the Agreement on Subsidies and Countervailing Measures (SCM) and the General Agreement on Trade in Services (GATS) limit the conditions that can be placed on investors. The Agreement on SCM is the most significant of these, as it concerns disciplining incentives. Some bilateral and regional free trade agreements (FTAs) have imposed stronger disciplines on performance requirements.

Section 6. The Current (Fragmented) Governance of FDI – Sherry Stephenson and Uri Dadush

Despite the importance of FDI, its governance is fragmented. There is no single, comprehensive multilateral treaty or institution to oversee investment activity. Previous attempts to bring FDI under multilateral purview have failed. The result is a complex and confusing overlay of disciplines at different levels.

At the multilateral level, there is a patchwork of partial investment rules within the WTO from the Uruguay Round, including rules in the Agreements on TRIMS and SCM, and the GATS. This collection of regulations is insufficient to provide a coherent and effective regulatory framework for FDI. At the plurilateral level, both the Organisation for Economic Co-operation and Development (OECD) and the Asia Pacific Economic Cooperation (APEC) forum have drawn up agreements on investment to be followed by their Members, either as a contractual obligation or as a guideline for best practice. The North American Free Trade Agreement (NAFTA) broke new ground in the negotiation of regional rules on investment, and others have followed. There are now 331 free trade, economic partnership or regional trade agreements (RTAs) with investment provisions. Negotiations of "mega-regional" trade agreements foresee the inclusion of investment chapters. Finally, at the bilateral level, there are 2,833 bilateral investment treaties (BITs); almost every country in the world has signed one (or several) of them.

This increasing complexity requires investors and governments to try and ensure consistency between differing sets of obligations. Overlapping obligations and divergent interpretations can engender costs in the form of time and inefficiencies, and may facilitate "forum shopping" by investors.

Section 7. A Holistic Approach to the New Trade–FDI Reality – Richard Baldwin

Given the complex and interconnected nature of 21st-century trade, the set of policies underpinning it must be a "package". Barriers to any part of the trade–investment–services–intellectual property rights (IPR) nexus become a barrier to all aspects. Recognizing this, many nations have unilaterally embraced certain forms of trade and investment liberalization and locked them in by signing deep RTAs and BITs with their main FDI providers.

Given the lack of a coherent multilateral framework, as discussed in Section 6, RTAs have come to the forefront. Today, RTAs and BITS are the de facto governance underpinning the regional supply chains in Asia, North America and Europe. The deep RTAs signed by two of the largest players in international supply chains – the United States and Japan – illustrate the sorts of provisions that firms look for when deciding on location; host nations look to provide these conditions to attract FDI. Most are deeper versions of provisions already covered by the WTO, but three "beyond-WTO" disciplines are included in US–Japan RTAs: IPR, investment protection and the free movement of capital. The facts for EU RTAs are much less clear – probably because most of "Factory Europe" is inside the EU's Single Market and is thus already disciplined. Other RTAs, besides those of the United States, Japan and the EU, include very few provisions beyond tariff reductions.

Absent a multilateral effort to integrate these new disciplines into the WTO system, world trade governance is headed for fragmentation. Specifically, supply-chain disciplines seem to be on track to harmonization by mega-regionals and mega-bilaterals. The problem is that, on the current trajectory, harmonization will exclude China and other large emerging economies. The multilateralization of supply-chain disciplines would redress this situation. It might also make the system more equitable by 1) bolstering the bargaining power of developing countries vis-à-vis high-tech firms and 2) facilitating the integration of more developing countries into international supply chains.

Section 8. Towards Global Governance of FDI? Issues on Getting to a Multilateral Approach – Peter Draper, Beatriz Leycegui, Alejandro Jara and Robert Lawrence

The final section makes the case for an MAI. Six reasons are stressed. First, the rise of GVCs sharpens the need for global and holistic regulations; GVCs need global rules. Second, there is a proven appetite for international investment regulation; nations are "voting with their pens" for more discipline – signing hundreds of BITs and RTAs. But the result lacks coherence in terms of rules and application. Third, the North-South divide is disappearing on the investment-governance issue. Emerging markets' role in FDI has grown tremendously in recent years – both as home and host nations. Fourth, the stigma that has been historically attached to FDI has sharply abated in recent years. Many countries are pursuing economic liberalization for the recognized benefits it brings. Fifth, and by contrast, the fragile and slow recovery of the world economy has led some countries to adopt protectionist measures against trade and investment. This regression heightens the need for multilateral rules. Sixth, increased FDI by SOEs and sovereign wealth funds (SWFs) presents new challenges to ensuring that competition conditions in the global marketplace remain equitable and do not give rise to national security concerns.

If an international investment agreement (IIA) is to emerge in the future, the WTO is the logical home for it. The WTO has the potential to yield more equitable outcomes and ensure non-discrimination, and it provides access to a dispute settlement mechanism that has worked well. This IIA may entail provisions in different areas, including the protection of investors, establishing investor-state dispute settlement and subjecting the agreement to the WTO state-state system, and providing post-establishment national treatment. Pre-establishment or access provisions on investment are also important, as are notions of corporate social responsibility. In any case, there is a sense that the balance of rights and obligations needs to be revisited.

The agreement would be open in the future to all WTO Members, even if they were initially unwilling to join. Those that do go ahead could decide to do so on a most favoured nation (MFN) basis, on a conditional MFN basis, or on the basis of a minimum number (or critical mass) for full MFN implementation. Negotiation of mega-regional agreements could inspire future plurilateral and multilateral negotiations, either within or outside the WTO. On the other hand, global supply chains would become considerably more efficient if governments pursued an international supply chain agreement under the auspices of the WTO, including investment, services, border management procedures, standards and technical regulations, e-commerce and competition policy.

Since these issues are likely to remain contentious for the foreseeable future, WTO Members should consider establishing a working group on investment regulations with a view to airing the issues and potentially developing a work programme.

1 Introduction

Anabel González

FDI is a powerful instrument for growth and development. Its relevance is enhanced today by its role as the crucial engine of trade, via global value chains, and by the critical need to increase investment flows to boost the global economy, create jobs, and promote knowledge and productivity enhancements.

With this in mind, the World Economic Forum Global Agenda Council on Global Trade FDI decided to concentrate its work on Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: The Case for a Multilateral Agreement on Investment. The Council built on prior work to identify ways to encourage more FDI in both developed and developing countries as a means of enhancing prosperity worldwide.

The Council – with the contribution of all Members – reached two main conclusions during its discussions: 1) different barriers and distortions are preventing the realization of the full potential of FDI and 2) the current fragmented governance of FDI contributes to the confusing landscape faced by investors and governments.

Council Members hence make a strong case for negotiating an MAI. While they are mindful that this has been tried in the past without success, Members are convinced that conditions have changed. The rise of emerging economies and the spread of GVCs have blurred the old North-South debates that doomed previous efforts. Today's political, economic and technological conditions have created the right circumstances to pursue an MAI.

Council Members believe that an MAI should be negotiated under the auspices of the WTO. Such an agreement would allow all countries to express their views and would have near-universal coverage. However, since this is a complex endeavour, the Council proposes to also explore alternative formats within the multilateral system. As a start, Council Members recommend that WTO Members establish a working group on investment regulations, the goal of which would be to identify and clarify the key facts, issues and effects. This could potentially lead to the development of a work programme.

To achieve this objective, this comprehensive report addresses a wide array of relevant issues in reaching an MAI. It has benefited from the written contributions of many Council Members, to whom all are grateful. Thanks go to Richard Baldwin for reviewing the paper and to Roberto Crotti for his support to the group. As Chair of the Council, I bear full responsibility for any problems in editing and compiling these contributions.

This report is organized into the following seven sections:

- In Section 2, Gary Clyde Hufbauer and Peter Draper present the most salient facts and figures on FDI. They highlight its importance, while making the case that more FDI is needed to inject more growth into the global economy.
- In Section 3, Richard Baldwin refers to the new relevance of FDI in the context of global value chains, explaining its role in international production in the 21st century.
- Section 4 presents different perspectives on FDI. Selina Jackson and Jean-Pierre Lehmann explore some of the emotional reactions underlying its opponents in different parts of the world, Susan Schwab examines the alleged rationale for limiting investment, Wang Yong discusses the political economy underlying some FDI restrictions and Salim Ismail presents an African opinion on the opportunities for FDI to further integrate these countries into the world economy.
- Section 5 refers to distortions and facilitators that impact FDI worldwide, including a corporate view presented by Karan Bhatia on the barriers confronting FDI, a reflection by Christopher Logan on the role of trade finance in funding trade and FDI transactions, and a discussion by Uri Dadush on the use of incentives to attract investment.
- In Section 6, Sherry Stephenson and Uri Dadush review the sets of disciplines governing FDI at the different levels of international governance and highlight the costs associated with the current fragmented approach to FDI governance.
- Section 7, written by Richard Baldwin, advocates a holistic approach to the new trade-FDI reality by developing coherent policies to underpin international flows in goods, services, investment and intellectual property.
- In Section 8, Peter Draper, Beatriz Leycegui, Alejandro Jara and Robert Lawrence argue for the need to move towards a system of global governance of FDI and highlight the issues that may arise from taking such an approach.
- The Council would like to stress the contribution that FDI can make to enhance trade, growth and prosperity, at both the global and national levels. Its Members urge world leaders to take the bold step of moving towards an MAI.

2 Facts and Figures

Gary Clyde Hufbauer and Peter Draper

FDI and international trade serve as the twin engines of world prosperity. Nominal world GDP has trebled since 1980, merchandise trade has expanded by a factor of six and the stock of FDI has expanded by a factor of 20. FDI and trade are clearly driving the world economy.

Econometric analysis suggests that a 10% increase in a nation's two-way trade relative to GDP (e.g. an increase in exports of goods and services plus imports of goods and services from 40–44%) increases GDP by at least 1.6% through a variety of channels.[1] Between 1990 and 2010, two-way trade in goods and services increased from 37% of world GDP to 56%, indicating that world income is around 8% larger today than in 1990 because of increased commerce. Econometric analysis likewise suggests that advanced country income has grown about 1.1% per year faster over the past two decades thanks to FDI, while developing country income has grown 1.4% per year faster.[2] Quite plausibly, world GDP is more than 20% larger today than in 1990 because of the huge expansion in world FDI – which has conveyed better technology, higher wages and overall development.

In 2012, global GDP was US$ 70 trillion, global exports in goods and services were US$ 22 trillion, the global stock of FDI was also about US$ 22 trillion, and global sales from FDI affiliates were US$ 28 trillion.[3] FDI affiliates represent a slightly larger conduit of international commerce than world exports. Baldwin argues in Section 3 that exports and FDI are not alternatives – rather, they are constant companions in the new world of global value chains. MNCs, the parents of FDI, account for some 80% of world exports, about half of which is embedded in global value chains.[4]

A century ago, the typical multinational enterprise was based on natural resources. That was the inspiration for Lenin's famous aphorism, "Imperialism is the highest form of capitalism". After World War II, manufacturing FDI came to the fore. In the 2000s, services took off. From 2005 to 2007, FDI flows into natural resources accounted for 8% of the total, while manufacturing accounted for 41% and services for 50%. Between 2008 and 2011, average FDI flows constituted 12% for natural resources, 44% for manufacturing and 44% for services. Alongside this compositional shift, the ratio of FDI to world GDP rose from 8% in 1990 to 29% in 2011.

An old, still important, question is what combination of forces explains the explosion of MNCs on the world economy. The answer is found not in large firms' access to cheap finance, but is instead bound up in the unique know-how of giant firms – a combination of copyrights, patents, trademarks, and most importantly, the trade secrets of production and distribution on a grand scale. This skill set is costly to acquire, and can easily represent half (or more) of a firm's enterprise value. Deploying this skill set worldwide through FDI benefits the host country, as there is no need to reinvent the wheel (or the iPod). FDI stimulates exports, makes money for the MNCs – while allowing them to control their technology – and spurs employment and investment in the home country (because the MNCs can grow faster). In other words, the engine behind MNC expansion leads to the somewhat surprising result that FDI growth is a win-win proposition.

Applying its skill set worldwide obviously has advantages for the firm. It is able to spread costs over a much larger volume of production and can derive benefits from locational diversity. But it also has advantages for the host country. It is much easier for China to access the auto manufacturing know-how of Mercedes than to acquire this expertise from scratch. Likewise, it is much easier for a medium-sized country like Malaysia to tie into a slice of electronics production (semiconductors) than to build a firm that would rival Texas Instruments or Dell. Finally, outward investment is good for the home economy. Detailed examination of the US experience shows that firms that go abroad expand faster at home than those that stay at home – jobs, investment, research and development (R&D) all benefit.[5]

With the world seemingly locked into a slow recovery and massive unemployment, creating jobs has become the new political mantra. Employment growth associated with FDI is impressive – some 21 million people were employed by foreign affiliates of MNCs in 1990, rising to 69 million in 2011.[6]

The origin and destination of FDI flows have changed remarkably in recent years. In the 1980s, FDI mainly flowed among OECD countries, principally the United States and Europe: on average, 95% was from the OECD and 73% was to the OECD. In the 1990s, FDI discovered emerging economies; during this decade, 32% of FDI flows were, on average, directed outside the OECD.

In the 2000s, the big news is FDI from emerging countries, which accounted for 11% of FDI inflows to OECD countries (Table 1). FDI outflows from developing and transition economies accounted for approximately 10% of global FDI outflows in 2000, rising to 32% in 2010 before receding somewhat last year (to 27%) as developed countries increased their share for the first time since the turn of the millennium.[7] Global FDI inflows are more concentrated in developing countries, which accounted for 45% of the total in 2011, down from 47% in 2010.[8]

Table 1: Inward FDI Inflows by Region, 2010

Source Country	Value (US$ billions)	% total
OECD	696.0	86.0
Europe (excluding OECD countries)	28.3	3.5
North Africa	0.2	0.0
Other Africa	4.3	0.5
Central America	-4.4	-0.5
South America	24.9	3.1
Middle East	0.3	0.0
Asia (excluding OECD countries)	33.9	4.2
Other	26.2	3.2
Emerging Market Total	87.5	10.8
World Total	809.6	100.0

Source: OECD Stat, available at http://stats.oecd.org/, accessed February 2013.

Table 2 shows that this sustained increase is largely an Asian phenomenon, centred on Hong Kong SAR and China, but more countries are getting into the act, including Mexico, Chile, Brazil, the Russian Federation and other transition economies, the Gulf States and offshore financial centres in the Caribbean. FDI inflows are similarly concentrated in East Asia, with Latin America gaining in prominence.[9]

While precise data are difficult to come by, much of these outward FDI flows are destined for other developing countries – a trend that is likely to intensify as global economic restructuring increases in the wake of the financial crisis.

