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Chapter VI

INTERNATIONAL FINANCE AND POLICY SPACE

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A. Introduction

To be fully effective, policies aimed at structural transformation require a favourable macroeconomic framework. This means economic policy must aim to keep the key macroeconomic prices (interest rates, wages and exchange rates) at levels that favour robust capital accumulation, domestic market growth and trade competitiveness. Macroeconomic policy must also avoid excessive instability or unsustainable domestic and external imbalances. In all these areas, international finance can play an important, but sometimes disruptive, role. Indeed, foreign capital inflows, depending on their size and composition, may increase or reduce economic policy's room for manoeuvre and, more generally, support or undermine growth and development.

Regarding size, neither extreme scarcity nor an overabundance of foreign capital contributes positively to policy space. On the one hand, scarcity may restrict the volume of imports of goods that are essential for speeding up the development process, in particular capital goods that cannot be produced domestically, to the extent that such imports cannot be financed by current export earnings. A shortage of external financing may therefore hamper policies aimed at supporting GDP growth, investment and diversification. On the other hand, an overabundance of foreign capital inflows usually generates financial bubbles, currency appreciation, current account deficits and rising indebtedness of domestic agents. These developments also affect policy space, as they weaken the likely impact of monetary and credit policies and the regulation of key macroeconomic prices. In the absence of capital account management, the situation in developing and transition economies that have access to international financial markets (and are thus also exposed to the vagaries of those markets) tends to oscillate from one extreme to the other: overabundance leads to the accumulation of external liabilities, followed by sudden stops or even reversals of capital inflows, possibly precipitating a financial crisis, which in turn is followed by a period of capital scarcity.

Economies are particularly vulnerable to financial instability when international capital flows are mainly of a short-term nature. Unlike the foreign capital that is used in fixed capital formation,[1] short-term flows are normally used for the acquisition of financial assets, real estate investments or consumption credit, directly or through the intermediation of domestic financial systems. Such flows are particularly prone to boom-and-bust cycles, depending mainly on events in the more developed economies. They exacerbate the fragility and vulnerability of domestic financial systems and lead to unsustainable current account deficits.

Indeed, excessive exposure to external capital flows and the fact that in large part they were not oriented to productive uses were major factors in the build-up of economic crises in developing and emerging economies in the past few decades, beginning with the Latin American debt crises in the 1980s. These were not only balance-of-payments and banking crises; they were also fiscal crises, as governments themselves resorted to external borrowing and, in addition, felt compelled to bail out private debtors and socialize their losses (Díaz-Alejandro, 1985). As a result, their fiscal policy space shrank dramatically as governments had to service their external debt while economic recession depressed fiscal revenues and access to private credit dried out. In such a situation, the only remaining sources of credit supply were official institutions (mainly the Bretton Woods institutions), which imposed policy conditionalities on their lending that placed the whole burden of adjustment on what then became debtor countries, and further altered these countries' policy space. This experience has been recently replicated by some developed countries that were severely hit by the global financial crisis that started in 2007-2008.

Partly as a reaction to these negative experiences, authorities in a number of developing countries have tried to reduce their dependence on foreign capital. They have sought to avoid current account deficits and reduce their external debts, and many of them have significantly increased their international reserves in order to lessen their external vulnerability. Some of them have been particularly reluctant to return to IMF-led adjustment programmes.

Therefore, there is a strong case for governments to manage capital flows by seeking to influence not only the amount of foreign capital movements, but also their composition and use. Such a pragmatic and selective approach to capital flows, rather than unrestricted openness or a complete ban, could help maximize policy space within a given development strategy and given existing international institutional arrangements. This chapter examines possible ways for applying needed policies in the context of financial globalization, as well as various obstacles to such policies (see also chapter V).[2]

Constraints on the ability of governments to introduce proactive policies can be either de facto or de jure. De facto restrictions on capital management refer to pressures from existing and potential lenders and investors. They may deem a country's capital control measures as detrimental to the "business climate", and may therefore reduce or threaten to withdraw capital flows to that destination. The risk of this happening may deter governments from applying capital management measures, but this could increase the symmetric risk of excessive short-term capital inflows as well as sudden outflows.

De jure obstacles stem from multilaterally or bilaterally agreed rules that forbid or limit a resort to capital management measures. For instance, countries joining the OECD or the EU commit to maintaining open capital accounts to other members, and within various regional trade agreements countries often pledge to liberalize trade in financial services.

