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**Investment Implications of Selected WTO Agreements  
and the Proposed Multilateral Agreement on Investment**

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**Abstract**

The substantial increase in foreign direct investment (FDI) in recent years has triggered a discussion of a uniform treatment of investment in international law. Most contributions to the multilateral investment framework derive from the World Trade Organization (WTO) agreements on trade liberalization. The resulting framework is incomplete, as the WTO agreements restrict their focus on investment to aspects related to international trade and often apply to selected sectors only. A broader investment regime is needed to provide a more neutral incentive framework for investment liberalization and to promote efficient international investment flows.

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## Summary

The present multilateral legal framework on investment is patchy in coverage, biased in favor of certain flows, and ambiguous in its impact on investment. Increased investment and capital flows in the world economy have magnified the importance of a complete, neutral, and coherent legal framework to promote a more efficient allocation of world savings. Most present international investment rules are found with a trade bias. Broader investment rules are currently being discussed at the OECD.

This paper discusses some implications of these agreements for investment, focusing especially on the WTO agreements and on their macroeconomic investment implications. The Agreement on Trade-Related Aspects of Intellectual Property Rights, the General Agreement on Trade in Services, the Agreement on Trade-Related Investment Measures, and the Agreement on Subsidies and Countervailing Measures are each analyzed for their likely effects on investment.

Despite the significant influence of these WTO agreements on the magnitude of different kinds of investment, the resulting net changes in investment are likely to be small. This result points to the high degree of substitutability among different instruments or channels of investment, showing that a partial coverage of investment by an agreement might lead to suboptimal allocation of investment flows. Substitutability also underlines the importance of the definition of investment for the proposed multilateral agreement on investment. If it restricts its coverage of investment flows to foreign direct investment, this agreement could cause new inconsistencies within the emerging multilateral framework of investment rules and establish a double standard for the capital account.

## I. Introduction

The substantial increase in foreign direct investment (FDI)<sup>2</sup> in recent years has triggered a discussion on a uniform treatment of investment in international law. Although trade and investment are interrelated, the existing multilateral legal framework on trade is by far more elaborate than that on investment. Like free trade flows, free movement of capital contributes to economic growth and welfare as it fosters intertemporal optimization of consumption, helps finance the balance of payments, and promotes efficient allocation of worldwide savings. International investment rules can also help increase security of national investment policies and liberalize further existing investment regimes. For the above reasons, multilateral investment issues are of interest to the Fund.

This paper surveys the present multilateral legal framework on investment embodied in the WTO (World Trade Organization) agreements, and the proposed Multilateral Agreement on Investment (MAI) and how they may affect investment flows. Most of the present contribution to the multilateral investment framework is from the WTO agreements on trade liberalization and its impact on investment is complex.<sup>3</sup> The resulting framework is very incomplete, as the WTO agreements restrict their focus on investment to aspects related to international trade and often apply to selected sectors only. The focus of the planned MAI is still open. It argues that, as FDI has become more of a complement than substitute to cross-border trade flows, a broader investment regime is needed to provide a more neutral incentive framework for investment liberalization and protection and to promote efficient international investment flows. Furthermore, due to the fungible nature of FDI, an international investment agreement with a broad definition of investment would better serve the purpose of protecting investments and efficient allocation of savings. The Fund's concern for investment issues is, *inter alia*, related to promoting all kinds of capital flows for the purposes of financing the balance of payments and fostering economic growth. Securing an efficient allocation of resources and improving stability of investment rules represents the major nexus between the Fund's interest in investment, WTO agreements with implications for investment, and the current initiative for multilateral rules on investment.

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<sup>2</sup>By definition, FDI is characterized by the fact that the investor exercises a direct control over the investment. Country-specific accounting standards for FDI often deviate from IMF (International Monetary Fund) guidelines. While FDI flows represent the sum of paid-in capital and retained earnings according to IMF standards, the United States adds loans between parent companies and their affiliates to this definition. See Graham (1995), p. 2.

<sup>3</sup>Despite this rather poor coverage of investment, the international legal framework on investment encompasses a wide diversity of bilateral, regional, plurilateral and multilateral instruments. Many of the plurilateral and multilateral instruments are legally binding to their members. These instruments include, for example, the OECD Code of Liberalization of Capital Movements (1961), the Convention of the Settlement of Investment Disputes between States and Nationals of Other States (1965), or the Convention Establishing the Multilateral Investment Guarantee Agency (1985). Many important regional instruments are embedded in the broader framework of regional economic integration schemes, like the Treaty Establishing the European Community (1957) or the North American Free Trade Agreement (NAFTA) (1992). Despite all multilateral efforts, Bilateral Investment Treaties (BITs) constitute a key element within the international legal framework on investment. Up to June 1996, nearly 1,160 BITs have been concluded.

## **II. Issues with Trade and Investment and the Fund's Interest in Investment**

Before discussing the WTO agreements on investment, it is useful to review briefly the trade and investment relationship and the Fund's interest in investment, or in particular, FDI.

### **Trade and investment relationship**

Two different recent phenomena point to the increasingly complementary relationship between FDI and trade. These are the strengthened relative importance of the service sector and the increased significance of intangible assets for economic activity. Trade in services often requires market presence and intangible assets are not always tradable. The complementarity and the surge in FDI in the 1980s started to test the adequacy of the present framework of international trade/investment law, in which trade-related rules are liberalized while investment rules are very partially covered. In the past, when trade and FDI were viewed as substitutes in achieving market access, FDI rules were neglected, and the liberalization of trade flows continued within the General Agreement on Tariffs and Trade (GATT). The increased importance of market presence as motive for FDI, and the complementarity of the relationship between trade and FDI, support the case for a broad international agreement for investment to neutralize incentives between trade and investment.<sup>4</sup>

### **The Fund and Investment**

The Fund's Articles of Agreement are an important element of the international legal framework for investment and represent the only global regime that applies to international monetary movements. The Fund's jurisdiction over current international transactions has been an important contribution to the expansion of cross-border trade and investment. For example, the obligation to liberalize current international transactions requires unimpeded repatriation of profits from foreign affiliates. At present, the Fund's jurisdiction is primarily restricted to current account transactions. Even without jurisdiction over capital account transactions, the Fund promoted the liberalization of cross-border capital flows through surveillance and programs. For example, Fund programs help catalyze other financial flows to a country. International investors often consider the existence of a Fund program as some guarantee of sound macro policies in a country.

A considerable part of the interest the Fund attaches to capital flows--both to FDI and to portfolio flows--is related to its macroeconomic policy concerns. Addressing savings-investments imbalances and ensuring efficient investments to enhance growth are essential elements of Fund programs and policy advice. In the financing of external imbalances FDI can play an important role. The benefits of FDI compared to other sources of finance are related to its relative stability and long term nature. The sensitivity of FDI inflows to the host country's macroeconomic conditions seems to be lower than with other forms of investment inflows. While inflows of FDI depend on a number of essential preconditions, such as a stable

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<sup>4</sup>See Low (1995), p. 49, in support of this view.

and reliable legal environment and a minimum of public infrastructure, they rely less than portfolio investments on the sustainability of the fiscal deficit or on the level of the real interest rate. But portfolio investments are also important, as all sorts of capital flows significantly affect the macroeconomic performances of countries.

### **III. Implications of Selected WTO Agreements for Investment**

WTO agreements incorporate a trade-dominated perspective on investment and result in a patchy coverage of investment rules or issues. As these agreements aim at reducing different distortions and impediments to international trade and at increasing security of market access conditions by establishing a framework of transparent rules, they inevitably tackle questions of relevance to investment. However, the present framework only covers a small part of the complex trade-investment interrelationship. Some rules, for example subsidies, only cover goods, or some types of subsidies or TRIMs (Trade-Related Investment Measures), or only services have some rules on establishment. As a result, these agreements may have ambiguous effects on investment. Their effects on trade are not unequivocal either. The patchwork nature of WTO rules on investment is reinforced by the current limited geographical coverage of WTO agreements with 130 members, compared to, for example, the Fund's almost global membership (181 members).