Table 2: Average Annual Accumulated FDI Outflows, US$ millions, 2008–2011

Country	2008–2011
Hong Kong SAR	72,887
People's Republic of China	60,652
Russian Federation	54,766
British Virgin Islands	50,121
South Korea	20,270
Singapore	17,740
Brazil	16,023
India	15,772
Malaysia	12,834
Taiwan	10,126
Mexico	9,845
Cayman Islands	9,500
Chile	9,359
United Arab Emirates	9,272
Kuwait	7,862
Thailand	6,070
Indonesia	5,307
Kazakhstan	5,175
Colombia	5,048
Qatar	4,300
Saudi Arabia	3,616
Libya	2,722
Venezuela	2,671
Turkey	2,549

Source: UNCTAD Handbook of Statistics 2012, pp. 345-351.

Based on bare statistics, it might seem that all is well in the world of FDI and trade. That would be a mistake. Trade growth in 2012 – supposedly a recovery year – might not exceed 2.5%, which is well below the average of 4.4% between 2000 and 2010. FDI flows will barely reach US$ 1.6 trillion, well under the US$ 2.2 trillion figure of 2007. These disappointing figures are not simply an aftershock of the recent recession. Rather, they are harbingers of a sputtering world economy, more cause than effect. The leading explanation of slow growth can be found in policy failure – both official tolerance of creeping protectionism and official neglect of fresh liberalization.

It has been argued that international trade and investment have reached their natural limits, that rapid growth since World War II has exhausted nearly all the scope for raising the ratio of trade or FDI stock to global GDP. This argument is unfounded for two reasons. First, barriers at the border (and especially behind the border) remain high on average, even though in some instances countries go out of their way to welcome foreign investors. Second, the density of investment and trade within large countries – such as the United States, the EU or China – is much larger than that across national borders, conservatively by a factor of three for trade and perhaps five for investment.[10] In fact, there is evidence to suggest that 'global connectedness' has declined since 2007 in the wake of the global financial crisis. The DHL Global Connectedness Index also debunks the notion that globalization has reached its limits by showing that there is major scope for further integration along both depth and breadth metrics.[11] Its primary author, Pankaj Ghemawat, has an interesting term for the "globalization has reached its limits" argument – "globaloney".

To recover from its growth slump, the world economy needs a big dose of new FDI. At the current rate, US$ 1.6 trillion, new FDI flows are little more than 2% of world GDP. Doubling that rate, to around US$ 3 trillion annually, seems entirely plausible, and would serve as a tonic for the world economy.

3 The New Relevance of FDI: The GVC Perspective

Richard Baldwin

International trade used to be much simpler. Goods were made in one nation and sold in another. In this 20th-century world, manufacturing FDI was mostly a substitute for trade – e.g. GM bought Opel to produce American cars for Europeans in Europe rather than exporting them from Detroit.

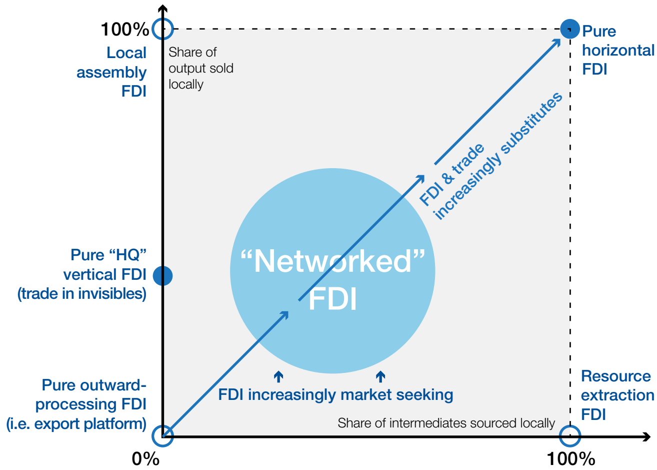
Trade in today's world is radically more complex.[12] The information and communications technology revolution has internationalized supply chains, which has created a tight supply-side linkage between trade and FDI: the "trade–investment–service–IP nexus".[13] Today's international commerce comprises complex, two-way flows of goods, services, people, ideas and investments in physical, human and knowledge capital – in addition to trade in raw materials and final goods. These connections make it almost irrelevant to talk about trade without also talking about FDI – at least for many products and markets.

As complex international supply chains are pervasive features of modern manufacturing, it is useful to have a simple diagram to organize thinking on trade and FDI linkages. The most natural focus is on the trade behaviour of foreign affiliates, i.e. the share of affiliate production sold in the local market, and the share of affiliate intermediate inputs that is sourced from the local market. Figure 1 plots the sales and sourcing behaviour for a given FDI affiliate as one point in the box. Affiliates engaged in the traditional categories of FDI appear as dots around the edges of the box. The substitutability of FDI and trade increases along the diagonal (southwest to northeast); the market-seeking aspect of FDI increases for points higher up in the box.

- Pure "market-seeking" FDI is the northeast corner: affiliates sell all output locally and source all intermediates locally.
- Pure "efficiency-seeking" FDI is the eastern border: all intermediates are sourced locally, but some of the output is exported.
- Pure "export platform" FDI (i.e. outward processing) is the southwest corner: all intermediates are imported and all output is exported.
- "Tariff-jumping assembly" FDI – in which all intermediates are imported and all output is sold locally – is the northwest corner.
- Pure "resource-extraction" FDI is the southwest corner: intermediate inputs are sourced locally and all output is exported (e.g. cash-crop agriculture, mining, fishing). In many cases (e.g. oil drilling), some intermediates may be imported, so the point would be on the interior of the bottom edge of the box.

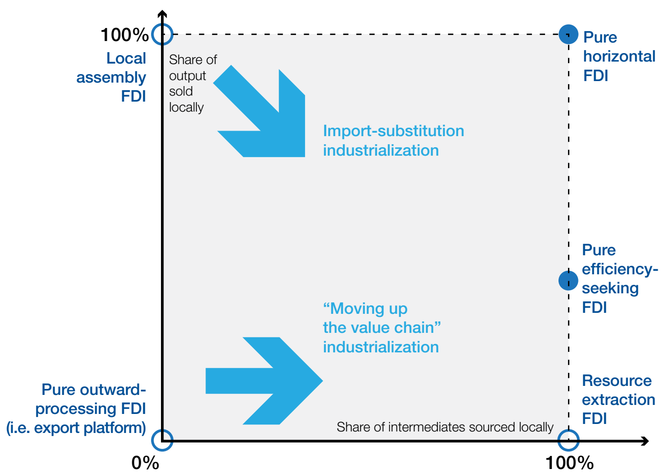
Most affiliates today are in the middle of the box – especially those engaged in global value chains. They import some (but not all) of their intermediates and export some (but not all) of their output. Trade and FDI are intimately connected for such affiliates. Indeed, trade and investment are neither complements nor substitutes – they are simply two facets of a single economic activity: international production sharing.

Figure 1: The Sales-Sourcing Box Diagram



The sales-sourcing box can also illustrate typical development strategies involving FDI (Figure 2). The traditional import-substitution strategy, for example, involves starting with local assembly and pushing multinationally to produce more intermediates locally; the eventual goal is to export. This would show up as a move from the northwest corner towards the southeast corner. The 21st-century version of this strategy – pursued by China and other East Asian nations – starts from the southwest "outward processing" point and seeks to induce multinationals to source more intermediates locally. This is a pure "eastward" move from the lower left-hand corner. In some cases, there is also a desire to develop the local market for the final good. This would be a push to move affiliates' positions northeastwardly.

Figure 2: FDI and Development Strategies



4 From Rejection to Hope: Different Perspectives on FDI

4.1 Emotional Reactions to FDI

Selina Jackson and Jean-Pierre Lehmann

Recent decades have witnessed an exponential increase in FDI, in terms of capital and geographic reach, as highlighted by Hufbauer and Draper in Section 2. FDI is, in many ways, the bellwether of globalization. It has also become far more complex, partly in response to new technologies and production methods, notably in the case of the spread of global supply chains, as shown in Section 3. FDI is a fundamental dynamic of global economics, but (arguably more than any other activity) it can lead to quite strong political, ideological, emotional – and often quite irrational – reactions.

In 1998, the Republic of Korea was at the height of the financial crisis that had been triggered on 2 July of the previous year in Thailand as a senior economic adviser to then-incoming Korean president Kim Dae-jung mused on what he saw as the two most urgent measures that needed to be taken: boost exports and attract inward FDI. But he had a dilemma.[14] “Imagine”, he said, “we go out and there is a crowd of 100,000 Koreans. I say to them, ‘fellow Koreans, to save our country, we must boost exports’. They will cheer raucously. Asking Koreans to export is like asking rabbits to run. Then I continue and say, ‘and we must promote inward foreign direct investment’. There would be a stunned silence, a shock, perhaps leading to a riot: the shame, the humiliation of allowing foreigners to invest in our country!” Korea may have its own specificities, but the syndrome is not uncommon. The emotional reaction to FDI can be spurred by a variety of reasons, including memories of colonization, nationalism or even xenophobia.

The ideology lying behind the occasional visceral opposition to FDI can be found in the works of the Argentine economist Raúl Prebisch, who coined the *dependencia* (dependency) theory, according to which countries on the periphery (i.e. developing countries) that opened their markets to foreign investments would inevitably become dependent on the metropolitan (i.e. industrialized) countries. According to this theory, to generate sustainable growth and development, foreign investors should be kept out and import substitution industrialization preferred. Prebisch’s influence has spread well beyond Argentina, to Latin America and Asia.

Under President Carlos Saúl Menem (1989–1999), Argentina undertook sweeping reforms that led to quite massive inflows of FDI. As much of the FDI into Argentina (and other parts of Latin America) was from Spanish companies, especially Spanish banks, it was not uncommon to hear grumblings about an alleged “second *conquista*”. Even recently, current President Cristina Fernandez De Kirchner ousted the Spanish oil company Repsol in a highly publicized vitriolic dispute.

In India, passions flared in 2012 over a proposal to permit FDI in retail, though again it corresponds to a deeper psychosis. In private discussions it is not uncommon to be reminded that India was colonized by a “multinational company”: the East India Company, which retained sovereignty over India from 1757 to 1858. The quite profound opening-up reforms of the early 1990s notwithstanding, many Indians, perhaps even the majority, remain suspicious of FDI. FDI is also highly emotionally associated with the 1984 Bhopal disaster, when a pesticide plant owned by Union Carbide exploded, causing thousands of deaths and injuring far more.

A strong ideological aversion to inward FDI can also be found in many industrialized countries. Perhaps the most flagrant European example is France, for example when then-French Prime Minister Dominique de Villepin intervened in 2005 to prevent Pepsi from taking over Danone to defend “France’s national interests”. This is in spite of the fact that France has a large share of both inward and outward FDI. The recent public comments by the French Minister of Industrial Renewal, Arnaud Montebourg, directed at Indian steel investor Lakshmi Mittal in a row over Mittal’s plans for steel investments in the Socialist-leaning steel belt illustrate how political and strong these forces can be.

Occasional outbreaks of virulent negative reactions also happen in the United States, as was the case with *Newsweek’s* outburst against Sony in 1989 when it acquired Columbia Studios, as it had “bought a piece of the American soul”.[15] Fujitsu’s attempt in 1987 to acquire Fairchild Semiconductor resulted in Congressional concerns that such a strategically sensitive company should not be acquired by Japan, even though their owner at the time, Schlumberger, was French. Eventually Fujitsu had to withdraw and the sale was made instead to National Semiconductor. American mistrust of Japanese inward direct investment lasted throughout much of the 1980s and early 1990s, but as the Japanese economy fell into the doldrums in the 1990s it was perceived as much less of a threat. Controversies over inward FDI from other “sensitive” sources, however, did not cease.

In 2006 a storm was raised in Congress over the fact that a company from the United Arab Emirates, Dubai Ports World (DPW), was acquiring Peninsular and Oriental Steam Navigation Company (P&O), which would give DPW management authority over six major US ports. Once again the national security alarm bell was rung because “foreign” ownership of such vital assets to the national interest would be threatening and detrimental. As with the Fairchild/Schlumberger/Fujitsu case, the fact that P&O was itself a “foreign” (British) company seemed to be ignored.

The DPW affair came the year after another big FDI-related hurricane, involving the attempt of the Chinese oil company China National Offshore Oil Corporation (CNOOC) to acquire the American company Unocal. Eventually CNOOC had to give up. Instead, seven years later it acquired the Canadian company Nexen, a deal that was approved by the Canadian Government on the grounds that it was to Canada's net benefit. One consequence of the 2005 CNOOC-Unocal affair is that Chinese companies have been wary of investing in the United States. This would seem to be justified by a good number of further illustrations, including attempts to block Chinese telecoms companies Huawei and ZTE from investing in the United States and the rejection of a Chinese company's proposal to build wind turbines near a military facility in Oregon.

China's inward FDI story is interesting. In striking contrast to some of the other big Asian economies – notably Japan, Korea, India and Indonesia – China's economic reform programme of the late 1970s invited inward FDI. Investment was initially limited to special economic zones (SEZs) and involved certain constraints, including the requirement to have a Chinese partner and provisions for technology transfer. China started very late on its economic modernization programme and had no major corporate brands or entities – e.g. in comparison to a Korean Samsung, a Japanese Toshiba or an Indian Tata; therefore it saw inward FDI as a fast track to growth and development. In the course of the early/mid-1990s, China opened up its inward FDI regime considerably further, to much of the rest of China beyond the SEZs, and allowed the establishment of wholly owned foreign enterprises on its territory.

In recent years, however, as China's economy has matured – and as it seeks to develop and promote more indigenous companies and technologies – attitudes and policies with respect to inward FDI have changed. Foreign investors complain about more government intervention and restraints. FDI has also become inexorably involved in politics. In 2005, and again in 2012, violent anti-Japanese demonstrations have seen Japanese factories, showrooms and distribution centres attacked.

Among the big economies, the most striking exception to the nationalist trend is the United Kingdom. This was mainly the work of Prime Minister Margaret Thatcher (1979–1990), who combined nationalism with pragmatism. Thus when she opened up the country to foreign investment from Japanese automobile companies, she famously commented that she "did not give a fig" whether the cars were foreign or British, so long as they were manufactured in the United Kingdom.