Over the past 25 years, a large number of countries have signed international investment agreements (IIAs), either in the form of bilateral investment treaties (BITs) or as an "investment chapter" of an RTA. Such agreements provide for special treatment of foreign investors, which tends to reduce the policy space of the participating governments. A key component of those agreements is the "investor-State dispute settlement" (ISDS) mechanism, whereby national governments accept the jurisdiction of foreign arbitration centres on issues that might directly or indirectly affect the profitability of foreign investments and the rights of foreign investors under provisions of the IIAs. Such mechanisms have allowed international investors to sue governments and obtain monetary compensation for policy measures that, in one way or another, allegedly affected the profitability of those firms. Some of these measures consist of regulations directly related to the public interest or to development choices, such as public health, environmental protection and the kinds of energy sources a country opts to exploit. Others are related to macroeconomic management, including exchange rate management and restructuring of the banking system in times of crisis.

This chapter is organized as follows. Section B discusses the need for capital management and other prudential measures to enable governments to preserve their policy space for conducting macroeconomic policies and pursuing their national development strategies. It reviews the experiences of developing countries that were affected by volatile capital flows before and after the global financial crisis. It then analyses the obstacles to capital management policies and examines which policies countries can still apply – and in some cases are implementing – in order to avoid the potentially disruptive macroeconomic impact of capital flows and better channel them to finance investment and development goals. Section C addresses the challenges IIAs pose to governments, which face a trade-off between what they believe is a way of encouraging inward foreign investment while preserving their sovereignty in a number of strategic areas. It examines in what ways and to what extent these agreements have reduced the policy space of governments seeking to implement proactive industrial policies, and thus possibly undermining the development contribution of foreign investment flows. Finally, it considers some of the alternative approaches currently being discussed by policymakers in developing countries to address the serious shortcomings of IIAs.

B. Capital management in an era of globalized finance

1. Capital flows and their impact on macroeconomic policy space

The traditional view on how openness to capital flows affects macroeconomic management has been termed the "impossible trinity" or "trilemma", following Robert Mundell, according to which a country cannot have an open capital account, a fixed exchange rate and monetary sovereignty at the same time. For instance, with capital account openness and a fixed exchange rate, the central bank would lose its ability to determine the money supply, because an expansionary monetary policy would tend to lower interest rates. This would cause capital outflows, and therefore reduce international reserves and the monetary base, hence cancelling the initial monetary expansion. The same mechanisms would work the other way to compensate for a contractionary monetary policy.

However, the reality is often more shaded, as countries do not opt for either complete capital openness or a totally fixed exchange rate, nor do central banks aim at full autonomy, and there cannot be completely closed capital accounts in the era of globalization. Hence, the real challenge seems to be how to flexibly manage the capital account and other policy variables in order to generate a favourable macroeconomic framework for growth and structural change at a time when the volume and pattern of international capital flows exceeds the capacity of most countries to absorb them productively.

This section examines how the rapid opening up of developing countries to international capital flows since the late 1970s has affected their ability to conduct their macroeconomic policies in two major ways. One channel consists of the direct impact that capital movements have on key macroeconomic variables, such as exchange rates, monetary aggregates and interest rates, which in turn affect the availability and cost of domestic credit, asset prices, and consumption and investment decisions. The other has to do with the greater leverage of the main international financial agents on economic policy decisions. This is because policymakers frequently have to take into consideration the agenda, perceptions and interests of foreign investors in the formulation of their macroeconomic policies, since the portfolio decisions of those investors may have a significant impact on economic growth and the stability of domestic financial systems.