The following sections discuss key investment-related WTO agreements, their relationship to the Fund's interest in investment, and investment in general.

#### **The TRIPs Agreement**

The TRIPs Agreement makes protection of intellectual property an integral part of the multilateral trading system as reflected in the WTO. This acknowledged the growing importance of intellectual property in international competition in many areas of economic activity. The agreement not only requires national treatment and most favored nation (MFN) treatment, but also provides for a dispute settlement procedure and minimum standards of protection. These standards, which have to be implemented gradually<sup>5</sup> in members' national legislation, comprise the main elements of protection, including the rights to be conferred and the minimum term of protection. The agreement covers patents (including plant variety protection), copyright and related rights, trademarks (including service marks), industrial designs, layout designs of integrated circuits, undisclosed information (including trade secrets), and geographical indications (including appellations of origin).

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<sup>5</sup>Least-developed countries are exempted from the application of the provisions of the agreement for a period of 11 years counted from the date of entry into force of the WTO Agreement, i.e. January 1, 1995, except for the introduction of national and MFN treatment (with which they have to comply as of January 1, 1996 - see Article 66 of the TRIPs Agreement). Other developing countries may delay the application of the agreement for a period of six years, again with the exception of national and MFN treatment - see Article 65 of the TRIPs Agreement.

Table 1 summarizes the likely effects on investment of TRIPs. While these effects encompass both increases and decreases in investment, the net impact on investment in developing countries may not be significant, especially in the short and medium term.

**Table 1. Economic Implications of the TRIPs Agreement for Investment**

Effects on Investment	Net Impact on the Magnitude of Investment	Effects of Potential Interest to the Fund
The protection of IPRs may increase investment in research and development activities.	Increase	This effect is likely to induce inflows of capital and long-term growth while it also improves dynamic efficiency in countries with innovative capacities.
Investment in the production of counterfeits may decline if it does not continue under new licenses.	Decrease	Economic growth rates might be lower in consequence. The corresponding decline in investment opportunities might induce capital outflows from countries without innovative capacities or other investment opportunities. Furthermore, these countries face major efforts in economic restructuring.
Any decline in counterfeit production may negatively affect the balance of payments due to higher imports, lower exports, and higher payments of royalties and fees abroad.	Not applicable (in terms of the national accounts, an investment takes place if claims on domestic assets are exchanged against a net import of foreign goods and services)	Countries without innovative capacities are likely to face a need for additional external finance as the balance of the current account deteriorates.
The market power associated with enforceable IPRs can lead to higher expenses on consumption and cause a reallocation of resources from investment to consumption.	Decrease	Lower investment will reduce economic growth. At the same time, higher prices for the protected good might reduce the volume of goods traded.
FDI inflows may increase as a result of a more reliable legal framework and a better investment climate.	Increase	Inflows of FDI contribute to sustainable economic growth as they channel investment capital and intangible assets into the host country and provide a rather stable inflow of external finance.
FDI inflows may decrease to the extent they were needed to channel confidential knowledge within multinational corporate networks into a country to serve a foreign market.	Decrease	As a result, the cross-border marketing of protected products can rely on other instruments. If it relies on licensing, FDI will be replaced by local investment. This will only take place if the host country's economy can provide the necessary production facilities.
If a country does not have the necessary administrative capacities to ensure an effective protection of IPRs, the amount of resources needed to build up such capacities might absorb investment capital and reduce private investment.	Decrease	In developing countries without large administrative capacities, the implementation of the TRIPs Agreement is likely to absorb relatively large resources which can create or worsen financial imbalances in the public sector and, in consequence, reduce private investment and economic growth.

The linkages between enforceable IPRs, investment, and trade are highly complex. A firm that wants to have access to a foreign market can rely either on trade, FDI, or licensing. The protection of IPRs aims at the elimination of distortions in the choice of instrument for market access. Between 1986 and 1990, the worldwide growth in royalty payments and fees as a compensation for the use of IPRs increased by 21.8 percent annually in nominal U.S. dollars, compared to a 14.3 percent increase in the growth of exports of goods and non-factor services, and a 19.8 percent rise in the outward stock of FDI. In line with the worldwide decline in growth of gross fixed capital formation in the early 1990s, the relative predominance of licensing growth increased further. Between 1991 and 1993, compensation for the use of IPRs increased at an average rate of 13.0 percent, while export growth fell to 3.5 percent and the stock of outward FDI grew at an average rate of 7.2 percent.<sup>6</sup>

Economically, the IPRs addressed by the TRIPs Agreement fall into one of three broad categories: i) rights for the protection of knowledge that is to be kept from free public use in order to encourage the future creation of such knowledge, such as patents, layout designs of integrated circuits, and undisclosed information and, to some extent, copyrights; ii) copyright and related rights to protect cultural expressions and investments made for their dissemination; and iii) trademarks, industrial designs and geographical indications that help overcome informational asymmetries between the producer and the consumer at least partially by signaling quality characteristics of the product.

The grant of IPRs in respect of technological innovation often occurs in the form of a patent. The temporary protection provided by a patent is meant to create an incentive for research and development activities. Without a patent, the use of the information that results from such activities cannot be restricted, and the researcher alone would bear the costs of the knowledge-creating activity while the profits would be widely spread. The “public good” character of the information, therefore, would lead to a suboptimal level of production of such information. If law enforcement ensures the exclusive use of knowledge, such a disincentive to develop technological innovation will in consequence be taken away. The resulting market power of the patent holder will lead to a rent transfer in favor of the producer, because this market power consists in the ability to raise prices above marginal costs. Dynamic efficiency, at which the establishment of IPRs aims, can only be achieved at the expense of a redistribution of wealth. Temporary market power is exchanged against longer term growth prospects.<sup>7</sup> The level of protection that yields an optimal result in terms of social welfare cannot be determined.

A major reason for the creation of patents and copyrights is to prevent unrestricted access to new knowledge. Its implications for investment can already be derived from the rationale presented above:

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<sup>6</sup>See UNCTAD (1995), p. 4.

<sup>7</sup>See Primo Braga (1995), p. 36, in support of this argument.



- Investment in research and development activities may increase as a result of enforceable IPRs. This can also induce an increase in investment for new production facilities. Thereby, the implementation of the agreement can improve long term growth prospects and have a positive effect on dynamic efficiency. Although these investments may initially occur mainly in developed countries, open developing economies with IPR protection are likely to participate in this development as well.
- In the production of counterfeit and pirated goods, the agreement may result in disincentives for investment. The resulting reduction in domestic investment opportunities might lead to outflows of investment capital. Depending on the form of market access chosen by multinational corporations, the investment in counterfeit production might be replaced by FDI or a local production plant operating under license. While this can foster the transfer of intangible assets to the host economy, it does not necessarily induce diffusion of knowledge incorporated in these assets. The consequences of the resulting economic restructuring for investment and growth in these countries are uncertain.
- A more immediate and important consequence of the restructuring can affect the balance of payments, if production of counterfeit goods is substituted by foreign imports. With reduced local production, the balance of the current account may deteriorate, not only because of the changes in trade flows, but also as a result of the royalty payments and fees. This can create a further need for developing countries to raise external finance. However, production of these goods can also continue under new licensing, reducing the balance of payments effect.
- The temporary market power associated with enforceable IPRs may lead to price increases. Depending on the degree of substitutability and the price elasticity of demand, these increases can induce higher expenses on consumption, and shift financial resources from investment to consumption, thereby reducing economic growth.<sup>8</sup>

The above consequences for investment are unlikely to be spread evenly internationally. As developed countries have the highest concentration of companies with knowledge-intensive activities, the additional investment in research and development that can result from enforceable IPRs is likely to take place mainly in developed economies (although many of them already had extensive IPR laws before the TRIPs agreement). Decline in investments in counterfeit production, which, unless subject to new licences, would theoretically be subject to a complete elimination, is likely to take place largely in developing countries.