It is reasonable to generalize that countries that are genuinely positive towards FDI have small, outward-looking economies, notably Singapore, Hong Kong SAR, the United Arab Emirates, Luxembourg, Ireland, Cyprus, Costa Rica and Uruguay. Each of these countries has realized its "inter-dependencia" with the global economy. They take the view that FDI brings an influx of capital, new technology and skills – including managerial and marketing practices, and, increasingly, global production networks. These countries have also recognized that FDI is an important tool for development by bringing increased financial resources and access to global supply chains, which boosts export competitiveness, generates employment and strengthens the skills base, and enhances technological capabilities. Since investment policies in these countries are generally more liberal, their regulatory regimes are among the most transparent and user friendly.

Of course, not all FDI is the same, and corporate motivations for an investment may drive the negative reaction. FDI can take the form of greenfield or brownfield investments, market/resource/efficiency- seeking investments, or mergers and acquisitions.

A brownfield investment that cleans up a former steel mill and converts it into office space or a shopping mall will be better received than a greenfield investment that is perceived as pushing out local industry and repatriating profits to the corporation's home economy rather than the local economy, notwithstanding the fact that the greenfield investment may be creating new jobs, production capacity and the potential for technology transfer. Similarly resource-seeking investments that aim to benefit from factors of production that are more easily obtained in a foreign market (such as inexpensive labour or natural resources) versus a home market may be viewed as exploitative and therefore less favourably welcomed than market- or efficiency-seeking investments that aim for new customers or economies of scale. Mergers and acquisitions tend to be the most common type of FDI, and can become visible and highly political depending on the characteristics of the acquiring company or the target of the acquisition, as in some of the examples cited above.

Given the range of emotional reactions to FDI and its accompanied political consequences, it is no wonder that countries have engaged in fierce competition to attract the "right" kinds of investments, which has spawned a slew of potentially distortive incentives, as discussed further by Dadush in Section 5.2

4.2 Why Countries Say They Impose Barriers to FDI

Susan Schwab

At the national policy level, various factors may come into play as rationales for limiting inward FDI. In fact, attitudes about FDI differ significantly depending on where in a given country a given policy-maker might be. The attitude of the average member of the US Congress, for example, may differ from that of the average city mayor or state governor. Similarly, a central government official in Beijing may have a different attitude about a prospective foreign investment than his or her municipal or provincial counterpart. For the local official, the prospect of jobs and local economic development generally trumps other concerns. At the national policy level, a variety of different factors may come into play or be cited as a rationale for limiting foreign investment. The most frequent such factors appear to include the following:

- Opposition from (or on behalf of) domestic competitors that fear the introduction of foreign-invested competition. This is of particular concern when the domestic manufacturing base has been protected and faces the prospect of a new plant turning out more competitive products. In some cases, limits on the investment may apply to domestic and foreign would-be investors alike, for example precluding multi-brand retailers from investing in the name of protecting small shop owners. The use of anti-monopoly rules as the rationale for and means of blocking a foreign acquisition may also be seen as another variety of FDI protectionism.
- Various nationalistic and populist motivations seem to be at (or just below) the surface of many decisions to limit FDI. These have been most evident when foreign acquisition of a national brand, national champion or piece of "trophy" real estate has been at issue, or in the articulated fear of exploitation of finite natural resources and agricultural land. All too often, these sentiments have come to take on anti-foreign, xenophobic or anti-US/Chinese/Japanese/Indian, etc. overtones, as discussed before by Jackson and Lehmann.

- Governments' desire to extract the maximum amount of "benefit" for their domestic economies, people or indigenous industries from a foreign investment can lead to restrictions such as requiring joint ventures, limiting foreign equity participation levels in joint ventures, demands for technology transfer, forced localization/minimum domestic content or value-added requirements, etc. Interestingly, restrictions imposed at one level of government may exist in parallel with investment incentives offered by another level of government that are designed to encourage such investment.
- National security reasons and restrictions vary in their levels of transparency and degrees of severity. Some countries maintain catalogues that articulate entities and sectors that are off limits to foreign investors in the name of national security; others have open investment policies with clearance processes for a narrow range of foreign acquisitions of firms that are considered particularly sensitive. It is difficult to generalize rationale, but examples of reasons – when given – include access to critical infrastructure, sensitive technologies, sensitive locations and excessive reliance on imports for an industrial base.
- Finally, there seems to be a general catch-all category, the common denominator of which involves the fear of losing control to some outside force. These concerns are perhaps subsets of other categories, but include such examples as a fear of long-term balance of payments issues, that a foreign government source of FDI could threaten the withdrawal of funds to influence behaviour, that the foreign acquirer of a domestic corporation will fail to be a good local corporate citizen and so on. National security and nationalistic concerns alike can be enhanced when the source of the "foreign" funds is a government or government-related entity, which raises the question of motives beyond those traditionally recognized as commercial.

It is interesting to note that political and government attitudes (although not necessarily actions) involving outbound FDI seem to differ far more across countries than those involving inward investment. In this regard, some countries actively encourage outward investment by their MNCs, seeing FDI as a vehicle for exports and global expansion, while in other countries politicians demonize outward investment as the act of "exporting jobs".

4.3. Why Countries Constrain FDI: The Political Economy of Asymmetry

Yong Wang

While this is a new era of economic globalization, with the rise of a single global market, the political foundation of the global economy has not changed greatly: it is still based on international politics and a true world government is still far away. Thus it was no surprise when President Obama indicated at the G20 London summit in 2009 that he came to the conference to support US interests.[16] "Global governance" refers to a combination of negotiation, confrontation and coordination among nation states with different national interests related to global issues. There is a fundamental mismatch between the global economy and nation state-centred international politics. Within national borders and in the international system, countries, groups and industries benefit from trading with each other. They earn absolute gains, but at the same time compete for the relative size of those gains. This mixed perspective of relative and absolute gains helps understand why countries constrain FDI.

Historically, the relations between trade and investment have always been intertwined and complicated. After World War II, many countries became sceptical about a market economy system, and developing countries championed economic autonomy and thus pursued import substitution strategies to promote the industrialization of their local economies, as mentioned by Jackson and Lehmann in Section 4.1. While erecting high import barriers, they welcomed FDI, which was perceived as a means of creating local value-added production. Latin America was the setting for most of Prebisch's analysis on development; some countries, like Brazil, experienced rapid growth until the 1980s debt crisis.

From the 1950s to 1970s, other developing countries, including some newly independent ones, adopted a more radical approach to development. These development strategies were influenced by the *dependencia* theory and different versions of Marxist socialism, which promoted the view that developing countries could only advance if they "delinked" themselves from the international economy, which was dominated by Western industrialized nations.[17] These countries were opposed to trade, FDI and loans from international banks. Before it opened up, China was a vivid example of this model; it pursued a centrally planned economy and import substitution industrialization. The Cold War, with its ideological divide, played out in the background of this scenario.

From the 1970s and 1980s, however, the perception of FDI and trade among developing countries gradually experienced great changes. The success of the export-oriented development strategies of East Asia's four dragons prompted developing countries that had advocated economic autonomy to re-examine their development philosophy and growth strategies. They gradually adopted a new development paradigm that included encouraging processing exports, opening up the economy to FDI and embracing a market economy. One striking example of this shift is the proposal by the economist Fernando H. Cardoso (who later became president of Brazil) of a new development idea called "dependency-associated development",[18] which was inspired by the successes of the newly industrialized economies in East Asia. It is important to note that South Korea did not pursue dependency-associated development, but instead based its development strategy on borrowing from international banks and financial institutions while protecting its domestic market from imports and FDI flows. South Korea and Japan's development strategies differed greatly from the policy recommendations of the 'Washington Consensus' that the International Monetary Fund (IMF) promoted in the 1980s and 1990s.

The changes to embrace export, FDI and a market economy were institutionalized in the form of the new agreements resulting from the Uruguay Round, which involved areas such as intellectual property, trade-related investment measures and trade in services. Driven by trade and investment liberalization, and cross-border capital flows, economic globalization peaked before the Asian financial crisis of 1997–1998. The erosion of political solidarity among developing countries, and the G77's failure to coordinate and produce a uniform position on the Uruguay Round negotiations in particular, accompanied this transformation.[19]

The uneven and incomplete implementation of the Uruguay Round agreements by developed countries – particularly in the areas of textile and agriculture trade, and the protection of intellectual property rights and investment – has been cited as slowing the catch-up efforts of newly industrializing countries[20] and impeding the use of industrial policy tools by developing countries that had previously been utilized by developed countries.[21] These factors underlie the decision to orient the Doha Round as a developing round, to try to redress the distribution of the costs and benefits of implementing the agreements. The decade-long deadlock of the Doha Round suggests that the gaps in assessing the role of the WTO have widened. Furthermore, the global economic crisis of 2008 has triggered a new wave of rising protectionism in both developed and developing countries, which endangers the authority of the multilateral trading system.

Economic globalization is in search of a new direction. It is important to recognize that it would be too costly to retreat from a single global market and to remember the lesson of the Great Depression in the 1930s. The failure of nations to rein in protectionism only brought disaster to everyone. Countries seem to have understood this and have worked together in the framework of the G20 to cope with the impact of the 2008 global financial crisis. The WTO has continued to serve as a major bulwark to stem the rising tide of protectionism.

The global financial crisis has revived old concerns about the loss of control over FDI and produced new scepticism about the rise of state-owned enterprises, all in the context of a more complicated picture of the global political economy that includes the rise of emerging economies and new major power rivalry, especially between the United States and China. The major emerging economies have chosen to work together in the club of BRICS (Brazil, Russia, India, China and South Africa) to promote their ideas on reforming the international economic order. They seek greater influence in the IMF and the World Bank, and hope the WTO can voice their concerns in the Doha Round. The United States, for its part, has become reluctant to advance multilateral negotiations and has turned to promoting regional FTAs – mainly the Trans-Pacific Partnership (TPP) and recently the Transatlantic Trade and Investment Partnership (TTIP) – to achieve the claimed 21st-century high standards in areas such as investment, SOEs and others.[22]

At the same time, both China and the United States have imposed restrictions on the investment of MNCs and SOEs in each other's territories, citing the need to safeguard national security and indigenous innovation. While China and other developing countries are still concerned about the oversized presence of Western MNCs, the Western public seems to be more sensitive to FDI inflows from China's SOEs. The West labels this as "state capitalism", as it is concerned about the distortions created by subsidies and other forms of governmental support, as well as by the possibility that SOEs may serve the foreign policy objectives of the home state.[23]

The rapidly increasing investment flows from China and other emerging economies into Africa have also generated some concerns about the revival of so-called colonialism. Critics suggest that these flows are mainly directed at the low value-added mining and farming sectors, while manufactured products are dumped in these countries.[24] Some sceptical people even label China's increasing investment in Africa as "neo-colonialism", though systemic studies have refuted this argument.[25]

Citizens' advocacy groups in China have called for local governments to pay more attention to environmental interests when attracting foreign investment, and these pleas have impacted public policy. Recent public protests against the local governments in Xiamen and Nantong aimed to stop chemical industry investments from Taiwan and other sources.

In this new political economy context of global trade and investment, the question is how to better understand the concerns of different types of countries regarding the role of FDI, and how to address those concerns to ensure that any FDI agreement strikes a balanced deal that serves all parties' interests. And this is where the negotiation of a multilateral framework on FDI, within the WTO, may be important, as Draper, Leycegui, Jara and Lawrence argue in Section 8.

Given that FDI is no longer limited to outflows from developed countries,[26] and the increasing importance of global supply chains, an MAI may now be feasible. This may be an impossible task, however, if the different groups of countries cannot understand each other better and do not make a political determination to compromise. A more comprehensive understanding of the barriers to FDI is key, as is taking a broader perspective of FDI. It is important to pay attention to the relative size of FDI and its different influences on the economy of the host country; respect the political and economic autonomy of the host country, not only superficially but also substantially; sympathize with the development interests of developing countries, especially small and weak ones, to ensure that FDI complements the industrialization of local economies rather than "crowds out" local manufacturers; include an international competition clause to address developing countries' concerns about pricing manipulation by some MNCs or the coalition to exercise monopoly powers; and better protect the environment and labour rights.

4.4 A View from Sub-Saharan Africa: Fresh Opportunities for Integration

Salim Ismail

The issue of FDI as a driver for trade and development holds great resonance in Africa. FDI flows to Sub-Saharan Africa remain modest, yet have increased steadily over the past decade. Inbound direct investments have exceeded total aid flows since 2005, and in 2011 they stood at US$ 36.9 billion – equivalent to 2.4% of global flows.[27] While the continent may have been a comparatively peripheral region in the transformations that have occurred in the global economy over the past two decades, a growing number of voices in corporate and analytical circles recognizes that African markets have serious future investment potential.

While acknowledging the many challenges that still need to be overcome to effectively mobilize resources towards advancing the socio-economic objectives of a very diverse set of nations, a noticeable sense of African economic dynamism supports this positive perception. Several developments have raised the profile of an important number of African countries as promising investment destinations.

The first such development is rapid GDP growth. Continent-wide output expanded by 5% in 2012, and over half of Sub-Saharan Africa's 48 countries are forecast to grow above that rate in the coming years.[28] Although this upward trend from an admittedly low base says nothing about the quality or sustainability of growth, it prompted the *Financial Times* to identify Africa's "road to prosperity" as one of the marked "bright spots in the world economy" in an end-of-year editorial.[29] A second notable element is the macroeconomic resilience demonstrated by many African nations following the financial crisis and the subsequent depressed demand from traditional export markets in Europe and the United States. This resilience is perceived as the consequence of prudent economic management and greater political stability, as well as China's intensifying engagement with the continent as a commodity importer and large-scale investor – especially in infrastructure. Demographics offer a third component of Sub-Saharan Africa's inherent potential. Seventy percent of the population is under the age of 25, and the region will enjoy a favourable dependency ratio – or demographic dividend – over the coming generation. This provides a great opportunity if capitalized upon through employment creation and broad-based growth. These young and increasingly urban citizens will also be responsive to the possibilities made available by the rise of telecommunications and information technology that is taking hold across the continent. Finally, the political process of regulatory reform has gained momentum in many African nations, with policy efforts targeted at strengthening domestic business environments and investment frameworks. Within these broadly encouraging dynamics, a general set of challenges in the context of international trade and investment is worth highlighting.

While Sub-Saharan Africa needs to attract investment and absorb technological and managerial know-how in virtually every sector – from agriculture to manufacturing, services and infrastructure development – the global market for FDI is hugely competitive, and investors have become highly sensitive to political and macroeconomic instability. Despite low wages, for example, the region has largely been bypassed by the shifting geography of efficiency-seeking investments in global production chains in labour-intensive manufacturing, due to poor levels of productivity and competitiveness. Furthermore, while there is mounting evidence that global firms are now looking to tap into rising African consumer affluence,[30] most African nations, with the exception of South Africa and Nigeria, remain at a disadvantage compared to other fast-growing regions with respect to market-seeking incentives, owing to narrow markets and weak regional integration. Renewed efforts within the East African Community and the South African Development Community to strengthen integration dynamics can be applauded in this light. And even though Africa's successes of the past decade are far from restricted to commodities and natural resources, extractive industries continue to attract nearly half of inbound investment flows.