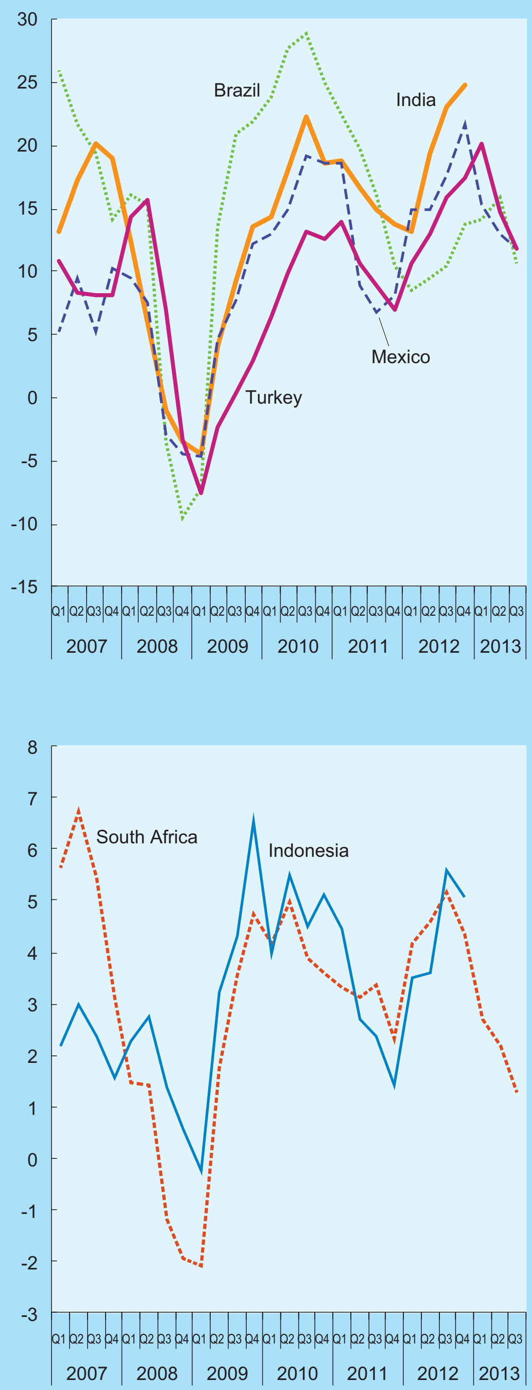
(a) Impact of capital flows on macroeconomic variables

Given the size of accumulated global financial assets, the impact on a country's macroeconomic stability of even marginal changes in its international

Chart 6.1

CAPITAL INFLOWS, 2007 Q1–2013 Q3

(Billions of current dollars)



Source: UNCTAD secretariat calculations, based on IMF, *Balance of Payments Statistics* database.
Note: Capital inflows refer to portfolio and "other investment" flows (3-quarter moving average).

capital flows can be huge (Haldane, 2011). These flows tend to follow a global financial cycle, in which "push factors" in the developed economies where the main suppliers of international credit are based have more influence than country-specific "pull factors" (i.e. countries' demand for credit) (Rey, 2013).[3] Indeed, almost all the major "waves" of capital inflows received by developing countries since the late 1970s were triggered by expansionary monetary policies in developed countries (Akyüz, 2012), and were amplified by the leverage cycles of global banks (Bruno and Shin, 2013). But they were also influenced by risk perceptions in the developed countries' financial markets. Those waves usually came to an end with monetary tightening in the reserve currency countries. This pattern was repeated following the global financial crisis. Moreover, the capital inflows received by developing and emerging economies have remained synchronized since that crisis (chart 6.1). After the sharp flight-to-safety of capital in late 2008, resulting in a significant withdrawal of foreign portfolio and "other" investments from developing countries, capital flows to these countries recovered − or even surpassed − pre-crisis levels. This was at a time when developed countries followed very expansionary monetary policies and developing countries seemed to have successfully recovered from the global crisis. Alternating episodes of financial strain and restored confidence in developed countries, despite continued monetary easing, may explain the fall in capital flows to developing countries in mid-2011 and their subsequent recovery one year later. Risk perceptions also changed significantly, due to anticipated changes in United States monetary policy, as reflected in new volatility of capital flows to developing countries.

Since the global financial cycle is driven mainly by developed countries' economic conditions and decisions, there is no reason for it to be aligned with developing or transition economies' macroeconomic conditions and financial needs. Even though the major developed countries that issue reserve currencies have committed themselves to taking into account any possible repercussions of their policy actions for other countries, their monetary authorities are essentially guided by the needs of their own domestic economies. This can lead to inconsistencies between their goals and those of other countries. For instance, since the 2008 financial crisis, the United States Federal Reserve has been pursuing an extremely expansionary monetary policy to support domestic activity. This policy has effectively led to large capital flows to a number of emerging economies, as a result of which they have experienced a domestic credit boom and an unwanted currency appreciation. Conversely, the progressive reduction of monetary support in the United States may lead to a financial shock in emerging economies resulting from a reversal of capital flows, higher interest rates and credit attrition.