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<sup>8</sup>The displacement of imitators will even further expand the demand for the protected product. The net impact on the demand for the protected product depends on whether the “market power effect” is bigger than the “market expansion effect”; see Primo Braga (1995), p. 39.

*TRIPs, FDI, and other forms of market access*

Lack of IPRs may also encourage FDI. A firm that wants access to a market where IPRs with patents, for example, are not adequately enforced, may have to rely on FDI to ensure control over the proprietary information. Lack of IPRs may also increase FDI in marketing activities that partially substitute the enforceability of knowledge by establishing closer ties to consumers.

In countries without IPRs, direct investment can be important for market access in knowledge-intensive products, if the knowledge is incorporated in the production process. In this case, the issuing of a license to a local company to produce the product would imply transfer of production technology to the holder of the license. This could lead to a broader diffusion of the technology if the corresponding property rights cannot be enforced.<sup>9</sup> Consequently, intra-firm exports on these products are likely to be higher to countries with weak IPR protection,<sup>10</sup> although intra-firm trade would always be an alternative to FDI. Knowledge that is incorporated in the final product and that allows for product imitation, can hardly be kept secret, no matter if, and in what way, a firm has access to a foreign market. Therefore, the enforcement of IPRs appears to be of only minor importance in the choice of strategy for market access in these products.

In some cases, FDI can be part of a firm's reaction to weak enforcement or the complete abolition of IPRs. This logic is based on direct investment as a firm's strategy for reinforcing marketing efforts in the foreign market, and to react to counterfeit production by establishing closer relations with clients and consumers. Although this strategy represents a major response of firms to the imitation of their trademarks, industrial designs, and geographical indications, it is also frequently used in the context of unenforceable patents and copyrights. After the abolition of process pharmaceutical patents in Brazil in 1969, FDI in pharmaceuticals had one of the highest growth rates in Brazilian industry. FDI inflows increased by 600 percent between 1971 and 1979 in current U.S. dollars. This development can be attributed to the increase in the transfer of knowledge within multinational corporate networks, a superior position in the marketing of these products, and acquisitions of emerging local competitors. As a result of this development, in 1980 foreign controlled corporations maintained a market share of 71 percent in the pharmaceuticals market.<sup>11</sup> On the whole, the evidence presented in these studies suggests that the enforceability of knowledge-related IPRs has had no significant net impact on FDI.

With a view to this evidence, further implications of the TRIPs Agreement for investment are:

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<sup>9</sup>Nogues (1993), p. 42, argues in this context "that the decision to license and transfer technology depends much more on the legal strength of the licensing agreement and the adaptable capacity of the buyer to absorb technology" than on the strength of the legal regime protecting IPRs.

<sup>10</sup>See Ferrantino (1993) for empirical support of this argument.

<sup>11</sup>See UNO (1993), p. 27.

- FDI flows might increase as a result of a more reliable legal framework in some countries, while they can decrease in sectors where FDI was used to channel confidential knowledge into a country to serve a foreign market.
- If FDI decreases, cross-border marketing has to rely either on exports, licensing, or some form of joint venture. On average, this does not necessarily mean that less nonfinancial assets are transferred to the host country. It can imply, though, that local partners of multinational corporations need to raise more investment capital themselves.
- The establishment of effective law enforcement involves a significant amount of resources that have to be raised by the government. This financial effort can absorb investment capital and might worsen fiscal imbalances in some countries. Such imbalances could represent impediments to investment and economic growth.

There is no empirical evidence yet on the impact of the TRIPs agreement on investment. Past studies on the effects of the protection of IPRs on investment either concentrates on the impact of this protection on FDI flows, or on its impact on investment in research and development. With FDI, it has already been pointed out that a better protection of IPRs may also decrease investment. While results reported in Ferrantino (1993) point to increases in intra-firm exports taking place between parent corporations and their foreign affiliates as a result of a weak protection of IPRs, recent research conducted by Mansfield (1994) reveals a positive impact of a higher level of protection of IPRs on FDI (Gould/Gruben (1994)) and presents some evidence that the protection of IPRs has a positive impact on investment in research and development and, subsequently, on economic growth in developing countries. This evidence suggests that the impact increases with an increase in the degree of openness of the host economy. On the whole, these empirical results represent rather weak support for any significant linkage.

Both the conflicting influences of different parts of the TRIPs Agreement and the available empirical evidence suggest that the enforceability of IPRs would seem to have mixed effects on net FDI (although effects on FDI can be substantial for individual sectors or countries).

### **The GATS (General Agreement on Trade in Services)**

The strengthened relative importance of the service sector has already been pointed out in the first part of this paper. The GATS responded to the need to extend the framework of multilateral trade rules to services. It is applicable to any service that is not supplied in the exercise of governmental functions. Taking into account the limited tradability of services, the GATS cannot ignore the issue of factor movements to ensure market access for services. The agreement defines trade in services by considering four different modes of supply for services: the cross-border supply of a service by a supplier in another country (Mode 1); consumption abroad (Mode 2); the establishment of a legal entity that originates in the territory of one member country for the purpose of commercial presence in another member country (Mode

3); and finally, the temporary movement of natural persons for the purpose of supplying a service in a different member country (Mode 4).<sup>12</sup> The GATS establishes a number of obligations that apply to trade in services, for example, to all four modes of supply defined in the agreement, including FDI. These obligations encompass unconditional MFN treatment (subject to reservations) and transparency. Market access and national treatment are negotiable and apply to opened sectors only.<sup>13</sup> At present, the sectoral coverage of the GATS is modest, as countries made very limited commitments. By 1994, market access and national treatment commitments (positive list approach) had been submitted by 96 members. Most commitments were made by the 18 “high income countries”. Their market access commitments, for example, covered 48.5 percent of the 155 non-overlapping service sectors defined, while those made by the 78 developing countries covered only 11.4 percent. Nonetheless, because the scope of the GATS is legally quite broad, the potential coverage is extensive if commitments are expanded in the future. In this regard, the importance of the GATS will depend on the ability of the initial agreement to induce further negotiations. The potential impact of the agreement on investment is considerable. Table 2 (below) summarizes the economic and legal implications of the GATS for investment.

Market access is not explicitly defined by the agreement. Instead, six measures listed in Article XVII of the GATS are prohibited in opened sectors, but reservations on these can be made. This can seriously limit the impact of the agreement on reducing distortions to FDI and limit actual liberalization. This list of prohibited measures is meant to be exhaustive (no other types of restrictions can be introduced). The prohibition of limitations on the number of service suppliers, the total value of service transactions or assets, the total quantity of service output, and the number of natural persons employed can be regarded as the conceptual equivalent to the prohibition of quantitative restrictions on cross-border trade in goods. Furthermore, the provision prohibits restrictions concerning the type of legal entity chosen for the commercial presence of the service supplier and local-equity requirements. Tax measures that would impede market access are therefore not covered by the agreement, as long as this taxation does not hurt a country’s national treatment obligation.

National treatment, as defined in Article XVII of the GATS for the sectors specified in the schedules, does not necessarily refer to a treatment identical to the treatment of domestic companies. In some cases, identical treatment could worsen the conditions under which foreign companies have to compete with domestic firms.<sup>14</sup> The agreement therefore requires a treatment no less favorable than the treatment a member accords domestic services and service suppliers.

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<sup>12</sup>See Article I of the GATS and Hoekman (1994a), p. 177.

<sup>13</sup>These figures represent sectoral commitments adjusted for mode of supply weights, proportion of service sectors excluded from liberalization, and sector weight in GDP as reported in Hoekman (1994b), p.19.