FDI can serve as a potent tool for economic development and poverty reduction in Sub-Saharan Africa – most notably through employment creation, knowledge transfer and diversification out of low-value, resource-based production. Many countries in Africa have the capacity to attract increased flows of private capital from both developed and emerging nations. Reaping the dividends of these investments will require establishing productive market-state relations that align economic, social and environmental objectives.

There are a few promising and diverse examples from Africa's southern cone. For example, Mozambique is engaged in a process of tropical agricultural development with Brazilian and Japanese investments that could offer significant long-term rewards. Likewise, South Africa has successfully opened renewable energy tenders for independent power producers with the participation of European and Indian partners, among others. Botswana can be credited with an imperfect, yet commendable, record of governance and poverty reduction in its diamond-led economy. And Lesotho is capitalizing on US African Growth and Opportunity Act preferences to attract capital to its vigorous textile and clothing industry. Mauritius has also gradually developed into a regional services hub on the back of a strategy originally based on the establishment of SEZs that cater to labour-intensive apparel manufacture.

The example of Mauritius merits attention in light of the historical importance of the textile industry as a route to economic development and structural transformation through low-wage employment creation. Sub-Saharan Africa's textile industry has suffered immensely from Asian competition over the past decade. Production has declined, businesses have closed and jobs have been shed. Low-income Madagascar is a case in point. As wage pressures in China and Asia continue to intensify in the coming years, there is no reason why African nations should not draw renewed interest from key drivers in an industry with highly fragmented global production networks. To attract foreign investment, African countries should narrow skill gaps and logistical bottlenecks, and create stable environments that incentivize inward investment in labour-intensive production. Strategies will differ, and may rely in the short to medium term on inducements found in industrial or export processing zones. Yet recent experience in Asia suggests that, given a minimum level of policy foresight and capable economic leadership, there is a substantial potential for business development, productivity gains and job creation in the textile industry.

Ensuring that inbound FDI flows act as a source of inclusive and sustainable growth in Sub-Saharan Africa, however, calls for some precautionary remarks. In domestic environments that are often characterized by weak institutions, some degree of corruption and limited administrative capacity, there is a risk that social and environmental regulations will be undermined to accommodate investors or global sourcing arrangements. The death by fire of over 900 textile workers in Dhaka in November 2012 due to unacceptable working and safety standards is a tragic reminder of the shortcuts that can be taken to achieve global efficiency gains. International companies have a responsibility to move beyond minimum levels of compliance to safeguard the social and environmental integrity of their investments and supply chain strategies. Another point to be considered from an investment policy and governance perspective is that technological transfers and knowledge spillovers that are often associated with FDI and GVCs are not automatic.[31] Upgrading to higher-value activities can be a challenge for many African nations, and will warrant policy adjustments based on domestic specificities and national objectives.

In conclusion, progress across the African continent over the past decade has not been uniform, but many nations are creating the conditions to enhance their participation in international trade and investment flows in goods and services. This opportunity must be seized.

5 From Barriers to Facilitation to Incentives Different Distortions of FDI

5.1 Barriers to FDI: A Corporate Perspective

Karan Bhatia

From the perspective of a major global industrial company, the relevance of the rules governing foreign investment has increased dramatically.[32] Once largely irrelevant to manufacturing companies that are focused principally on home markets, today the rules governing when, where and how a company can invest abroad are increasingly critical to business competitiveness.

This newfound focus on investment is due in part to the shifting balance of power in the global economy. As companies increasingly look outside their borders for growth, all of the rules governing activities by "foreign-headquartered" companies – including those governing investment – become increasingly relevant. But this new focus on investment is also attributable to a change in how companies seek to innovate, manufacture, sell and service their products.

Thirty years ago, the bulk of trade occurred under a "build-it-here, sell-it-there" model. General Electric (GE), for example, would design, source and build its industrial products in one country – most often the United States – and seek to sell them around the world. With a few exceptions, GE investments in most countries abroad consisted of a few offices that principally housed a sales force. Not surprisingly, these companies were far more concerned with traditional "trade" rules – tariffs and quotas, for example – than the arcane rules governing foreign investment.

Fifteen years ago, the model began to change, as such companies began experimenting with "in-country-for-country" (ICFC) production models. While the goods themselves may have been designed in home markets, various elements of manufacturing and assembly happened locally, and the companies increasingly sought to utilize local supply chains where possible. In this ICFC model, investment rules became more clearly relevant, as they often dictated how or where local production could be established. But many governments – anxious for the jobs and technology that ICFC programmes promised – typically imposed a small number of restrictions or conditions that were quite manageable.

Industry today is transitioning yet again – this time to an "in-the-world, for-the-world" model of production, as explained by Baldwin in Section 3. In short, this is a world of GVCs – in which companies will innovate, source, produce and service in a globally integrated manner. Driven by a commercial imperative to be closer to their customers – and aided by better logistics, ubiquitous communications, human resources that are increasingly comfortable working globally, sophisticated sourcing operations and a new emphasis on cultural adaptiveness – companies like GE increasingly examine every country as a potential place to innovate, manufacture and service goods.

With this new production model, the rules governing foreign investment have become an increasingly important – and in some cases, determinative – factor in deciding where and how investment occurs. The rules affecting investment have, in effect, become the rules of international trade.

Left to market forces alone, four factors should principally shape investment decisions: size of market; quality of the enabling physical infrastructure; quality of the human infrastructure; and the regulatory and legal environment (including, importantly, the strength of rule of law in the country). These factors should drive governments that are seeking foreign investment to pursue sound fiscal and monetary policies, invest in their people (healthcare, education, etc.), invest in infrastructure, and build durable and transparent political, legal and judicial institutions.

Troublingly, since the global financial crisis, an increasing number of laws, policies and practices seek to distort investment decisions and, effectively, skew international trade. These policies are adopted for the seemingly benign purpose of supporting jobs and economic development, but they use means that not only are clearly illegitimate under established trade rules, but are also economically unsound and ultimately hinder economic development. These policies introduce distortions into global capital and trade flows that risk reciprocal action by other countries, and yield economically sub-optimal outcomes.

Many of the investment-distorting rules and conditions that multinational companies are confronting around the world fall into one of the following categories:

1. *Rules or practices that preclude or cap FDI in certain sectors.* While many countries have long imposed restrictions on FDI in certain sectors for reasons of national security, and some have had blanket preclusions of investment in certain "strategic" sectors, the recent practice of publishing detailed "investment catalogues" makes clear that investment policy is being increasingly utilized to protect certain sectors for national champions.
2. *Rules or practices that constrain flows of capital, technology, people or other resources needed to establish viable, competitive operations in country.* A number of countries nominally permit FDI, but impose conditions on other business operations (e.g. cap the number of work permits afforded to critical foreign employees, or limit capital inflows) that effectively bar investment or permit it only in furtherance of national industrial policy.
3. *Rules or practices that condition investment on commitments to transfer technology or undertake other actions that the investor would not otherwise carry out.* Governments often condition investment approvals on transferring technology to local joint venture partners or others, again often in service of national industrial policies. Such practices distort investment decisions – discouraging some companies from engaging in the market altogether, while causing others to structure investments differently than they would in the absence of these requirements.
4. *Rules or practices that condition access to local markets (including government procurement markets) on meeting certain local content requirements or establishing/maintaining certain local assets in country.* This tactic has been a particularly pernicious, and has grown dramatically in the wake of the global financial crisis and resulting employment pressures. From 2008–2010, GE tracked the growth of these measures in jurisdictions around the world that affect it and found that there had been an explosion in the number of local content measures that it confronted around the world.
5. *Policies that limit the availability of certain raw materials to locally invested companies.* Recent years have witnessed the adoption of raw material export restraints, which effectively compel investments that would not otherwise have occurred. This is part of a more general phenomenon of establishing export restraints in different areas.
6. *Subsidies that seek to incentivize investment.* While many in business are the beneficiaries of such subsidies and see them as a "benefit", it must be acknowledged that they too distort investment decisions, as discussed by Dadush in Section 5.3.

Recognizing the challenge posed by these investment rules, other governments have sought to address them in various ways. The issue of investment preclusions has been raised in a number of bilateral dialogues. A number of ongoing bilateral and regional trade negotiations have sought to include commitments to bar local content requirements. In a couple of instances, WTO litigation has challenged raw material export restraints (China raw materials case[33]), government procurement preferences for locally manufactured goods (Canada wind turbine case[34]) and investment subsidies (Airbus-Boeing[35]).

However, these efforts have all been ineffective in stemming the growing tide of investment rules, or the distortions of investment resulting from them – to the detriment of: consumers in countries that are denied competition; of businesses that are denied economic opportunities; of smaller, less economically powerful countries that lose out on investments when potential investors are forced to relocate production to larger neighbouring economies as a condition of market access; and, in the long run, of the economies imposing them. Clearly, this issue demands a multilateral resolution. Generally, however, the global rules governing investment afford uncertain protection.

5.2 Facilitators of FDI: Trade Finance

Christopher Logan

According to the WTO, 80–90% of world trade relies on trade finance.[36] Trade finance is truly the plumbing that makes international trade flow and provides the day-to-day funding to support one-off FDI transactions. If trade finance becomes more difficult to obtain, this is a risk to trade and FDI, and if trade finance becomes more efficient, it is an opportunity to increase trade and FDI.

Despite its importance in supporting FDI and trade flows, trade finance is not measured efficiently in aggregate. Some estimates note that global trade finance is in the range of US$ 10–12 trillion per year,[37] which dwarfs annual FDI levels of approximately US$ 800 billion.[38] Given the large size of this market and its underlying importance to global trade and FDI, it would be useful to see renewed efforts to track the size and changes to this market in a more holistic and systemic manner.

Today, the primary instrument for trade finance is the Letter of Credit (LOC). The modern form of LOC is governed by the International Chamber of Commerce (ICC) Uniform Customs and Practice (UCP) for Documentary Credits; UCP 600 is the latest version.[39] However, the history of LOCs dates back as far as Egyptian and Babylonian times circa 3000 BC, and most certainly to the 12th and 13th centuries in Mediterranean Europe. These instruments are certainly useful, as they have tremendous history and legal precedence, but they are not ideal for trade finance transactions in the 21st century.

Small and medium enterprise (SME) value chains rely heavily on LOCs and trade finance in general, and these companies are most at risk to disruptions in the trade finance market. SMEs play an important role in the GVCs of the larger MNCs, as many component parts and even final assembly operations for MNCs are now performed by SMEs, often in emerging markets.

The global financial crisis has had a significant negative impact on the availability of trade finance over the past several years. According to World Bank estimates, 10–15% of the decline in world trade in late 2008 was attributable to a decrease in the supply of trade finance.[40] In addition, the WTO noted that the spread above the London Interbank Offered Rate (LIBOR) for trade finance rose from 10–20 basis points up to 300–600 basis points during the same period.[41]

New banking regulations may also have adverse effects on trade finance in the future. The financial community and other stakeholders have been very vocal about their concerns regarding the Basel III bank capital requirements, which may increase pricing and decrease the availability of trade finance. While there have been some efforts to soften the implementation of Basel III, it will be important to ensure that these new regulations do not produce unintended negative consequences for trade finance.

New models of trade finance are beginning to provide alternate financing mechanisms to the traditional LOC. Some banks and a few logistics service providers are offering "supply chain finance solutions", which are more comprehensive than LOCs. These solutions may take the form of international accounts receivables financing or factoring, or various forms of asset-backed lending. The market size for these solutions is difficult to quantify, since most transactions are private. These emerging trade finance offerings should provide more options for large and medium-sized companies.

Trade finance is a key facilitator of both trade and FDI, and therefore greater attention should be paid to ensure its continued availability and efficiency.

5.3 Incentives to Attract FDI[42]

Uri Dadush

The desire to attract the "right" kind of FDI often leads countries to engage in a global competition. Many countries, regions, and states or cities within countries have established investment promotion agencies and enacted policies to incentivize FDI. These normally include incentives of a fiscal or financial nature. The former are designed to reduce a firm's tax burden and include tax concessions in the form of a reduced corporate income tax rate, tax holidays, accelerated depreciation allowances on capital taxes, exemption from import duties and duty drawbacks on exports. The latter consist of direct contributions to the firm from the government and include grants, subsidized loans, loan guarantees, the participation of publicly funded venture capital in investments involving high commercial risks and government insurance at preferential rates.

It is understandable that authorities compete fiercely to attract FDI that creates jobs and helps revitalize local economies. A successful case is the BMW plant in Greenville, South Carolina, which is located close to the previously under-used Port of Charleston. In the early 1990s, BMW received US$ 130 million in incentives (about US$ 200 million today), including tax incentives, road improvements and job training. In turn, the company invested some US$ 2.2 billion in the region and created more than 5,000 jobs, in addition to the thousands more that were created by the automotive parts suppliers and research facilities that subsequently invested in the area.[43]

But investments do not always succeed, and money spent on incentives can be wasted and even drag down the city or region that courted a firm. For example, the failure of Mamtek's US$ 65 million investment in 2011 in an artificial sweetener plant in Moberly, Missouri sparked debates on government subsidies for foreign investors. The city of Moberly had issued US$ 39 million worth of special bonds to help the Chinese parent firm finance its US factory, in addition to the promise of US$ 18 million in state aid and tax incentives. Mamtek missed the first bond payment and stalled the construction of the facility. Standard & Poor's subsequently downgraded the city's credit rating.[44]

However, dramatic failures are probably the exception. More often, cities or states simply end up paying a higher price than they may need to. For example, in 2004 and 2005, Dell opened a series of call centres in the United States and Canada, which prompted bidding wars among a number of cities. In July 2004, Dell announced that it would locate a call centre in Edmonton, Alberta. Edmonton triumphed over Calgary, Winnipeg and three US cities. It put together an incentive package worth about CAD$ 6 million, but it may have been possible for the city to land this deal without offering such a large and expensive carrot, given its success in attracting Ford, GE Credit, Neiman-Marcus and Convergys without incentives.