International capital flows generally generate a financial cycle in the receiving countries. Capital inflows tend to result in an increase in domestic banks' credit supply, a fall in interest rate spreads and an appreciation of domestic assets and the exchange rate. This provides a new stimulus for increasing domestic credit, as the economy tends to grow faster and higher asset prices improve the (apparent) solvency of borrowers. On the other hand, it also stimulates new capital inflows, including in the form of carry trade.[4] But these effects of capital inflows greatly increase financial fragility, as growing indebtedness and deteriorating current accounts eventually lead to a reversal of those flows and, possibly, a financial crisis.

> The global financial cycle is driven mainly by developed countries' policy decisions guided by the needs of their own domestic economies …

In order to be able to create and maintain domestic macroeconomic and financial conditions that are supportive to growth and structural transformation, governments must have at their disposal suitable policy instruments to prevent or cope with these recurrent shocks. They must be able to follow countercyclical fiscal and financial policies, including through discretionary fiscal spending and adapting bank leverage to moderate credit during economic booms while preventing deleveraging during depressions. They must also be able to maintain key financial prices, such as interest rates and the real exchange rate, at levels that promote productive investment, expand domestic incomes and demand, and increase external competitiveness. This may require active intervention by central banks as well as complementary macroeconomic measures, such as an incomes policy.

> … thus, such a cycle is not necessarily aligned with developing or transition economies' financial needs.

A combination of macroeconomic and financial policies can form a coherent framework for a catch-up growth strategy and structural transformation. Such policies would include low interest rates, exchange rate management aimed at fostering a competitive economy, investment-oriented fiscal and financial policies, and an incomes policy aimed at boosting domestic demand. These would need to be accompanied by prudential policies that can regulate capital movements in order to limit any undesired impacts they may have on macroeconomic variables, such as those discussed above. But such policies face resistance by those who argue that financial liberalization contributes to the optimization of factor allocation. They stress that, in order to prevent negative financial shocks and make finance work for development, the key is to gain and retain the confidence of financial markets.

(b) The confidence game

Following capital account liberalization and a succession of international financial shocks since the 1980s, developing countries were under strong pressure from international financial institutions to adopt confidence-building policies and structural reforms. They believed that such measures would contribute to economic stability and help reduce the likelihood of economic crises caused by volatile flows. Recommended policies included fiscal austerity and the adoption of corner solutions for their exchange rate regimes (i.e. either fully fixed or fully flexible exchange rates), which, supposedly, could withstand speculative attacks against a country's currency. Accompanying economic reforms were expected to include liberalization of markets and privatization of both State assets and delivery of essential services.

These recommendations, particularly influential during the 1990s, were closely linked to a broader set of adjustment measures that international financial institutions had been recommending since the external debt crisis of the 1980s (*TDR 2006*, chap. II). The proposed policies and reforms were based on an understanding that free markets ensure an efficient allocation of resources, thereby leading to both stability and growth. Therefore, it was suggested that countries should implement measures which would demonstrate to financial markets that they were opting for "credible" policies. Such confidence-building with those markets would attract continuous capital inflows and help prevent a full-blown economic crisis. Playing this "confidence game" (Krugman, 1998) forced policymakers into guessing which policies financial market agents would judge to be good for addressing specific economic conditions, even if these may not be considered the most suitable by the policymakers themselves and by a non-negligible number of economists.

A major problem in playing this game is that market actors' perceptions of a developing country's policies and economic conditions, and assessments of their sustainability, are frequently influenced by their ideological belief in self-correcting financial markets and their disapproval of public intervention, such as regulation of the financial system and countercyclical policy measures. In addition, their perceptions can change very rapidly, even if no change in such policies and conditions has actually taken place.[5] The result of these changing perceptions has been that, in times of economic turbulence in international financial markets, countries face a great deal of uncertainty as to whether adoption of "credible" policy choices would be effective or not in mitigating major turbulence effects on their economies and, ultimately, in avoiding an economic crisis. At the same time, given the close alignment between the markets' understanding of confidence-building policies and mainstream economic reasoning, governments have few possibilities to adopt alternative macroeconomic policies, even if they consider these to be more appropriate for tackling their economic difficulties.[6]