<sup>14</sup>Hoekman (1994a), p. 178, mentions the example of a foreign insurance company that would have to fulfill the requirement of locally held reserves.

Incorporation of investment in the GATS primarily focuses on FDI as a means to overcome the lack of tradability of services compared to traditional forms of cross-border trade. In this respect, the agreement already constitutes a multilateral investment regime. It enables service corporations to become transnational by creating the conditions for an international corporate network for the supply of their services. The cross-border marketing of goods also relies increasingly on commercial presence in foreign consumer markets. Investments of manufacturing companies in wholesale and marketing or finance-related affiliates abroad are covered by the agreement if the establishment of such affiliates aims at supplying a service related to the marketing of goods. An affiliate concerned only with the distribution of products that have been produced abroad is not covered by the agreement. In fact, it seems difficult to make a clear-cut distinction between those foreign affiliates that really supply a service abroad and those that do not. Only the experience that will emerge from decisions on individual cases can uncover where the line has to be drawn. This, naturally, can limit the investment coverage of the agreement.

**Table 2. Economic and Legal Implications of the GATS for Investment**

<b>Effects on Investment</b>	<b>Net Impact on the Magnitude of Investment</b>	<b>Effects of Potential Interest to the Fund</b>
FDI inflows in the service sector undertaken by TSCs can increase.	Increase	Additional investment improves the growth prospects of host countries. In developing countries, such investment improves the investment climate if it is undertaken in service industries that provide basic infrastructure in sectors as utilities, transport, telecommunications, banking, and insurance. If these investment flows allow for privatization of these industries, they also help to correct financial imbalances in the public sector, thereby improving economic efficiency.
FDI in service affiliates that is undertaken by manufacturing companies can increase.	Increase	As far as these investments aim at improving access to foreign markets, they are likely to induce further trade. Marketing efforts reflected by these service affiliates will induce increasing competition. In developing countries, this might lead to either increases in competitiveness and efficiency or to decreases in the market share captured by domestic producers.
Liberalization of cross-border financial flows that aim at establishing commercial presence in the form of FDI.	Increase	The GATS blurs the distinction between capital and current account transactions for FDI in service affiliates in opened sectors. In consequence, investment decisions can be distorted toward services if other capital flows are restricted.
Liberalization of cross-border movements of financial capital if a service that is supplied internationally mainly consists in this transfer.	Increase	While this also blurs the distinction between capital and current account transactions, this provision of the GATS establishes a partial liberalization of the capital account. The cross-border movement of capital can contribute to a more efficient worldwide allocation of global savings.
FDI can decrease to the extent that it reflects a suboptimal structure of industrial organization that has been set up to evade trade restrictions.	Decrease	While this decline in cross-border investment would improve economic efficiency, it can lead to lower investment and slower economic growth in former host countries.

These two aspects of the GATS focus on FDI for the purpose of commercial presence in another member country. Their implication for investment is:

- FDI in the service sector (that is undertaken by TSCs) may increase. This additional investment can improve growth prospects of host countries. It can also contribute to growth in developing host countries in two other ways. As a substantial amount of FDI made by TSCs in these countries is invested in privatized companies that provide basic infrastructure, the resulting modernization of services in utilities, transport, telecommunications, banking, and insurance can improve the investment climate, which in turn can induce further direct investment. Moreover, the privatization of state-owned service suppliers can help to correct financial imbalances in the public sector, and can thereby improve allocative efficiency.
- FDI in service affiliates that is undertaken by manufacturing companies may increase. As these investments are made to improve market access, they can induce further trade. They can also result in increased competition in the host country. Depending on the adaptability of domestic producers, this can lead either to increases in efficiency, or decreases in the market share captured by domestic competitors. In many developing countries, this effect can reduce the market share of domestic producers. For a number of smaller developing countries and Least Developed Countries (LDCs), this effect may not seem very important, due to the small size of their domestic market.

In contrast to the TRIPs Agreement, several provisions of the GATS regulate cross-border financial flows. While GATS provisions aim to liberalize international exchange of services based on a broad definition of trade in services, they represent a partial multilateral regime on investment. GATS appears to be more a by-product of trade liberalization than a complete and coherent legal framework on investment. The agreement, in addition to current account convertibility, establishes free movement of capital among member states, but for some flows only:

First, it requires freedom of capital inflows linked to establishing a commercial presence in the form of FDI (Mode 3 in Article I:2© of the GATS), to supply a service in another member country in sectors with market access commitments. This case is described in a footnote to Article XVI of the GATS on market access that specifies that “if a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2© of Article I, it is thereby committed to allow related transfers of capital into its territory.” This suggests that a country could impose restrictions on outflows of capital intended to finance FDI in services.

GATS provisions on payments and transfers of **capital** are, in theory, broader in scope than those of the Fund (in practice, they depend on commitments made). The Fund’s Articles of Agreement allow for restrictions on capital account transactions, unless they fall into the categories defined in Article XXX of the Articles of Agreement that are considered part of the capital account--...all payments due in connection with...normal short-term banking and credit

facilities". Restrictions on these flows require Fund approval. In the GATS, restrictions on FDI on inflows for establishment in opened sectors (and for current account transactions) are prohibited without WTO approval. GATS thereby blurs the distinction between capital and current account transactions for FDI inflows. The impact on investment can be large, if countries make open commitments on establishment.

Second, the GATS requires free cross-border transfer of capital if this is needed to provide the service.<sup>15</sup> This case too is described in the footnote to Article XVI of the GATS on market access. It specifies that "if a Member undertakes a market access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I (Mode 1) and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital". This provision blurs even more the distinction between capital and current account transactions, because the international transfer of capital can be an essential part of a service transaction (usually a current international transaction)<sup>16</sup> from one perspective, while it represents a movement of capital without impact on the current account (capital account transaction) from another perspective. This second case is likely to have even more far-reaching implications for investment:

- Because of the high degree of substitutability and fungibility of different types of capital movements, cross-border investment will probably increase. The magnitude of this increase will depend on the actual commitments made by members. The resulting freedom of capital movements can contribute to a more efficient worldwide allocation of global savings.

The GATS requires free transfers only on transactions related to specific commitments. This applies to all current and to covered capital transactions. In this respect, the agreement accounts for the interests and the provisions of the Fund in two different ways. The first includes a derogation of the Fund's jurisdiction over exchange measures in connection with current international transactions (Article XI), and to capital account restrictions imposed at the request of the Fund (Article XI:2). The second is a derogation for restrictions imposed to safeguard the balance of payments (Article XII). It covers exchange restrictions (current **and** capital) as well as measures related to trade (such as quantitative restrictions) that are unrelated to the Fund's jurisdiction.

While the agreement is likely to induce new cross-border investment, the liberalization of the international supply of services can also reduce such investments. If the

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<sup>15</sup>For example, in the case of cross-border remittances carried out by banks.

<sup>16</sup>According to the definition in GATS, not all service transactions are current international transactions.



decision for FDI relies on considerations to evade trade restrictions,<sup>17</sup> then the liberalization of trade in goods and services will reduce these investments to the extent that they reflect a suboptimal structure of industrial organization. For the cross-border supply of services, this might be the case, for example, in the construction industry. Cross-border investment in affiliates often results from restrictions to the movement of natural persons for the purpose of supplying a service. In consequence, service corporations will set up capacities in other countries to serve their markets, thereby reducing economic efficiency. This argument incorporates further implications for investment:

- Cross-border investment may decrease to the extent that it reflects a suboptimal structure of industrial organization that has been set up to evade trade restrictions. In this respect, the GATS increases economic efficiency as it helps to avoid costly double capacities.