Investment incentives reflect a coordination failure among governments and are, like most subsidies, a source of inefficiency. They distort markets as artificial restrictions on investment do, though in different ways. The provision of incentives also has the potential to exacerbate regional disparities, since wealthier and more successful cities/provinces/countries are often able to provide larger incentives. For example, Hyundai received incentives of about US$ 117,000 per job from Alabama in 2002, but only about US$ 75,000 per job from the Czech Republic in 2007. Alabama's per capita income in 2006 was US$ 29,414, while the Czech Republic's was US$ 12,680 at current exchange rates and US$ 21,470 at purchasing power parity exchange rates.[45]

Although competition among local authorities can be a good thing, incentives are an unhealthy form of competition. They can also distract attention from the hard decisions needed to improve the business climate and from investing in the skills of the local labour force, for example. In extreme cases, they can encourage investments that are inherently unprofitable and ultimately unsustainable. In the longer run, developing countries that become over-reliant on incentives to attract investment can adversely affect their own development.

One can learn about the challenges confronting attempts to regulate incentives at the global level from the experiences of the EU and federal states such as the United States, Canada and Australia in regulating incentives internally. In general, states have had only partial and modest successes in doing so.

The EU undertook the most comprehensive effort to regulate investment incentives. EU "state aid" rules start from the presumption that subsidies should not be used by Member states unless they contribute to a goal of the EU as a whole, and do so in a way that least distorts trade within the EU. Critical elements of disciplining the use of state aid are transparency and oversight. The European Commission must be notified of all subsidies in advance, and can prohibit or modify them if they are in violation of EU law. State aid disciplines also designate maximum aid intensity levels for every location within the EU. Poorer areas of the EU can provide larger subsidies than richer ones, and the most prosperous regions are prohibited from giving any aid at all. Governments can thus only give support to firms in proportion to the disadvantage of the region.

In the United States, by contrast, disciplines on investment incentives remain very weak. Indeed, the most significant force for reform in the United States has been private non-governmental organizations. There have been attempts to use the federal tax exemption on certain types of local authority bonds as leverage to limit the incentives given to investors. Industrial revenue bonds are federal tax-exempt bonds issued by local governments to fund a wide variety of projects. Until 1986, there were few restrictions on them; they were very popular with local governments because the entire cost of tax deductibility was borne by the federal government. In the 1986 tax reform, caps were put on the amount of bonds that could be issued, and restrictions were placed on their use.

There have also been efforts to limit incentives competition among individual states, including two unsuccessful regional no-raiding agreements. State governments have entered into two voluntary no-raiding agreements. In the 1980s, the Council of Great Lakes Governors approved an anti-piracy pact, but it collapsed even before it went into effect. A 1991 agreement among New York, New Jersey and Connecticut met the same fate a few days after it started. New York City has been a particular target of nearby jurisdictions and has been subject to local companies threatening to move out of the city in order to receive retention subsidies.

The National Governors Association (NGA) has been active in hosting discussions on how to limit incentives competition. State governors are, of course, aware of the dangers of bidding wars for investment. However, the NGA has consistently argued that there should be no federal intervention to stop incentives, thus preserving state sovereignty, while also arguing that states should refrain from bidding wars because avoiding them is good policy. Clearly, this is a case in which moral suasion only goes so far.

Canada and Australia are two federal states in which competition for investment at the sub-national level has at times been severe. In both instances, the pressures have led to attempts to control incentives.

In Canada, the subsidized relocation of investment was a major problem in the 1990s. In this context, the Code of Conduct on Incentives was agreed to in July 1994 as part of the Agreement on Internal Trade, whose parties include the federal government, all 10 provinces and two of the country's three territories. The code explicitly prohibited relocation subsidies and provided for an agreement among governments to make their "best efforts" to avoid bidding wars. Canada has enacted other disciplines to limit the use of incentives to attract investment. In eight of Canada's 10 provinces, local governments are prohibited from giving incentives. Manitoba and Saskatchewan, the two provinces that still allow municipal incentives, have populations of just over two million and few major cities. One often-allowed exception is support for R&D, which is generous in Canada.

In Australia, bidding wars and poaching were also considered to be a problem for the states and territories. Five of the country's six states (New South Wales, Victoria, Tasmania, South Australia and Western Australia), plus the Northern Territory and the Australian Capital Territory, reached an agreement in 2003 to end bidding wars among them and provide annual reports to each other on their investment attraction. The three-year agreement was renewed for another five years in 2006. A year later, Victoria's treasurer noted that the signatories had saved "tens of millions of dollars" as a result of the agreement and that "…some jurisdictions [were] noticing a decrease in the number of companies seeking incentives to relocate from one State or Territory to another".[46] The agreement remains largely informal, however, with no monitoring or enforcement mechanisms.

BITs rarely, if ever, address the disciplining of investment incentives, because their purpose is to protect the investor rather than place limits on benefits that the investor might receive from a host government.

In the United States, investment incentive agreements (IIAs) are entered into by the Overseas Private Investment Corporation (OPIC) with host governments. There are over 150 IIAs between the United States and foreign governments. In general terms, these agreements provide for allowing the operation of OPIC's programmes in foreign countries, recognition of OPIC's rights and international arbitration between governments if disputes arise that cannot be settled by negotiation. The "investment incentive" in IIAs is the permission for OPIC to operate in the country, offering benefits to the investor such as political risk insurance, loans or equity investment.

The long-standing stall in the Doha Round trade negotiations has coincided with increased recourse to bilateral and regional FTAs to advance countries' trade and investment agendas. Typically, these FTAs have imposed stronger disciplines on performance requirements than the WTO Agreement on TRIMS. The 2004 Australia–United States FTA goes beyond the TRIMS agreement by additionally banning export requirements, requirements or preferences for host country purchases, conditioning domestic sales on export performance, technology-transfer requirements and requirements that the investor be the exclusive supplier of its products to any market. However, the investment chapter also explicitly permits governments providing investment incentives to enforce "compliance with a requirement to locate production, supply a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory".[47]

The WTO has at least three agreements that touch in different ways on foreign investment: the Agreement on SCM, which abolishes export subsidies for most products (agriculture is a notable exception) and regulates the response to them; the GATS, which aims to improve access to markets for services, including by providing the right of establishment; and the TRIMS agreement, which limits the conditions that can be placed on investors, such as setting export targets.

As concerns disciplining incentives, the Agreement on SCM is the most important. It includes the provision that all WTO Members must give notice of subsidies to the WTO Secretariat. In principle, these submissions should cover all subsidies given within a Member country, at all levels of government, and include the amounts spent on such support. If adhered to, this would be a valuable transparency exercise. However, as of April 2013, a number of large WTO Members, including China, Egypt, Indonesia, Pakistan, Philippines, South Africa and Thailand, had not submitted their 2011 "new and full" notifications, and many Members submitted these notifications long after the 30 June 2011 deadline. Furthermore, the next round of new and full notifications is due by 30 June 2013, and as of April 2013, only four had been submitted.

On a different issue, Article 27 of the Agreement on SCM establishes "special and differential" rules for developing countries. An important consequence of this article is that it enables certain poorer countries to maintain incentives that are conditioned on export performance (such incentives are common in the context of export processing zones), which would otherwise run afoul of the prohibition on export subsidies. The list of WTO Members qualifying for this exemption includes all of those designated by the United Nations as "least developed" plus certain other Members with a per capita gross national product (GNP) under US$ 1,000 (calculated, pursuant to a WTO Ministerial Decision, in real terms over three consecutive years). The largest WTO Members on this list that have not graduated based on their GNP per capita are India and Indonesia. In addition, Article 27 provides a mechanism whereby other developing country Members can obtain extensions of the transition period to eliminate their export subsidies. Pursuant to special procedures adopted by the General Council in 2007, a total of 19 developing country Members received the last annual extension, for calendar year 2013, to be followed by a final two-year phase-out period (2014–2015).

6 The Current (Fragmented) Governance of FDI

Sherry Stephenson and Uri Dadush

Despite its importance, the disciplines governing FDI lie in the shadow of those governing global trade. There is no single, comprehensive multilateral treaty or institution to oversee investment activity. Various attempts to bring FDI under multilateral purview in the past have been unsuccessful. The result is a complex and confusing overlay of bilateral, regional and, in very limited areas, plurilateral disciplines. The negotiation of mega-regionals (e.g. TPP and TTIP), if successful, may improve this situation in some instances, or may result in just another layer of complexity.

6.1 Efforts at the Multilateral Level

There have been several attempts to govern investment at the multilateral level. In addition to the efforts to address the topic in the Havana Charter of 1948 – which ultimately failed for other reasons,[48] a second attempt was made by the OECD through its four-year effort (1995–1998) to craft an MAI. The effort involved OECD Members and a few key developing countries. When made public in 1997, the draft agreement drew widespread criticism from civil society groups and developing countries, and the ensuing public pressure and opposition led to the withdrawal of first France and then other countries from the agreement. The effort was suspended at the end of December 1998.[49]

A third attempt to bring investment under multilateral rules took place within the WTO itself, in the context of the Doha Development Agenda, when investment and three other "Singapore issues" (competition policy, government procurement and trade facilitation) were originally included within the Doha negotiating mandate. However, dissension within the WTO ranks made it impossible to reach a decision by consensus on the modalities for negotiating these issues, and therefore negotiations could not be launched as planned at the 2003 Cancun Ministerial Conference. While the EU, Japan and Korea were supportive of negotiating all four issues, most developing WTO Members were generally opposed, and the United States preferred to focus on market access rather than on generalized disciplines.[50] In August 2004 three of the four "Singapore issues" (including investment) were dropped from the Doha Agenda, and negotiations were subsequently launched on only one subject: trade facilitation.[51]

These repeated failures to consolidate a multilateral investment regime have left in place an irregular, overlapping and complex "patchwork quilt" of over 3,000 agreements in the IIA universe, consisting of 2,833 BITs and 331 "other IIAs, primarily FTAs with investment provisions, economic partnership agreements and regional agreements" (see the table in the Annex).[52] This incoherent and often contradictory picture of FDI governance, with its associated costs and inefficiencies, undermines the tremendous value that investment brings as a source of world economic growth and employment, generator of world trade flows and driver of innovation and technological change.

6.2 Partial Investment Rules at the Multilateral Level

The Uruguay Round resulted in a patchwork of partial investment rules within the WTO. There are three agreements currently in effect that cover aspects of FDI, but they are not related in any way; nor are they comprehensive.

The first of these is the TRIMS Agreement covering trade in goods with a few disciplines but no investor protections.[53] The second is the GATS, which covers FDI in services, defining FDI as one of the four ways of trading services (mode 3 or "commercial presence"). Certain generalized disciplines within the GATS on MFN, transparency and notification, and domestic regulation apply to FDI in services, but there are no comprehensive disciplines that address investment guarantees and protections.[54] The third is the Agreement on SCM, which abolishes export subsidies for most products and regulates the response to them, as discussed by Dadush in the previous section. These three existing WTO agreements are insufficient to provide a coherent and effective regulatory framework for FDI at the multilateral level.

Agreements at the plurilateral, regional and bilateral levels have attempted to remedy inadequacies at the multilateral level in dealing with FDI, though in doing so, they have created their own network of overlapping – and sometimes contradictory and incoherent – disciplines, adding to the "patchwork quilt" on FDI. The table in the Annex summarizes the types of agreements that have been negotiated at various levels on FDI and their membership.

6.3 Plurilateral Agreements on Investment

At the plurilateral level, both the OECD and APEC have drawn up agreements on investment, to be followed by their Member economies, either as a contractual obligation or as a guideline for best practice.

The OECD *Code of Liberalisation of Capital Movements* (1961) and the *Code of Liberalisation of Current Invisible Operations* (1972) constitute a complementary set of legally binding rules that are obligatory for OECD Members. They stipulate the progressive, non-discriminatory liberalization of capital movements, the right of establishment and current invisible transactions (mostly services). The Codes provide a framework for countries to progressively remove barriers to the movement of capital through peer policy reviews and country examinations to encourage unilateral, rather than negotiated, liberalization. Under the Codes, an adhering country is entitled to benefit from the liberalization of other adhering countries, regardless of its own degree of openness. In July 2012 the OECD Council adopted a landmark decision on governance of the Code of Liberalisation: non-OECD Members willing and able to meet the standards of adherence are welcome to join and will benefit equally from all rights and obligations.[55]

The OECD has also developed the 1976 *Declaration and Decisions on International Investment and Multinational Enterprises* (DIIME), which constitutes a policy commitment to improve the investment climate, encourage the positive contribution of multinational enterprises to economic and social progress, and minimize and resolve difficulties that may arise from their operations. The DIIME is obligatory for all OECD countries, but non-OECD Members can also adhere to it; at present nine other countries (Argentina, Brazil, Colombia, Egypt, Latvia, Lithuania, Morocco, Peru and Romania) have subscribed to the Declaration.[56]

APEC Members developed a set of "Non-binding Investment Principles" in November 1994, which set out agreed guidelines for 12 different areas of investment, including national treatment, investment protections and dispute settlement. The principles are of a very general nature, however, and have not been further elaborated since then.[57] APEC Members also worked on a series of model measures for commonly accepted RTA chapters from 2005 to 2008 to serve as guidelines for high-quality and consistent provisions. The work was completed for model measures in 15 chapters, but investment was not one of the areas included, given the lack of agreement on how to address it in RTAs.[58]

6.4 Regional Agreements on Investment

There has been a continuing trend in the world economy towards using RTAs as the preferred mode of negotiation for rules on investment.[59] NAFTA broke new ground in 1994 with an innovative approach to investment rules and disciplines that are applied in a generic manner to goods and services in a separate chapter. Cross-border trade in services and investment are addressed in chapters devoted to each. Investment rules and disciplines cover both matters of investment protection (which are typically treated under bilateral investment treaties) and liberalization through market access (typically with respect to both pre- and post-establishment rights). These are combined with investor-state and state-to-state dispute settlement provisions, all of which apply to both goods and services, in an attempt to reflect the integrated framework of modern production and trade decisions. Investment in this context is often defined broadly to cover FDI as well as portfolio investment and other capital movements.

NAFTA's comprehensive approach to investment liberalization and disciplines has been adopted by several countries in RTAs around the world. Some countries have preferred to deal with investment in RTAs using a hybrid approach, by including provisions on "commercial presence" for FDI in services as well as a separate chapter on investment (goods and services). Still other countries have followed the GATS approach, dealing only with FDI in services and no other investment provisions.[60] Although there is currently no commonly accepted way of dealing with investment in RTAs, investment chapters are becoming more numerous in regional agreements, as in the case of the Mexico–Central America Free Trade Agreement and the CARIFORUM–EU Economic Partnership Agreement. The lack of common treatment, however, makes it a challenge for investors to navigate the legal possibilities across different RTAs.