In particular, fiscal responsibility has been an important element in arguments for a confidence-building strategy on the grounds that market operators and rating agencies usually attach great importance to fiscal balances when they assess credit risk, not only the risk on sovereign bonds but also on debt issued by the domestic private sector. Indeed, this drives the view that integration into global capital markets has a positive impact on fiscal discipline, and therefore on macroeconomic stability.[7]

However, this view overlooks the fact that, in many cases, economic imbalances and related instability are caused by private excessive borrowing and spending, encouraged by easy access to external financing. This was amply demonstrated during periods of abundant capital inflows, which corresponded to periods of expansionary monetary stances in developed countries (such as 1976−1981, 1991−1997 and 2001−2007), when fiscal policy played a minor role in the rapid increase of domestic demand, rising private debt and deteriorating external balances. Conversely, when capital flows decreased or reversed, in many cases triggering a financial crisis, fiscal austerity – when applied – was unable to restore the confidence of financial markets and cause a resumption of private capital inflows. On the contrary, by further cutting domestic demand, fiscal retrenchment accentuated economic depression, and consequently, increased the perceived credit risk.

> International capital flows generally generate a financial cycle in the receiving countries and increase their financial fragility, which can eventually lead to a financial crisis.

To the extent that they give rise to boom-and-bust episodes, large and unstable capital movements affect fiscal policy and fiscal space. This is not because they favour balanced fiscal accounts and low debt ratios, but rather because the financial crises they cause entail large fiscal costs, due to both costly bailouts of private banks and non-financial debtors and to public revenue losses resulting from shrinking taxable incomes. Thus, fiscal expenditure does not always decrease after crises, but its composition changes, with higher payments on debt servicing and lower expenditures on investment, social transfers and public services.

In the context of strong capital flows, countries have been advised to adopt either a totally fixed or a fully flexible exchange rate regime – the so-called "corner solutions" (Eichengreen, 1994; Obstfeld and Rogoff, 1995). They have been told that, by moving to one or the other of the corners, they would be better able to withstand an external shock, and thereby avoid a currency crisis, which could rapidly develop into a generalized economic crisis. Outcomes in the 1990s, however, have provided little support for this advice. Neither full exchange rate flexibility nor "hard pegs" brought about economic stability. On the contrary, they tended to exacerbate the impact of volatile capital flows. In times of monetary expansion in developed economies and growing risk appetite by international investors, developing countries lacked the macroeconomic policy tools to be able to absorb the resulting capital inflows productively and avoid major internal macroeconomic imbalances. Under a free-floating exchange rate regime, inflows led to strong nominal exchange rate appreciation, thereby weakening the international competitiveness of import-competing industries and exports. On the other hand, under a "super-fixed" exchange rate regime, inflows led to domestic credit expansion, asset price bubbles and an appreciation of the real exchange rate. In both cases, the result was almost invariably the emergence or deepening of current account deficits, making those economies overly dependent on continuous capital inflows. When these flows tapered off or reversed into capital outflows, policymakers typically responded by sharply increasing short-term interest rates and using a contractionary fiscal policy to maintain the confidence of international investors, thereby reinforcing the recessionary effects of the outflows.[8] They could not generally prevent a steep currency depreciation, its pass-through to inflation and a rapid deterioration of the balance sheets of those agents − including the public sector − that had net debts in foreign currency.

Following the crises of the late 1990s and early 2000s, most developing and emerging market economies had less confidence in the ability of market mechanisms to handle large and volatile capital movements. When a new wave of capital inflows took place between 2003 and 2008, most of these countries adopted a more hands-on approach to their exchange rate systems, generally implementing a "managed floating" regime in order to prevent excessive volatility and mispricing. They preferred to accumulate international reserves rather than passively accept strong currency appreciation.[9] In addition, adoption of capital controls in some countries and more prudent banking policies prevented the generation of new credit bubbles. As a consequence, most developing and emerging countries were able to apply countercyclical policies and avoid financial distress during the 2008-2009 global financial shock. However, this did not mark the end of the "confidence game". In the years following the eruption of the crisis, pressure by financial market agents in favour of fiscal austerity and against public intervention in financial markets resumed. Fiscal austerity policies – particularly in developed economies – were deemed essential for "ensuring that doubts about fiscal solvency do not become the cause of a new loss of confidence" in financial markets, which could trigger a new crisis (IMF, 2010: 28). In developing countries, as explained in chapter II, renewed instability in the financial account of the balance of payments reinforced the influence of actors that asked for a more "market-based" approach in exchange rate and capital management policies.