GATS as an international investment framework is unsatisfactory, as the structure of its rules and the nature of its market access commitments allow for very partial and conditional liberalization of services. It also only covers the service transactions. On the other hand, if the commitments specified in the schedules of the agreement were to be expanded to cover more service subsectors and countries and be made without limitations, the agreement could have a great impact on investment indeed.

### **The TRIMs Agreement**

National investment measures can be subdivided into two groups. The laws on expropriation, nationalization, compensation, and measures to restrict or prohibit access to specific sectors of the economy, are one group. These measures are potentially applicable to all private investments within a country. The second type of measures is more directly intended to influence corporate decisions on FDI, although these measures could theoretically be applied to all investments within a country. They can be further subdivided into positive and negative incentives according to the direct impact they have on the investment to which they legally apply. While positive incentives include fiscal, financial, and non-financial incentives, the negative incentives correspond to what the literature refers to as trade-related investment measures (TRIMs).<sup>18</sup> Attempts at further classification have been made by several authors.<sup>19</sup>

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<sup>17</sup>In this context, tariffs and quantitative restrictions for goods correspond to restrictions applied to traditional ways of cross-border supply for services.

<sup>18</sup>This taxonomy of national investment measures is not uniformly applied in the literature. Sometimes, TRIMs are said to include negative as well as positive incentives. While this would make sense from the perspective of economic analysis, it corresponds neither to the taxonomy used by major contributions to the literature on TRIMs (see for example Greenaway (1991)), nor to the coverage of the agreement.

<sup>19</sup>See for example the taxonomy proposed by Guisinger (1985), which suffers mainly from the missing distinction between input- and output-orientation neglecting the double character of TRIMs that are at the same time incentives and disincentives. A

(continued...)

The TRIMs Agreement covers only a small fraction of all national investment measures, as it mainly clarifies past legally binding GATT principles to a restricted number of trade-related investment measures. It is the first multilateral agreement to cope directly with a number of national investment measures by prohibiting some measures and by limiting the application of already existing investment measures to two, five, or seven years respectively, depending on the level of development.<sup>20</sup>

Negotiations on the TRIMs Agreement represented an early attempt to catch up on multilateral rules governing investment liberalization. Like other WTO agreements, the TRIMs Agreement reflects a trade-dominated perspective on investment. It only applies to investment measures that have an immediate impact on trade flows. The TRIMs Agreement reinforces the application of some WTO rules in trade in goods related to FDI<sup>21</sup> and thereby eliminates some national investment measures.

Based on WTO rules of national treatment and the elimination of quantitative restrictions, the agreement prohibits a number of TRIMs mentioned in an illustrative list.<sup>22</sup> The TRIMs Agreement takes over all exceptions that apply under the GATT 1994, explicitly restating the right granted to developing countries to deviate temporarily from national treatment and to introduce quantitative restrictions should these be necessary for balance of payments purposes and to the extent they are allowed under the relevant balance of payments provisions.<sup>23</sup>

While the TRIMs Agreement prohibits local content requirements, trade-balancing requirements, limitations on imports, foreign exchange balancing requirements, and domestic sales requirements involving restrictions on exports, it does not sanction other forms of TRIMs. For example, export performance requirements, earnings remittance limits, and local equity requirements are not covered. However, some of these may be against other WTO provisions. The substitutability of different TRIMs can be relatively high. Therefore, the prohibition of a limited number of TRIMs can induce a shift toward other investment measures. The resulting impact on economic efficiency is unclear.<sup>24</sup> However, such a shift can worsen the investment climate if it increases investors' uncertainty. Changes in the basic conditions for investment can lead to a decline in investment, because investment decisions rely on long term considerations. Table 3 summarizes the investment implications of the TRIMs Agreement.

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<sup>19</sup>(...continued)

taxonomy that is useful for economic analysis has been proposed by Greenaway (1991), pp. 146-150.

<sup>20</sup>See Article 5 of the TRIMs Agreement.

<sup>21</sup>The agreement does not apply to investment measures related to trade in services; see Article 1 of the TRIMs Agreement.

<sup>22</sup>See Article 2 and Annex: Illustrative list of the TRIMs Agreement.

<sup>23</sup>See Article 4 of the TRIMs Agreement.

<sup>24</sup>See Buchs (1996), pp. 47-48.

**Table 3. Economic and Legal Implications of the TRIMs Agreement for Investment**

Effects on Investment	Net Impact on the Magnitude of Investment	Effects of Potential Interest to the Fund
Investment may decrease as a result of the uncertainty induced by shifts to investment measures that are not covered by the agreement.	Decrease	Growing uncertainty of international investors may impede, or at least postpone, the international diversification of productive investment with negative consequences for economic efficiency.
Decreases in investment might result from fiscal imbalances if there were a shift towards positive incentives, because they are not covered by the agreement.	Decrease	For financial reasons, developing countries may rely more often on negative incentives than on positive incentives to attract FDI. Any shift to positive incentives can induce a heavy burden on the budget of these countries. Fiscal imbalances will result in a further decline of private investment.
FDI can increase because especially local content requirements can discourage direct investments from foreign companies. In knowledge-intensive industries, production sometimes cannot rely on local inputs because these inputs are of lower quality or simply not available.	Increase	FDI makes an important contribution to economic growth in developing countries. The implementation of the TRIMs Agreement might induce important transfers of technology to these countries.
Investment in local production of inputs will decrease in line with the liberalization of local content requirements.	Decrease	While this decrease of domestic investment can reduce economic growth in the short term, it can also improve the efficiency of resource allocation.
Production abroad might increase to export inputs that will substitute for local production. Depending on the production capacities available, this might induce further investment abroad.	Increase	Increases in foreign investment may be more likely in developed countries, if the input is capital or knowledge-intensive. If the input is labor-intensive, investment might increase in developing countries.
While the agreement prohibits restrictions on some current international transactions, it allows for restrictions on others.	Not applicable	

To modify the incentive structure faced by potential foreign investors, developing countries rely more often on TRIMs, while developed countries frequently use positive incentives or a combination of both. This makes the agreement more restrictive for developing countries.<sup>25</sup> On efficiency grounds, there is no *a priori* reason to favor positive incentives provided to foreign investors over negative ones. The scarce financial resources of developing country governments are likely to be the main reason why these countries prefer TRIMs to positive incentives. If a country introduces positive incentives to achieve the same

<sup>25</sup>Positive incentives are covered in other WTO agreements, e.g., subsidies rules.

effects on investment as through TRIMs, it is likely to create or widen financial imbalances in the public sector with adverse effects on investment and growth.

According to notifications made in the WTO, most of the TRIMs maintained by developing countries represent performance requirements that favor local inputs. If these are prohibited, imports can increase. The effect on the host countries' exports is unpredictable. On the one hand, the part of domestic production formerly used as an input under the local content requirement would now be available for exportation. Exports of domestic production are, however, very unlikely to increase in the short term, because if this production could have been sold at competitive prices, there would have been no need to introduce performance requirements. The prohibition of trade-balancing requirements would allow exports, for example, to exceed domestic sales. This might, in consequence, increase exports. Local content requirements weaken the competitiveness of domestic industry, as they reduce incentives for efficient production. They can also represent a major impediment to FDI, especially in technology-intensive industries. Consequently, the TRIMs Agreement can contribute to higher investment in the host country as well as abroad.

- The scope of the TRIMs Agreement, in particular coverage of only some frequently used incentives and the restriction of its application to trade in goods, may distort investment decisions, as countries may shift to other investment measures that are not sanctioned by other WTO rules. Efficiency might even decrease if the changes increase uncertainty for international investors about national investment regimes and result in the postponement of longer term investment.
- If developing countries have to rely more on positive incentives for investment as a result of the TRIMs Agreement, this could contribute to financial imbalances in the public sector, with negative consequences for investment and growth arising from distortions of incentives caused directly through the positive incentives, and indirectly through unsustainable budget deficits.
- The prohibition of performance requirements has positive effects on the magnitude of FDI invested in the host country. In particular, local content requirements in knowledge-intensive industries can represent an important impediment to FDI, as inputs are not available at all, or are not of the necessary quality.
- A rise in investment in exporting countries may take place if trade flows that substitute for locally purchased inputs increase. These trade flows will not necessarily arise between the home and the host country of the direct investment. Investment in local production of inputs will decrease as a consequence of its substitution for imported inputs.