Regional investment agreements are also being concluded outside of RTAs, which may be incorporated into future formalized trade agreements, as is the case with the 2012 Trilateral Investment Agreement between China, Japan and the Republic of Korea. This shift towards regionalism can represent a step towards multilateralism by consolidating and harmonizing investment rules, but can also lead to the opposite outcome: duplicating treaty layers, giving rise to potential inconsistencies and generally making FDI governance even more complex.

Investment rules are a part of the "mega-regional" trade agreements now being negotiated among or envisaged by major world trading partners. The TPP negotiations have a draft investment chapter in place, while the Association of Southeast Asian Nations (ASEAN) Regional Comprehensive Economic Partnership negotiations, launched at the ASEAN Economic Summit in November 2012, also envisage the possibility of incorporating investment disciplines. Lastly, the US–EU FTA announced by the US administration in January 2013 will certainly contain significant provisions for both investment protections and investment access. To the extent that the content of these future "mega-regionals" is similar, they could be leading the world economy on a path towards a global investment regime.

6.5 Bilateral Agreements on Investment

Nearly every country in the world has signed a BIT (or several dozen of them). The United Nations Conference on Trade and Development (UNCTAD) puts the number of BITs at the end of 2011 at 2,833.[61] Perhaps because of the larger existing number already negotiated, or because of the shift towards negotiations of regional FTAs or regional treaties, the number of new annual BITs signed has declined recently, with a total of 47 new IIAs signed in 2011 (33 BITs and 14 other IIAs), compared with 69 in 2010.

Both the United States and the EU have developed model BITs, with differing approaches in some key areas. The US-model BIT was elaborated in the 1980s, revised in 2004 and most recently revised again in 2012. In 2012, the United States revised its model BIT, introducing changes relating to transparency and public participation, sharpening the disciplines on SOEs, and strengthening protections relating to labour and the environment.[62] The European-model BIT is based on the Abs-Shawcross Convention model endorsed by OECD ministers in 1962. In an important change, following the implementation of the Lisbon Treaty in 2009, the EU was given exclusive competence on FDI with the authority to negotiate BITs on behalf of EU Members. The previously existing 1,200 BITs concluded by the EU Member states are being respected, but over time may be replaced with EU-wide investment agreements.[63]

These model BITs have been used by the United States and the EU, respectively, to make their agreements compatible between investment partners. However, this compatibility is elusive between the two main models. The fundamental difference lies in the extent of application of the treatment disciplines: while both “pre” and “post” establishment are covered in the US-model BIT, only investment “post” establishment is covered in the European model.[64] The US model also contains more disciplines on performance requirements and has more elaborate provisions in other areas, such as right of entry and sojourn of investors. Thus, although both models similarly cover a few major areas (admission and treatment, transfers, key personnel, expropriation and dispute settlement), they differ with respect to key aspects of investment and investor treatment, thus complicating the life of investors whose governments have signed BITs with both the United States and EU Members.

6.6 Where Do Developing Countries Fit in the Investment Picture?

Developing governments have been actively seeking partners for BITs as a way to promote trade and economic relations and to elicit interest in their economies as a destination for FDI. Only a few countries have refrained from the BITs race, most notably Brazil, which has signed BITs with 14 countries, none of which have entered into force.[65] Brazilian authorizes have feared that strong protection clauses and comprehensive investor–state dispute resolution mechanisms in BITs may restrict their ability to pursue an independent national development strategy, expose the country to liabilities caused by legal claims by foreign investors and increase the complexity of policy-making. Although the size and dynamism of Brazil’s domestic market have allowed it to abstain from international agreements, most developing countries do not have such homegrown advantages. In fact, most developing countries have chosen the opposite path: to attract as much FDI as possible to boost their economic growth.

Both China and India have signed several BITs; as of mid-2012, China had BITs with 128 countries, of which 101 are in force. India had signed BITs with 83 countries as of the same date, of which 67 are in force.[66] Neither India nor Brazil, however, has entered so far into any RTA with deeper disciplines on investment. And the quality of the BITs they have concluded is unequal, so the ability of these agreements to attract FDI will not be guaranteed.

Shifting patterns of global FDI in which South-South flows account for a larger share of global FDI will challenge developing countries’ typically cautious international investment policy approach. As capital importers, they may still have an interest in preserving safeguards in their BITs to support domestic development processes. As newly evolving capital exporters, however, these countries will have to (re)negotiate liberal BITs with developed and other developing countries to protect the foreign investments of their own national enterprises.

6.7 Costs Arising from the “Patchwork Quilt” of Investment Agreements

The increasingly complex global setting for international investment that has resulted from the “patchwork quilt” of agreements discussed above requires investors and governments to try and ensure consistency between differing sets of obligations. While these agreements carry the legal force of international treaties, the legal implications of overlapping sets of various obligations are not always clear. Each agreement has its own architecture, objectives, and cultural and legal specificity, which makes it difficult to assess the global picture and the actual investor disciplines and protections for each potential investment location.

A large number of investment agreements, notably the BITs, contain similar concepts (national treatment, MFN treatment, fair and equitable treatment, full protection and security), but have legal and/or textual variations that can result in divergent interpretations of the same general obligation under different agreements. This can engender costs, in the form of time and inefficiencies in trying to sort through the implications of various provisions in different investment contexts, and potentially divert investment flows from more efficient to less efficient locations.

Another question raised by the overlapping set of investment agreements is the possibility of “forum shopping” in the case of dispute settlement, where an investor may initiate multiple procedures on the same issue to take advantage of the potentially more favourable dispute settlement provisions available in different agreements.

7 A Holistic Approach to the New Trade–FDI Reality

Richard Baldwin

The last time multilateral trade rules were updated with the conclusion of the Uruguay Round, Bill Clinton was in his first term of office, data was shared by airmailing 1.4 megabyte HD floppy disks, cell phones looked like bricks and email was for computer scientists only. While GVCs existed back then – in sectors like microelectronics – most trade involved selling goods that were made in a factory in one nation to a customer in another. This simple trade needed simple rules – a fact reflected in both multilateral and regional trade agreements.

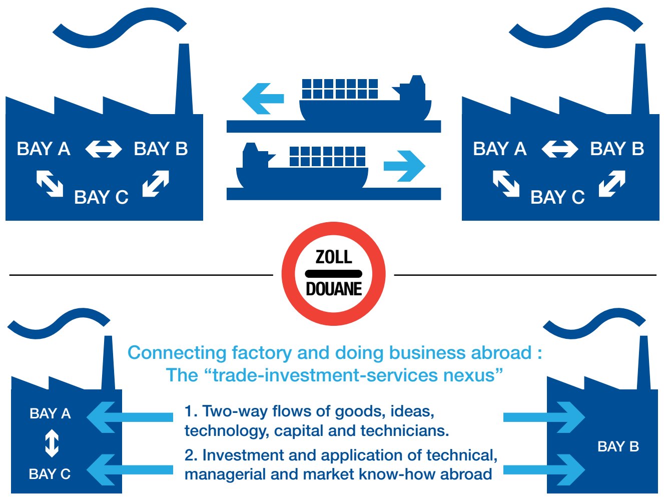
The spread of regional supply chains created a richer, more complex, more interconnected set of cross-border flows – especially linkages between trade and FDI. This changed nature of trade transformed policy-making globally, first by creating new supply and new demand for deeper disciplines, and second by creating a bond among various strands of policy-making – some of which were always viewed as international, but many of which are traditionally viewed as domestic policy issues.

The core logic of the shifting demands is easily identified. Traditional (20th-century) trade involved goods crossing borders. Lower transport costs and multilateral tariff cutting increased the volume of such trade, but the basic governance problem remained unchanged. The differences between 20th and 21st-century trade are illustrated in Figure 3. The top panel illustrates 20th-century trade, which was dominated by goods made in factories in one nation and sold to customers in another. There are complex two-way flows of goods, people and ideas (the double-headed arrows), but primarily within factories. The lower panel illustrates 21st-century trade. Here factories and offices have been unbundled internationally to create the trade–investment–services nexus, in which some of the complex two-way flows that used to take place within factories and offices now take place across international borders. It is useful to think of the trade–investment–services nexus as created by two distinct sets of necessities: connecting factories and conducting business abroad.

Trade in parts and components, trade in infrastructure services and FDI are the most easily measured aspects of this multifaceted, multi-directional commerce, but they are only the tip of the proverbial iceberg. Importantly, there is nothing qualitatively new about the linkage between trade and investment. The economics profession has tended to view trade and investment as separate phenomena – the standard question was whether they were complements or substitutes.[67] However more recent studies have highlighted their jointness,[68] for instance, by documenting their joint growth and dependence on policy liberalization from the 1980s.

Given the complex and interconnected nature of 21st-century trade, the set of policies underpinning it must be a ‘package’. Barriers to any part of the trade–investment–services–IP nexus become a barrier to all aspects. Recognizing this, many developed nations have unilaterally embraced certain forms of trade liberalization – especially the lowering of tariffs on parts and components – while embracing deep ‘pro-business’ reforms. These pro-business or pro-investment reforms aim to create a domestic policy environment that is hospitable to FDI. Since ultimately the FDI generators are the ones that must be convinced that the reforms will be durable and predictable, many developing nations have sought to lock them in by signing deep bilateral RTAs and BITs with their main sources of FDI. Japan has signed a series of such agreements with East Asian nations, just as the United States has with North and Central American nations. Most of the supply-chain links in Factory Europe are inside the EU, so few new bilateral RTAs were needed. The main exceptions are Morocco, Tunisia and Turkey.

Figure 3: Schematic Illustration of 20th - and 21st - Century Trade

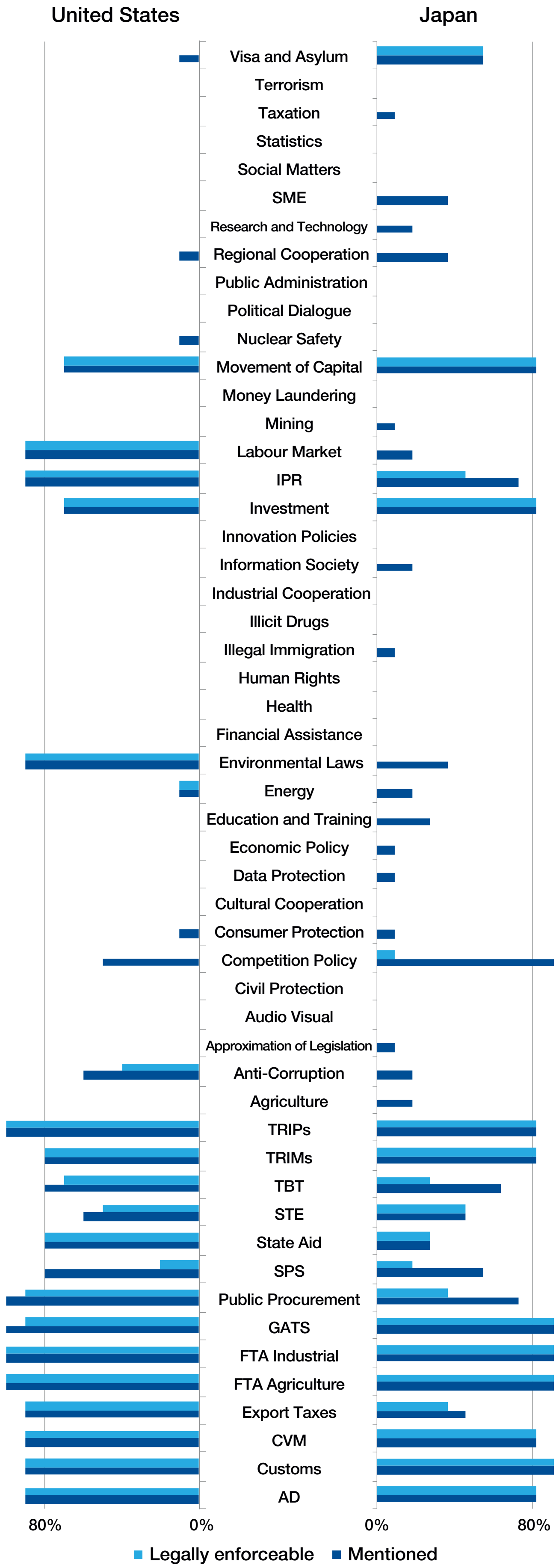


Twenty-first century trade creates the need for two new types of disciplines. These correspond to the two new elements of the associated international commerce:

1. *Supply-chain trade often involves producing abroad, either directly or via long-term relationships with independent suppliers.* This is the investment and intellectual property element: setting up business abroad is an essential part of 21st-century trade. This means that barriers to doing business abroad are now trade barriers. Likewise, much of the internationalization of supply chains involves the overseas application of a firm's advanced know-how. A lack of IP protection therefore becomes a barrier to trade. International supply chains in the 1960s and 1970s mostly involved developed nations with domestic laws that provided reasonable guarantees. As supply chains spread to developing nations with weaker domestic institutions, embedding such disciplines in international agreements became more important.
2. *Production among the facilities must be coordinated, which involves the two-way flow of goods, services, people, capital and training.* Barriers to these flows are now barriers to trade. Note that traditional trade barriers are part of this, but the list is much longer, as the cross-border flows are more complex (express mail, air cargo, trade financing and insurance, business mobility, etc.).

A good source listing the necessary disciplines is the deep RTAs that have been signed among nations for which the trade–investment–services–IP nexus trade is important. After all, GVCs have spread rapidly across Factory Asia, Factory North America and Factory Europe, all without any explicit agreement in the WTO. The governance underpinning these regional supply chains are RTAs – especially RTAs between the high-tech manufacturing hubs – the United States, Germany and Japan – and what might be called 'Factory economies' in North America (primarily Canada and Mexico), East Asia (primarily ASEAN nations) and Europe (primarily Central European countries and Turkey).

Figure 4: Share of US and Japanese Agreements with Deeper Provisions



Note: STE refers to the establishment or maintenance of an independent competition authority; non-discrimination regarding production and marketing condition; provision of information; affirmation of Art XVII GATT provision.

Turning to the content of the key deep RTAs that currently set the rules for supply-chain trade, the excellent dataset assembled by the WTO Secretariat as part of its 2011 *World Trade Report* allows us to spot the most important provisions.[69] For convenience, the various provisions are divided between beyond-WTO measures (those not mentioned in WTO agreements) and WTO-plus provisions (disciplines already covered by WTO rules, but where the RTA goes further). To distinguish between fluff and meat, each provision is noted as being legally binding or merely hortatory.

The deep RTAs sign by the United States and Japan show a fairly clear pattern (Figure 4). The provisions are listed in reverse alphabetical order, with the beyond-WTO issues coming first (up to agriculture) and the existing WTO provision at the bottom, again in reverse alphabetical order. The blue bars in the left panel show the share of all US agreements in the WTO database that mention each provision; the red bars show the share when the provision enters with legally enforceable language. Two points stand out: the United States is remarkably consistent in the provision-coverage of its RTAs; i.e. there is something like a US template, and most provisions that enter US agreements enter with legally binding language.