On the whole, neither the efficiency implications nor the impact of the TRIMs Agreement on investment in developing countries are straightforward because of the restricted coverage of the agreement. While prohibition of all national investment measures would induce efficiency gains, the TRIMs Agreement might in some cases simply lead to a shift

toward unprohibited investment measures. This might worsen the investment climate if it were to increase investor uncertainty.

### WTO Agreement on Subsidies and Countervailing Measures

**Table 4. Economic Implications of the WTO Agreement on Subsidies and Countervailing Measures for Investment**

Effects on Investment	Net Impact on the Magnitude of Investment	Effects of Potential Interest to the Fund
The elimination of subsidies can result in a more efficient allocation of resources. In consequence, investment can increase.	Increase	An increase in investment resulting from efficiency gains can promote economic growth.
Investment may decrease as a result of the uncertainty induced by shifts to investment measures that are not covered by the agreement.	Decrease	Increase in uncertainty can impede or postpone international diversification of productive investment with negative consequences for economic efficiency.
Shifts from specific to unspecific subsidies might cause fiscal imbalances which can result in decreases of investment.	Decrease	As developing countries often have very limited financial resources to grant specific subsidies and as there are rarely industrial pressure groups that insist on specific subsidies to prevent structural change in these countries, they may only be affected to a very limited degree by these shifts and their consequences.
Investment can increase as a result of the prohibition of export subsidies. A decrease in export activity will worsen the current account. In consequence, inflows of capital have to provide finance for current account deficits.	Increase	Exemptions and transition periods for developing countries reduce the impact of this effect on developing countries considerably. If the overall investment climate in these countries is unfavorable, capital might not flow in and a balance of payments crisis can result.
Investment induced by specific subsidies can decline, while investment can increase in other sectors that were not covered by subsidies.	Undetermined	The more a country used specific subsidies, the more likely it is to experience decreases in investment as a result of the economic distortions that have to be corrected. This effect might affect developing countries to a lesser extent for the reasons outlined above.

Prior to the WTO Agreement on Subsidies and Countervailing Measures, subsidies were not defined in the GATT. According to Article 1 of the Subsidies Agreement, a subsidy exists if there is either “a financial contribution by a government or any public body”, or “any form of income or price support in the sense of Article XVI of GATT 1994” and if “a benefit is thereby conferred”. The coverage of positive and negative incentives by both the TRIMs Agreement and the WTO Agreement on Subsidies and Countervailing Measures remains incomplete and appears to be rather unsystematic. Services are not covered either.

The agreement distinguishes among three different kinds of subsidies according to their trade impact (not economic impact) and foresees different consequences according to this classification. Firstly, subsidies are classified as **prohibited** if they are linked to export performance or favor domestic over imported goods. By prohibiting these incentives, the agreement partially complements the TRIMs Agreement that only applies to some negative incentives. While the TRIMs Agreement covers local content requirements, its provisions do not apply to export performance requirements. Secondly, subsidies that discriminate in favor of some firms or industries are referred to as **specific**. If these specific subsidies have adverse effects on other members, they are classified as **actionable**. These can be challenged either in WTO dispute settlement procedures, or by unilateral introduction of countervailing duties by trading partners. The third category comprises non-specific subsidies as well as specific subsidies granted to industrial research and pre-competitive development activities, environment and regional development. Non-specific subsidies do not discriminate between firms, industries, or groups of firms or industries. Subsidies in the third category are classified as **non-actionable**, which implies that no countermeasures can be applied.

The agreement certainly improves the multilateral legal framework on subsidies, as the clearer rules can improve predictability of national policies. Nevertheless, it should be noted that, due to the different treatment of different subsidies, the agreement can undermine the objective of improving allocational efficiency. While the elimination of subsidies can increase economic efficiency, two arguments cast doubts on this. First, non-specific subsidies are, in principle, allowed, while specific subsidies are classified as 'actionable'. Non-specific subsidies can have the same negative implications for economic efficiency as specific subsidies. Furthermore, a possibly induced shift from specific toward unspecific subsidies might increase public sector expenses, with adverse implications for investment and economic growth. This conclusion relies on the assumption that subsidies received by a limited number of firms or industries represent a more manageable fiscal burden compared to unspecific subsidies, which are often granted to all producers of certain products. It should be noted, however, that no conclusive evidence on such shifts is presently available. Second, changes in the government-induced incentive structure that can occur as a result of the agreement could, as in the case of TRIMs, increase uncertainty for potential investors and, therefore, worsen the investment climate with adverse consequences for investment. On the other hand, the general approach to make subsidies more predictable should improve the investment climate in the long run.

The implications for efficiency and investment are:

- Investment can increase in line with the gains in economic efficiency if subsidies are phased out. In cases where the decision for an investment would rely at the margin on the subsidy granted by government authorities, investment can decrease.
- The positive effects on investment might be offset by impediments to investment from the structure of the agreement. The different treatment of various subsidies might lead to shifts in the structure of the subsidies. Investment that has been induced by a specific subsidy might, in consequence, not be replaced by an investment that responds

to the new subsidy if investors anticipate further changes. Frequent changes in the incentive structure for investment add to the uncertainty faced by investors, which can reduce investment. This uncertainty can affect most investment in developing countries that already suffer from other impediments to investment, such as less stable macroeconomic policies. If the agreement improves predictability of subsidies in the long run, investment may increase.

- Subsidies that are defined as ‘non-specific’ remain permitted. As a result, governments might replace specific by non-specific subsidies, which can increase their financial burden. Created, or increased, fiscal imbalances can, in consequence, have an adverse impact on private investment and economic growth. As developing countries have greater difficulties in raising financial resources for public expenses, these countries can face widening fiscal imbalances that will diminish their growth prospects should they introduce new, non-actionable subsidies.

In addition to the arguments developed above, the WTO Agreement on Subsidies and Countervailing Measures has further implications for investment. These are:

- As export subsidies are prohibited by the agreement and must be phased out, and their elimination reduces exports, external imbalances may worsen in the short term. In consequence, inflows of investment capital may be needed to finance enlarged current account deficits. In the long term, the removal of export subsidies is likely to have an effect on the composition of trade rather than on the trade balance.
- The most straightforward impact of the agreement on investment probably consists of a decline in investment that has been induced by the subsidies which are phased out. As this decline is likely to take place in all countries that have to phase out specific subsidies, the net effect on investment will depend on the relative significance of the changes in incentives that the agreement induces. Countries with large specific subsidies are more likely to be negatively affected by the agreement than others.

The impact of the agreement on investment in developing countries is reduced by the limited coverage of the agreement--it does not apply to agricultural subsidies or to services. The former are subject to a separate agreement. Moreover, the agreement mentions specific transition periods. While existing and new export subsidies given by LDCs and developing countries with a gross national product below US\$ 1,000 per capita are not affected by the agreement,<sup>26</sup> existing export subsidies have to be phased out within eight years (by 2003) in developing countries, and within seven years in transition economies. These groups of countries are not allowed to introduce new export subsidies. Local content subsidies have to be eliminated in all of these countries within time limits ranging from five years for developing countries, to seven years for transition economies and eight years for LDCs. Furthermore, subsidies granted in the context of privatization are only classified as ‘actionable’ in

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<sup>26</sup> In the case of export competitiveness, these subsidies have to be phased out within time limits of two and eight years respectively.

economies in transition. Subsidies that are classified as 'non-actionable' can in fact become 'actionable' and face countermeasures if they have severe adverse effects on the domestic economy of another member.<sup>27</sup>

The overall impact of the agreement on investment is ambiguous. Changes in subsidy policies can increase or decrease investments in countries applying them. The definition of subsidies and disciplining of certain types of subsidies can increase the predictability of investment conditions, and thereby investments. The agreement also sets tighter disciplines on some investment incentives, which may increase the efficiency of investments and reduce competition for investment with costly subsidies. However, there may also be a shift to more general subsidies, or those allowed by the agreement (environment, regional, research and development). As these subsidies can be costly, competition for investment with subsidies can be shifted in favor of higher income countries.