Only 12 of the 52 provisions enter into 80% or more of US RTAs (i.e. RTAs to which the United States is a signatory). Setting the threshold lower to two-thirds, the number rises to only 17. The bulk of these involve disciplines that are already covered by the WTO, but where the RTA goes further – the most notable in terms of supply chains are the deeper commitments in services, TRIPs, TRIMs, customs cooperation and procurement.[70] Only five beyond-WTO provisions make it into at least two-thirds of the RTAs: three measures are clearly aimed at underpinning internationalized production (IPR, investment restrictions and assurances, and the free movement of capital), and two that reflect deeply entrenched US domestic concerns (labour and the environment).

The right panel of Figure 4 shows the same facts for Japan's RTAs. The basic pattern is not too dissimilar to that of the United States. Most of the legally binding provisions are extensions of existing WTO disciplines (bottom of the chart). Again, the supply-chain relevant ones are TRIPs, TRIMs, services and customs cooperation. Among the beyond-WTO provisions, the ones that appear most frequently in Japanese RTAs are movement of capital, IPR, investment, and visa and asylum (mostly dealing with business mobility issues). Competition policy is almost always mentioned, but almost never legally binding.

The facts for the EU's RTAs are much less clear, and so are not shown. This may have to do with the fact that most of 'Factory Europe' is inside the EU itself – and the EU is the ultimate deep RTA. As such, the EU itself is the guarantor of supply-chain disciplines for European high-tech firms.[71] It may also be related to the fact that the EU has a much longer and richer history with RTAs. The WTO database has information on 10 US RTAs, 11 Japanese RTAs and 58 EU RTAs. The earliest US and Japanese arrangements come from the 1990s, while Europe's date back to the 1960s. Be that as it may, only a handful of provisions appear in at least two-thirds of the EU agreements, two of which are classic, 20th-century trade provisions: tariffs on industrial and agricultural goods, and export taxes. The only legally binding near-universal supply-chain-linked provisions are customs cooperation and competition policy. The key deeper provisions seen in US and Japanese arrangements also appear in EU agreements, but without legally binding language: movement of capital, IPR and investment.

The same facts for all other RTAs give a varied picture. These RTAs are much more diverse and much, much shallower on average. Only 60% of them include deeper-than-MFN tariff cuts, to say nothing of more forward-leaning disciplines. This is to be expected, as RTAs that do not involve the high-tech generators of FDI do not need to provide disciplines for the trade–investment–services–IP nexus.

There is, however, some comfort in the pattern of beyond-WTO provisions that are included. The spikes in frequency occur in the movement of capital, IPR, investment and competition policy – all of which are supply-chain related provisions. In this sense, the shape of these other agreements is not radically at odds with the shape of US and Japanese agreements.

Today's trade is radically more complex, and this demands more complex, more holistic policies that underpin international flows in goods, services, investment and IP. As the WTO was otherwise occupied, the incipient governance gap was filled by uncoordinated developments elsewhere. The new rules and disciplines underpinning the rise of supply-chain trade have been (and continue to be written outside the WTO – primarily in deep RTAs, BITs, and autonomous reforms by emerging economies. Efforts to harmonize these new disciplines are taking place in mega-regionals (TPP, TAP, etc.) and mega-bilaterals that are under negotiation or discussion. But absent a multilateral effort to integrate these new disciplines into the WTO system, world trade governance is headed for fragmentation. Specifically, supply-chain disciplines will be harmonized by mega-regionals and mega-bilaterals that will, on their current trajectory, exclude China and other large emerging economies.

More directly, the economic argument for multilateralizing the existing supply-chain disciplines turns on network effects – i.e. the gains from having a single set of global rules. The political argument is that multilateralization would be necessary to prevent or remove the exclusion that is emerging with mega-regionals and mega-bilaterals.

While most offshoring relationships are primarily bilateral – typically organized by US, German or Japanese firms – the industries and firms involved are global. The US automobile company GM, for instance, runs an elaborate supply-chain trade network in and around Factory Europe, another in and around Factory Asia and yet another in Factory North America. There would be synergies for high-tech companies to have similar supply-chain disciplines in all three zones. Moreover, network externalities work in two ways.

Developing nations that have already joined supply chains would find the bargaining power of high-tech firms mitigated by a standardization of supply-chain trade disciplines. If US, Japanese and German firms were all set up for a global standard, firms from these three headquarter economies would be more substitutable as a source of offshored industrial jobs in any given developing nation. Or to put it differently, the existence of US-centric disciplines in NAFTA-like RTAs that differ from, say, Japan-centric disciplines in EPA-like RTAs, tends to tie particular developing nations to particular high-tech partners. A multilateralization of the rules would make it easier to play US firms off against, say, Japanese firms. For the same reason, multilateralization would make it easier for new nations to jump on the supply-chain industrialization path.

8 Towards Global Governance of FDI? Issues on Getting to a Multilateral Approach

Peter Draper, Beatriz Leycegui, Alejandro Jara and Robert Lawrence

The case for multilateral agreements on FDI is, not surprisingly, similar to that for trade. While countries can always liberalize unilaterally, agreements offer additional benefits that can come both from obtaining reciprocal treatment for outward investment and from providing a more secure system of governance, by agreeing on rules and systems for enforcement and dispute resolution. While bilateral agreements can more easily be adapted to particular circumstances, they may also have disadvantages in that they can lead to diversion, i.e. offer access to less efficient foreign firms and products, and regulatory complexity. By negotiating in a multilateral forum, small countries also have the ability to form coalitions and avoid the power asymmetries they confront in bilateral negotiations.

Despite these symmetries between trade and investment, and as discussed by Stephenson and Dadush in Section 6, international investment regulation remains the stepchild of the multilateral trading system. To be sure, there are some rules relating to investment in the TRIMs agreement, and in the GATS under mode 3, but a comprehensive agreement on investment is not part of the WTO Rules. Instead, international investment is primarily regulated through BITS and RTAs. Since FDI is such a key driver of international integration, this is a major omission. FDI and trade are natural complements, and the absence of an MAI prevents the system from achieving its full potential.

One reason the system evolved in this fashion is historical misgivings held by several developing countries towards developed country investors (Lehmann and Jackson, Section 4.1). Import-substitution approaches to economic development, and the associated desires for policy space, reinforced such opposition. Over time, developing countries' governments and public opinion have also become concerned with the need to better regulate the activities of foreign investors and to have a greater share of the benefits. Yet even among developed countries it has not proven possible to secure agreement on a comprehensive multilateral agreement on investment, as the failed negotiations in the OECD during the latter part of the 1990s attest.[72] All these fault lines (and more) carried over into the launch of the Doha Round in 2001, and were capped with the rejection of investment negotiations during the WTO's Cancun ministerial meeting in 2003.

8.1 Why the Time Is Right for a Multilateral Agreement on Investment

At least six reasons explain why it is timely to revisit the issue.

1. As argued by Baldwin in Section 7, the rise of GVCs sharpens the need for global and holistic regulations that underpin international flows in goods, services, investment and IP.
2. There is a proven need for international investment regulation, as demonstrated by the explosion of BITs and RTAs, which have led to significant differences in rules and lack of coherence in their application.[73]
3. As mentioned by Hufbauer and Draper, investment into and out of emerging markets has grown tremendously in recent years.[74] Thus a sharp North-South divide on the issue no longer exists, because many developing countries have a large and growing stake in protecting the investments of their own MNCs through a rules-based approach.
4. The historical stigma associated with FDI has sharply abated in recent years, as many countries have pursued economic liberalization and now recognize the benefits it can bring.[75]
5. By contrast, the fragile and slow recovery of the world economy has led some countries to adopt protectionist measures against trade and investment. Moreover, such protection or over-regulation may expand as many governments are more actively implementing industrial policies.
6. Increased FDI by SOEs and SWFs presents new challenges to ensuring that competition conditions in the global marketplace remain equitable and do not give rise to national security concerns.

8.2 Why an MAI Should Be in the WTO

If an IIA is to emerge at some future point, then for several reasons the WTO is the logical home for it. First, investment and trade are closely integrated through GVCs. As Dadush and Stephenson explained, the WTO provides effective regulation of trade, but only piecemeal regulation of FDI. Second, there is a growing unhappiness with various provisions in BITs and investment provisions in RTAs, particularly with their dispute settlement aspects. Multilateral negotiations could yield more equitable outcomes and ensure non-discrimination. Furthermore, the WTO's dispute settlement regime has worked well, especially in its most trying period during the current global financial crisis. It has a strong record with regards to Member participation, different levels of development and achieving compliance. Third, the current proliferation of investment regimes offers arbitrage opportunities for investors who are well placed to exploit it, yet confuses many others who are not. At the same time, regulating states' hands are increasingly tied in a confusing array of obligations.[76] A unified system would help overcome these problems.

Reflecting this groundswell of interest in multilateral investment regulation, there have been several recent attempts to reflect on what the content of such regulation should be. UNCTAD,[77] OECD,[78] ICC[79] and APEC[80] have all recently issued principles, recommendations and policies that could be used to effectively promote and regulate FDI. Overall, these guidelines and recommendations focus on a new development paradigm in which inclusive and sustainable development is at the centre of international investment policy-making. The new trend seeks to impose obligations and responsibilities on both governments and investors; the former through proposed rules for government treatment of investment, the latter by adhering to principles of corporate social responsibility.

While the principles issued by the organizations are in most cases well accepted, achieving consensus on the precise approach to a multilateral investment agreement is difficult. Below we provide a synopsis of the issues that are likely to be central to such an endeavour, and then proffer some brief thoughts on ways to promote our preferred outcome: a multilateral agreement housed in the WTO.

8.3 Issues in Investment Agreements

As discussed in previous sections, some RTAs typically and increasingly have a chapter on cross-border trade in services (GATS modes 1 and 2), and separate chapters for investments (GATS mode 3 plus and investor–state dispute settlement) and the temporary movement of (business) people (GATS mode 4). Many current RTAs also bind pre-existing market access for investors. This has value in itself, since governments are restrained from modifying the treatment granted under the agreements if they decide in the future to restrict investors' participation in their markets. However, a multilateral agreement that lifts restrictions on investors in key sectors that remain protected, such as transportation, telecommunications, and professional and financial services, could significantly help expand and improve the efficiency of GVCs. In other words, the value of eliminating restrictions on FDI – that is, *liberalizing* FDI – is greater than simply binding the "current applied" level.

The majority of BITs provide protection for investors by: 1) allowing for an international jurisdiction to rule on issues such as compensation in the event of expropriation; 2) establishing investor–state dispute settlement and 3) securing national treatment for the investor post-establishment. Some outlaw specific national policy instruments such as the use of performance requirements.

One deficiency in RTAs and BITs is the high cost of the arbitration procedures; in practice, only large companies have had access to such dispute settlement mechanisms. The more that developing countries invest abroad through small and medium companies, the greater the chance they will want to participate. An MAI could perhaps diminish litigation costs. Furthermore, some states and civil society activists oppose agreements that contain investor–state dispute settlement obligations. Since the WTO's dispute settlement mechanism is a state–state system, it at least has the important advantage that it is widely accepted. WTO dispute settlement could also limit the scope of state obligations and responsibilities and increase the pressure to comply. The downside is that companies would be reliant on their governments to bring such cases, which introduces factors other than corporate interests into the equation, thereby making the process unpredictable. From the investor's standpoint, this is an argument in favour of investor–state dispute settlement, but it would require amending the Dispute Settlement Understanding to give effect to it in the WTO context.

Much of the growing civil society critique (for example, The South Centre, IISD's Investment Treaty News, various editions)[81] of international investment agreements is rooted in provisions contained in BITs. However the critique also involves RTAs that centre on investor–state dispute settlement, the associated recourse to international arbitration panels, and concerns that by having access to such provisions foreign investors are accorded more rights in host nation markets than domestic companies.[82]

The background to this critique is that the rapidly growing use of international arbitration panels by MNCs results in substantial awards against states, as well as some associated concerns that panels that (according to this critique, primarily reflect corporate interests) too easily construe legitimate policies as expropriation. This has become especially contentious even in developed countries, when foreign-owned companies have claimed that environmental regulations are regulatory takings (i.e. expropriation). In essence, this critique revolves around the perception that the balance between foreign investor rights and host government obligations has swung too far in favour of the former. For example, critics argue that it is inherently problematic that foreign investors can sue a sovereign government in a foreign jurisdiction, whereas local companies cannot. Proponents counter that there is a need to ensure national treatment for foreign companies when governments violate key WTO laws such as the TRIMS agreement, which covers, inter alia, performance requirements for MNCs. Furthermore, since BITs are reciprocal, investors from both parties presumably have the same access and rights in each other's markets, although this point does not reassure critics who are concerned with asymmetric power relations in BIT negotiations.

Systemically, pre-establishment or access provisions on investment are also important. For example, the United States has BITs that include pre-establishment obligations that guarantee market access and the free transfer of funds unless a particular sector or subsector has been reserved. Proponents argue that this approach provides a more secure investment environment, and the host state still has the policy space to restrict access to targeted sectors by including this in the agreement. Critics would prefer that the host state retain more discretion rather than be obliged to define restricted sectors upfront. Behind this concern is often a desire to protect local producers, but also general concerns over 'exploitation' by MNCs of host country citizens or resources. Proponents would therefore argue for a level playing field, or national treatment, for MNCs; critics are sceptical of national treatment except under defined circumstances.