### **Implications of the proposed MAI for investment**

The MAI that is currently being negotiated at the OECD (Organisation for Economic Cooperation and Development) will focus entirely on investment—its protection and liberalization. If the agreement is limited to FDI, it could lead to distortions in capital flows between different types of investments. While a comprehensive agreement on FDI would certainly remedy many of the deficiencies of WTO agreements that concern investment, an MAI restricted to FDI would leave out other important investment issues and could even create new inconsistencies within the multilateral framework of investment rules.

The proposed MAI meets most of the criteria for a good international investment agreement. It aims at uniform treatment of FDI in international law. This will eliminate differences in the treatment of FDI in the service and the manufacturing sector resulting from the GATS. It will also help to close the gap between the elaborate international legal framework on trade and the rather poor coverage of investment by international law.<sup>28</sup> Moreover, the MAI will cover all kinds of national investment measures, thereby completing the partial coverage that resulted from the TRIMs Agreement and the WTO Agreement on Subsidies and Countervailing Measures.

The definition of investment in the MAI will be crucial in eliminating some existing distortions in international investment regimes. The following discussion about implications

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<sup>27</sup> See Articles 27-29 of the WTO Agreement on Subsidies and Countervailing Measures. Even the transition periods mentioned in the agreement may be extended upon consultation.

<sup>28</sup> Despite this rather poor coverage of investment, the international legal framework on investment encompasses a wide diversity of bilateral, regional, plurilateral and multilateral instruments. Many of the plurilateral and multilateral instruments are legally binding to their members. These instruments include for example the OECD Code of Liberalization of Capital Movements (1961), the Convention of the Settlement of Investment Disputes between States and Nationals of Other States (1965), or the Convention Establishing the Multilateral Investment Guarantee Agency (1985). Many important regional instruments are embedded in the broader framework of regional economic integration schemes, like the Treaty Establishing the European Community (1957) or the North American Free Trade Agreement (NAFTA) (1992). Despite all multilateral efforts, Bilateral Investment Treaties (BITs) constitute a key element within the international legal framework on investment. Up to June 1996, nearly 1,160 BITs have been concluded.



of the MAI for investment will therefore only focus on possible definitions of investment and their impact on cross-border movements of capital.

Impediments<sup>29</sup> to investment can take different forms and be set up at different stages of the investment process. These forms range from prohibitions and quantitative restrictions for the investment itself to distortions of incentives related to the investment or to limits on cross-border transfers of capital or expropriation. The stage of the investment process that is subject to regulation can either be the acquisition of the real asset, or of a financial asset preceding the real investment, whether cross-border or domestic. The investment can also be subject to regulation after the establishment phase. There are three options to deal with these in the coverage of investment by the MAI. Table 5 reviews these different options and their implications for investment.

Any definition of investment that would only cover the post-establishment phase without any immediate impact on cross-border movements of capital (**Option 1**) would not significantly improve the existing international legal framework on investment. Governments could easily shift to other measures regulating foreign investment. If the MAI wants to provide a comprehensive coverage of national investment measures, it would also have to cover cross-border financial flows. FDI is not identical to investment, because it represents only one possible form of the financial flow from saving to investment<sup>30</sup>. For example, data on U.S. direct investment abroad and capital expenditures by majority-owned foreign affiliates

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<sup>29</sup> Impediments here is meant in the sense of modifications of the market-based investment decision, induced by both incentives or disincentives set up by the host country.

<sup>30</sup> From a macroeconomic perspective, the recorded FDI constitutes a flow-of-funds concept. It is not identical with the investment as it simply represents a possible form of the financial flow from saving to investment. Economically, FDI is a source of funds while only the capital expenditure of the subsidiary, which is a use of funds, can be considered as real investment. Therefore, many authors have expressed doubts concerning the usefulness of FDI data for economic analysis. Does the FDI that takes place in these countries represent additional investment which increases the gross fixed capital formation or is it merely a different form through which investment capital from abroad is provided? The fact that economic analysis can hardly provide a clear answer to this question does not invalidate the argument for FDI as an important source of external finance. If an increase in inward FDI would lead to an increase in a country's gross fixed capital formation, it would clearly contribute to economic growth. If inflows of FDI would merely substitute for other capital inflows, the importance of FDI is still twofold: firstly, direct investment from abroad provides inputs other than financial in addition to the investment capital and is therefore likely to induce a more sustainable growth; secondly, if inflows of portfolio capital cease due to adverse macroeconomic conditions, the access of foreign investment capital to direct investment opportunities ensures that one channel for inflows of external finance remains.

**Table 5. Implications of Different Options for the Coverage of Investment by the MAI**

	<b>Options for the MAI's Coverage of Investment</b>	<b>Implications for the Fund's Interest in Investment</b>
<b>Option 1</b>	Coverage of the post-establishment phase only, with no immediate impact on cross-border movements of capital.	While such a limited coverage of investment is unlikely for the agreement, it would imply no major progress in the protection and liberalization of cross-border investment. Governments could easily rely on investment measures that would affect the establishment phase or that would restrict financial flows. On the whole, such an agreement would not add much to the existing legal framework on investment. In particular, it would not necessarily improve the global allocation of savings on efficiency grounds.
<b>Option 2</b>	Extension of the coverage of the agreement that is mentioned under Option 1 to FDI flows.	A coverage of FDI flows by the agreement would establish a double standard for capital account transactions. This would be inefficient as well as unsustainable with a view to the high degree of substitutability of different flows of funds. The various practical problems that would arise are mostly related to difficulties of the definition of FDI.
<b>Option 3</b>	Extension of the coverage of the agreement that is mentioned under Option 2 to all kinds of financial flows.	By covering all kinds of capital flows, the agreement would increase capital account liberalization. While this seems desirable on efficiency grounds, it might affect monetary, exchange, and balance of payments policies of member states.

of U.S. firms between 1973 and 1992 show that these variables are not equal in magnitude, nor do their movements show close correlation.<sup>31</sup> This might be due to access to finance in domestic or international financial markets.

Other problems might occur if the agreement covers cross-border movements of investment capital but the definition of investment remains narrow (**Option 2**). With a view to the already high and increasing substitutability of different capital flows that precede real investment, the MAI runs the risk of distorting international capital flows by covering only FDI. The focus on FDI could even reduce economic efficiency, as it would distort incentives in favor of one type of capital flow. It is also important to note that the MAI suffers to an even greater extent than the WTO agreements from the fact that, at least initially, it is not planning to rely on a broad membership.<sup>32</sup>

Different instruments to channel financial flows are highly substitutable. A restriction to the flows that are statistically recorded as FDI could lead to changes in the use of these instruments. FDI, if it is better protected by international law, may increase, while other forms of cross-border movements of capital may decrease. The emerging regime would, therefore,

<sup>31</sup>See Graham (1995), p. 4a.

<sup>32</sup>As the MAI will comprise at least all the OECD member countries, it will encompass all industrial nations.

favor financial intra-firm operations over the use of financial markets and financial intermediaries. The non-uniform definition of FDI represents another problem. While it often only records the sum of paid-in capital and retained earnings, loans between the parent company and the foreign affiliate might sometimes also be recorded as FDI.<sup>33</sup>

The implied partial liberalization of capital account transactions in this option might encounter two kinds of problems. While the substitutability of different financial flows casts doubt on the practicability of such a partial liberalization, the partial coverage of the capital account can also distort investment flows and, in consequence, to reduce economic efficiency. In fact, most of today's FDI finances mergers and acquisitions abroad, while only a smaller part is used for greenfield investment.<sup>34</sup> With acquisitions, shares of a company are often purchased step by step and sometimes without any initial commitment to gain control over the investment. Therefore, the definition of FDI would have to rely entirely on the intention of the investor, which is difficult to make in practice. As far as large multinational corporations are concerned, even less than 10 percent of the capital (which is the definition of FDI), can have a decisive impact on corporate decisions. Besides these practical problems in covering exclusively FDI, such a restricted coverage could discourage financial intermediation. The services performed by the banking system and other financial intermediaries represent an important contribution to the functioning of an economy. If FDI were to be better protected than other instruments for the cross-border movement of capital, this could provide disincentives to rely on financial intermediation, and could damage the banking system or impede its further development. Preferential treatment of FDI by international law could also reduce the degree of diversification in investment decisions. Furthermore, a distinction between FDI and other capital flows for the purposes of liberalization could have an impact on the conditions of transforming one kind of financial asset into another, for example, in the context of debt-equity swaps.

To avoid these distortions of cross-border financial flows, the MAI should cover a broad range of international investment flows. This would result in a truly universal investment regime in terms of coverage. This would make sense economically, as different forms of financial investment often precede some kind of real investment. The choice of an instrument for cross-border financial flows should rely on considerations of economic efficiency. A restriction of this choice may reduce economic efficiency. By covering all capital flows, the MAI would foster capital account liberalization (**Option 3**).

However, while liberalization of investment-related capital account transactions seems desirable for efficiency considerations; it can at the same time affect the conduct of monetary, exchange, and balance of payments policies of member states. If Option 3 would be selected for the coverage of investment by the MAI, the agreement would have to take these concerns into account. This could take place in a number of different ways:

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<sup>33</sup>The latter is, for example, the case in the United States.

<sup>34</sup>See Graham/Krugman (1989), pp. 16-17. More recent figures reveal that, for example in 1994, cross-border mergers and acquisitions amounted to US\$ 156.2 billion (IMF (1995b), p. 189), while the recorded total of FDI inflows was US\$ 212.5 billion (IMF (1995a), p. 57).

- A future MAI could distinguish between different classes of assets on the basis of motivation. This could favor the creation of lasting economic relations over short term movements of capital, but inevitably, such a distinction would need to be based on arbitrary criteria. For the needs of monetary, exchange, and balance of payments policies, this distinction might rely, for example, on the maturity of the asset. However, in practice, the distinction between different classes of assets seems to be an inadequate response to the problem. It would clearly suffer from the high substitutability of different instruments to channel financial flows. Any distinction between financial assets would cause inefficient changes in the use of these instruments without securing the effectiveness of national policies.
- The general exception of all measures taken by monetary authorities in the normal conduct of monetary and exchange rate policies represents another possibility to deal with these concerns. For example, the GATS exempts monetary policies from its scope. But, this solution suffers from a lack of transparency as it allows for a discretionary definition of the excluded measures by every individual member country.
- To cope with the deficiencies of the second solution, the MAI might include balance of payments safeguards similar to those in the GATS, which also account for the interests and legal provisions of the Fund, such as the Fund's jurisdiction over exchange measures with current international transactions, capital restrictions imposed at the request of the Fund, and restrictions imposed to safeguard the balance of payments.

In addition to the three proposals, there are certainly other possible solutions for the agreement to secure the effectiveness of national monetary, exchange, and balance of payments policies, while generally covering all possible kinds of cross-border financial flows under a broad definition of investment.

#### **IV. Conclusions**

The present multilateral legal framework on investment is patchy in coverage and biased in favor of certain flows. Its impact on investment is ambiguous. The increase in investment and capital flows in the world economy has increased the importance of a more complete, neutral and coherent legal framework for investment to promote a more efficient allocation of world savings. Most present international investment rules are found with a trade bias. Broader investment rules are currently being discussed at the OECD.

This paper discussed some implications of these agreements for investment, focusing on their macroeconomic investment implications. Its major findings are:

- To understand the approach toward investment incorporated in WTO agreements, it is useful to analyze the relationship between investment and trade. In the past, investment and trade have mostly been viewed as two alternative means of gaining access to a foreign market. Today, there seems to be increasing evidence for a complementary relationship of trade and investment, although substitutive elements may still exist. This calls for multilateral rules to eliminate investment barriers. The

importance of investment is also likely to increase in line with further liberalization of global trade. Furthermore, the high substitutability of various investment flows calls for a broad and more neutral legal framework for capital flows.

- WTO agreements are mainly concerned with a rules-based approach to trade liberalization. Several agreements that were concluded at the end of the Uruguay Round negotiations have implications for investment, but the rules cover only a small part of the complex trade-investment interrelationship. As a result, while these agreements may have ambiguous effects on investment, their effects on trade are not unequivocal either.
- The TRIPs Agreement may have adverse economic effects on investment. It does not cover financial flows. While it may lead to increases in investment in research and development and in FDI due to a more reliable legal framework, it might decrease the production of counterfeit goods and FDI that was undertaken to channel unprotected confidential knowledge within multinational corporate networks. Furthermore, small developing countries may need additional resources to ensure an effective protection of IPRs. Developing countries may also suffer from higher prices that can result from the market power associated with enforceable IPRs.
- In contrast to the TRIPs Agreement, the GATS covers some financial flows. In opened sectors, this may lead to a partial liberalization of the capital account. The economic effects of the agreement on investment are likely to be mostly positive. Trade in services that cannot rely on traditional forms of cross-border trade can increase in line with the liberalization commitments that have been made by member countries. FDI might decrease if these investments represent a suboptimal allocation of resources set up to evade trade restrictions.
- The TRIMs Agreement represents one early attempt to catch up on multilateral rules governing investment. The agreement suffers from different shortcomings and may therefore make only a limited contribution to promoting cross-border investment. These include the limited coverage of trade-related investment measures, and the fact that it basically restates the fundamental and already legally-binding GATT rules on national treatment and the elimination of quantitative restrictions. This may lead to further distortions in investment flows.
- The WTO Agreement on Subsidies and Countervailing Measures provides for the first time a definition of subsidies that may limit the use of investment incentives, although its coverage is very partial. The agreement may also increase investment by creating a more predictable legal environment for subsidies. Decreases in investment can result either from a shift toward more costly unspecific subsidies that do not have to be phased out, or from investment that has been attracted because of marginal advantages resulting from specific subsidies.

- Despite the significant influence of all discussed WTO agreements on the magnitude of different kinds of investment, the resulting net changes in investment are likely to be small. This result points to the high degree of substitutability among different instruments or channels of investment. This high degree of substitutability shows that a partial coverage of investment by an agreement might possibly lead to a suboptimal allocation of investment flows. It also underlines the importance of the definition of investment for the proposed MAI.
- The MAI that is currently being negotiated at the OECD is expected to make an important contribution to the liberalization and protection of cross-border investments. The agreement is likely to remedy some of the deficiencies of the reviewed WTO agreements concerning investment. However, if it were to restrict its coverage of investment flows to FDI, the MAI could cause new inconsistencies within the emerging multilateral framework of investment rules and establish a double standard for the capital account. This would be inefficient and unsustainable, especially in countries that have not yet liberalized their capital account, due to the high degree of substitutability of different flows of funds. While coverage of all kinds of financial flows would promote economic efficiency, it might adversely affect monetary, exchange, and balance of payments policies. In consequence, the agreement might encompass a derogation clause to secure the effectiveness of these policies.

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