In this light, it is important to note that recent attempts to produce general statements of principles and/or standards for regulating FDI all incorporate some notions of corporate social responsibility (CSR).[83] Perhaps the more these two issues become linked, the greater the likelihood of future acceptance of a multilateral agreement that establishes obligations not only for governments but also for companies, both domestic and foreign. Some specific ideas for incorporating CSR principles into investment agreements have been put forward by UNCTAD:[84]

1. To establish sanctions for non-compliance with host state laws at both the entry and post-entry stages of an investment
2. Deny treaty protection to investments that are in violation of host state laws that reflect international legally binding obligations (e.g. core labour standards, anti-corruption, environment conventions) and other laws as identified by the contracting parties
3. Provide for states' right to bring counterclaims under investor–state international dispute settlement systems arising from investors' violations of host state law (some advocate that this could be extended to carrying out corporate due diligence relating to economic development, social and environmental risks)
4. Provide that non-compliance with international CSR principles may be considered by a tribunal when interpreting and applying treaty protections or determining the amount of compensation due to the investor
5. Consider investors' adoption/compliance with voluntary standards when they engage in public procurement processes
6. Condition the granting of incentives on an investor's socially and environmentally sustainable behaviour

The EU may provide an example of movement in this direction. The European Commission is in the process of taking control over the negotiation of international investment agreements and is apparently considering embedding the right to regulate in its negotiating template. Furthermore, developed country governments have recently begun to take sceptical stances towards certain kinds of foreign investment from emerging markets, particularly those with a 'national security' flavour that originate from state-controlled entities.[85] This latter point reinforces the need for transparency in regulating incoming FDI, and for multilateral approaches that are designed to prevent 'liberal' interpretations of such regulations or arbitrary discrimination. This is ultimately in the interest of developed countries, since arguably much of this 'state capitalist'[86] FDI could be beneficial, whereas clear, transparent regulations would iron out the worst excesses that politicization of such inward FDI may entail.[87]

Overall, there is a growing sense that the balance of rights and obligations needs to be revisited.[88] The pendulum seems to be swinging back to an approach that is more sympathetic to host government prerogatives, but so far, at least, not in a manner reminiscent of the hostility of the 1960s and 1970s. On the surface, this would seem to favour consideration of a multilateral investment treaty, recognizing of course that WTO Member states are still far apart on some of the potential core provisions. Furthermore, to facilitate a balanced understanding and ease the political economy, perhaps it would be appropriate to retain a fundamental notion (such as that found in the preamble of GATS[89]) so that liberalization is not equated with deregulation. Useful is language also found in GATS concerning Business Practices (Article IX).[90] Recognizing such principles at the outset of the process might significantly smooth the path towards multilateral negotiations.

8.4 How to Pursue a Multilateral Approach

The virtue of having the negotiations at the WTO is that all countries could have their views shared and expressed. The agreement would be open in the future to all WTO Members, even if they were initially unwilling to join. Those that do go ahead could decide to do so on an MFN basis, on a conditional MFN basis or on the basis of a minimum number (or critical mass) for full MFN implementation. If Members decided to apply unconditional MFN to the agreement, then even countries that do not join might have an interest, since their MNCs could benefit, which might make it easier to get consensus even from sceptics. However, given the current stalemate of multilateral negotiations under the Doha Round, countries are more actively negotiating trade and investment agreements in bilateral and regional contexts. Progress made under regional agreements that cover an important number of countries, such as the TPP, could inspire future plurilateral and multilateral negotiations, either under the WTO or outside it. The disadvantage of staying outside the WTO is that the agreement would not be linked to the institutional and dispute settlement framework of this international organization that has proven to be so effective. One plausible advantage is that, in principle, it might be easier to reach agreement among 'like-minded' countries.

For example, countries that are negotiating a plurilateral international service agreement could also opt to, in parallel, negotiate investment. There is a close linkage between these disciplines. The countries could also negotiate a common denominator and grandfather current BIT or RTA obligations and benefits.[91]

On the other hand, and despite its difficulties and constraints, the efficiency of GVCs would considerably increase if "governments agreed to pursue a 'whole of the supply chain' approach rather than pursuing negotiations in separate pillars or silos" by negotiating an international supply chain agreement under the auspices of the WTO.[92] Investment disciplines would be negotiated together with services, border management procedures, standards and technical regulations, e-commerce and competition policy, among others.[93]

Since the issues are likely to remain contentious for the foreseeable future, WTO Members should consider establishing a working group on investment regulations with a view to airing the issues and potentially developing a work programme. This working group should explicitly consider the possibility of incorporating investment disputes into the WTO's dispute settlement system, with a dual track approach: the existing state–state system and a parallel investor–state system.

The support of the Group of 20 and Business 20, and the significant work of inter alia APEC, OECD, UNCTAD and the ICC, could help advance these efforts by providing political and strategic direction. The first step is to agree on the need to initiate multilateral processes, supported by the establishment of a working group on investment in the WTO to coordinate the necessary analytical work.

Annex

Elements of the Global Economic Governance Architecture of FDI

Level	Agreement	Legally binding	Coverage	Pre-establishment commitment	Absolute standard of treatment[1]	Relative standard of treatment		Expropriation and compensation	Transfer of funds	Dispute settlement
						MFN[2]	NT[3]			
Multilateral	GATS	X	Services	X	-	X	(X)	-	-	X
	TRIMS	X	Trade related	-	X	X	-	-	-	X
	TRIPS	X	Intellectual property related	-	X	X	X	-	-	X
Plurilateral	OECD CCM	X	Capital movements	X	X	X	-	-	X	-
	OECD DIIME	-	All investments	X		X	X	-	-	-
	APEC Investment Principles	-	All investments					X	X	X
Regional	NAFTA	X	All investments	X	X	X	X	X	X	X
	EU Investment Agreements		All investments							
	EU-CARIFORUM-EPA									
Bilateral	BIT (US model)	X	All investments	-	X	X	X	X	X	X
	BIT (European model)	X	All investments	-	X	X	(X)	X	X	X

[1] Fair and equitable treatment; [2] MFN treatment; [3] National treatment

Source: Berger (2008).

Endnotes

1. See Appendix A in Hufbauer, Schott and Wong (2010).
2. See Table 3.10 in Cline (2010).
3. Data are from the World Bank (2012) and UNCTAD (2012a). While host country sales of FDI affiliates are, of course, included in the host country's national GDP, the FDI contribution to these sales must be recognized.
4. UNCTAD (2012a).
5. Hufbauer, Moran and Oldenski (2013).
6. UNCTAD (2012a)
7. UNCTAD (2012b), p 4.
8. Ibid, p 38.
9. Ibid.
10. As noted, the world FDI stock is currently around US$ 22 trillion, while world GDP is around US$ 70 trillion. The world investment stock is probably at least 1.5 times world GDP, or around US$ 100 trillion. Clearly, the FDI stock is a fairly small fraction of the world investment stock, around one-fifth.
11. Ghemawat and Altman (2012).
12. Cattaneo, Gereffi and Staritz (2010).
13. See Athukorala and Menon (1997) or Baldwin (2011).
14. Private conversation between Jean-Pierre Lehmann and Kim Dae-jung in Seoul.
15. "Japan Invades Hollywood: Sony's $3.4 billion deal for Columbia – Five Ways to Meet the Challenge on Trade, Takeovers and Technology". (1989) Newsweek, 9 October.
16. CCTV (2009).
17. Dos Santos (1970) and Amin (1977).
18. Cardoso (1972).
19. Wang (2008).
20. Amin (1995).
21. Chang (2002) and Wade (2003).
22. Wang (2013) and Terada (2013).
23. Bremmer (2009).
24. Beeson, Mills and Wang (2011).
25. Brautigam (2009).
26. UNCTAD (2012b).
27. Ibid.
28. International Monetary Fund (2012).
29. Financial Times (2012).
30. Economist Intelligence Unit (2012).
31. Ismail (2012).
32. This section focuses on strategic or operational FDI, rather than «portfolio» investment. It bears noting, however, that portfolio investment has also increased dramatically.
33. WTO dispute settlement body, "Dispute Settlement: Index of disputes issues," Dispute DS394.
34. WTO dispute settlement body, "Dispute Settlement: Index of disputes issues," Dispute DS412.
35. WTO dispute settlement body, "Dispute Settlement: Index of disputes issues," Disputes S316 and DS317.
36. Aubin (2011).
37. Ibid.
38. See Table 1, Section 2.
39. International Chamber of Commerce (2006).
40. Asmundson et al. (2011).
41. Ibid.
42. The following sources were consulted for this section: Guimon (2010), Morisset (2003), Oxelheim and Ghauri (2004), and UNCTAD (2000).
43. Moore School of Business (2002).
44. Keller (2011).
45. Thomas (2011).
46. Treasurer John Brumby commenting on the occasion of signing the second Interstate Investment Cooperation Agreement (2006).
47. Australia-US free trade agreement (Article 11.9), available at http://www.dfat.gov.au/fta/ausfta/final-text/chapter_11.html.
48. Graham (1996), pp 70–1.
49. OECD, "International Investment Agreements Multilateral Agreement on Investment", available at http://www.oecd.org/investment/internationalinvestmentagreements/multilateralagreementoninvestment.htm.
50. Fergusson (2008).
51. The "July Package" decision was adopted by the General Council on 1 August 2004 (WT/L/579 2 August 2004).
52. This figure is provided by UNCTAD (2012b). The estimate is for the end of 2011. Notably, the World Investment Report no longer includes double taxation treaties among IIAs.
53. The TRIMS disciplines prohibit: 1) local content requirements, 2) trade balancing requirements, 3) foreign exchange restrictions and 4) export restrictions (domestic sales requirements). The TRIMs Agreement requires WTO members to notify the TRIMs they operate. Prohibited TRIMs include those that are mandatory or enforceable under domestic law or administrative rulings. For more information, see http://www.meti.go.jp/english/report/data/gCT9908e.html.
54. Moreover, national treatment for investors in the services sector is not guaranteed, and both market access and national treatment for investment in services depend on the type and quality of commitments that are undertaken by each WTO member in its services schedule.
55. OECD (2013a, 2013b).
56. The declaration consists of four elements: 1) The Guidelines for Multinational Enterprises constitute a set of voluntary rules of conduct for multinational enterprises. Observance of these guidelines is encouraged and facilitated by OECD member governments through National Contact Points. 2) National Treatment: Adhering countries shall accord to foreign-controlled enterprises on their territories treatment that is no less favourable than that accorded in like situations to domestic enterprises. 3) Conflicting requirements: Adhering countries shall co-operate so as to avoid or minimize the imposition of conflicting requirements on multinational enterprises. 4) International investment incentives and disincentives: Adhering countries recognize the need to give due weight to the interest of adhering countries affected by laws and practices in this field; they will endeavour to make measures as transparent as possible. Source: OECD, http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/investmentinstruments.htm.
57. The 12 areas of investment covered by the "Non-Binding Investment Principles" include the following: transparency, non-discrimination between source economies, national treatment, investment incentives, performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes, entry and sojourn of personnel, avoidance of double taxation, investor behaviour and removal of barriers to capital exports. Source: http://www.apec.org/Press/News-Releases/2010/~/media/965E37FDA6D848B4A0350D68D2A4BE1C.ashx.
58. The 15 model measure chapters include: safeguards, competition policy, environment, temporary entry for business persons, customs administration and trade facilitation, electronic commerce, rules of origin and origin procedures, sanitary and phytosanitary measures, trade in goods, technical barriers to trade, transparency, government procurement, cooperation, dispute settlement and trade facilitation. Source: http://www.apec.org/Home/Groups/Other-Groups/FTA_RTA.
59. UNCTAD (2012b), pp 84–6.
60. See Table 2 in OECD (2002) and Sauve (2000), pp 72–85.
61. UNCTAD (2012b), p 18.
62. Office of the US Trade Representative and US Department of State (2012), available at http://www.ustr.gov/about-us/press-office/press-releases/2012/april/united-states-concludes-review-model-bilateral-inves.
63. The EU focus in its negotiation of new BITs includes six principles: 1) a focus on long-term investment, i.e. investment that generates stable employment and growth; 2) improving market access and ensuring that foreign investments both at both pre- and post-establishment stages are treated like domestic ones; 3) fostering transparency by clarifying the regulatory framework; 4) ensuring that host and home states fully retain their right to regulate the domestic sectors; 5) freeing the flow of payments and investment-related capital movements, while preserving the possibility to of taking safeguard measures in exceptional circumstances; and 6) seeking to facilitate the movement of investment-related natural persons («key personnel»). http://ec.europa.eu/trade/creating-opportunities/trade-topics/investment/.
64. OECD (2004).
65. UNCTAD (2011).
66. UNCTAD (2012d), UNCTAD (2012e).
67. Markusen (1984), Helpman (1984) and Brainard (1997).
68. See, for example, Markusen (2000) or Hufbauer and Adler (2011).
69. A team of trade lawyers read through the text of about 100 agreements and noted the issues mentioned in each. The lawyers used a checklist of measures that was drawn up by Horn, Mavroidis and Sapir (2009). This checklist includes 52 measures – 38 of which are 'beyond WTO' disciplines, i.e. they involve disciplines that do not exist in WTO agreements today (e.g. prohibition of capital controls). The other 14 measures touch on disciplines that are covered by existing WTO agreements, but where the RTA goes beyond the disciplines in the WTO (e.g. tariffs reduced below the WTO-bound MFN rate). For each measure, the lawyers noted whether the RTA text covering the various provisions involved legally enforceable language or simply mentioned intentions in the area covered.
70. The list includes standard border measures like tariffs on industrial and agriculture goods, standard measures that could offset the lowering of border measures (subsidies, unfair competition, biased public procurement, onerous customs procedures) and a few behind-the-border barriers such as investment restrictions, trade-related intellectual property rights and technical barriers to trade (basically standards for industrial goods).
71. Note that the list of 52 provisions does not include the large number of extremely deep integration provisions in the EU's treaties, since Horn, Mavroidis and Sapir (2009) considered EU RTAs with third nations.
72. Lawrence and Devereaux (2003).
73. Aslund (2013) and Baldwin (2013).
74. In 2012, for the first time total FDI flows into emerging markets exceeded flows into developed markets, and cross-border mergers and acquisitions (M&A) by emerging markets rose to a record high of 37% of total M&A activity. UNCTAD (2012b, 2013).
75. Aslund (2013).
76. Pauwelyn (2012).
77. UNCTAD (2012c).
78. The OECD Guidelines for Multinational Enterprises established on the OECD Declaration and Decisions on International Investment and Multinational Enterprises. http://www.oecd.org/daf/inv/mne/oecddeclarationanddecisions.htm.
79. International Chamber of Commerce (2012).
80. The APEC non-binding investment principles.
81. South Centre (2012).
82. Peterson (2006).
83. See OECD (2011), International Chamber of Commerce (2012), APEC (2011) and UNCTAD (2012c).
84. UNCTAD (2012b) pp 135–6, 141, 154.
85. See Aslund (2013), Sauvant (2012) and Lehmann and Jackson, Section 4.1 of this report.
86. The Economist (2011).
87. Aslund (2013).
88. Sauvant (2012).
89. The preamble recognizes 1) the right of Members to regulate (and to introduce new regulations on) the supply of services within their territories to meet national policy objectives and 2) given the existing asymmetries with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right.
90. 1. Members recognize that certain business practices of service suppliers, other than those falling under Article VIII, may restrain competition and thereby restrict trade in services. 2. Each Member shall, at the request of any other Member, enter into consultations with a view to eliminating practices referred to in paragraph 1.
91. Aslund (2013).
92. World Economic Forum and World Bank (2013).
93. Ibid.

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