2. *The need for policy space for capital controls*

The global financial crisis showed, once again, that finance should be regulated. At present, there is broad consensus on the need for better regulation of domestic financial systems. Efforts to contain bank leverage, shadow banking and toxic assets have advanced at the international level (e.g. in the Basel Committee on Banking Supervision and the Financial Stability Board) and the national level (e.g. the Dodd-Frank Bill in the United States and the proposed ring-fencing of deposit-taking institutions from investment bank activities in the United Kingdom).[10] Moreover, macroprudential regulations that aim to avoid endogenous risk and contagion within the financial sector, as well as negative spillovers from the financial sphere to the rest of the economy, are under discussion (Galati and Moessner, 2011; Moreno, 2011; IMF, 2013; Tarullo, 2013; Esen and Binatli, 2013). However, these efforts remain tentative and face strong obstacles on several fronts.

First, since domestic and international financial markets are closely intertwined, it seems impossible to regulate the first if the latter are totally liberalized. Indeed, foreign capital flows to countries have caused financial fragility when they have been too abundant and volatile, not only because they have afforded easy access to credit that encourages excessive risk-taking at the micro level, but also because they generate macroeconomic distortions leading to systemic risks. A more selective approach to capital inflows is therefore indispensable if those flows are to be maintained at manageable levels and directed towards productive uses. At the same time, supervisory authorities in the countries from where those flows originate cannot disregard the potentially negative impact resulting from the possible accumulation of non-performing credits in the balance sheets of their financial institutions, which would eventually weaken their own financial systems.

Second, large private financial actors continue to resort to de facto pressures and persuasion to discourage policymakers from applying regulatory measures, particularly capital controls. But while it is understandable that major banks and other financial institutions with direct interest in international transactions would argue against regulatory restraints by claiming that their profit-making activities are in the general interest, this is deeply misleading. Similarly misleading is equating trading in financial assets and liabilities with trading in any other goods or services, implying that no special regulation is therefore justified (see, for example, Fama, 1980).

Third, policymakers and international institutions have been reluctant to regulate capital flows. Indeed, there is widespread belief that, with sound domestic regulation, financial deepening and strong macroeconomic fundamentals, any economy can benefit from free capital movements, as such a framework would minimize the economic instability they might generate and maximize their positive impact on growth. According to this view, even if some kind of capital management may be necessary in exceptional circumstances, such as a balance-of-payments crisis, it should be the exception, not the rule. It further posits that in normal times countries should refrain from using capital controls as an easy but precarious solution, and instead address the structural or macroeconomic shortcomings that are the true reasons for financial fragility. With some nuances, this has been the position of the IMF and the OECD and, to some extent, it has been translated into the formal rules set by these institutions as de jure obstacles to capital controls. This last constraint on policy space merits closer attention.

Even though the IMF's Articles of Agreement explicitly authorize the use of capital controls, the IMF discouraged them for many years. In 1997, at the Ministerial Meeting in Hong Kong (SAR China), its Managing Director even proposed incorporating free capital movement in the IMF members' commitments. However, the succession of financial crises that erupted immediately after the meeting, and the fact that capital movements were identified as a major cause of such crises, undermined support for fully open capital accounts.

It was only in 2012 that the IMF provided an "institutional view" on this issue (IMF, 2012). It proposed a planned and sequenced process of liberalization that would maximize the benefits that countries could obtain from foreign capital and minimize the costs of "large and volatile capital flows". Proposed policies would include a range of progressively deeper and broader supporting reforms, including reform of the legal framework, prudential regulation and supervision, and development of capital markets (including a deepening of domestic bond and equity markets and pension funds). The IMF conceded that "temporary re-imposition of capital flow management under certain circumstances is consistent with an overall strategy of capital flow liberalization" (IMF, 2012: 15), and can therefore be used to prevent risks to stability, together with macroeconomic adjustment and macroprudential measures. However, not all the tools were accorded the same status. It suggested that capital flow management (CFM) measures may be useful under certain circumstances for supporting (never for substituting) macroeconomic adjustment, but macroeconomic, structural and financial policies remained the primary tools for handling destabilizing capital flows. In addition, as CFMs involve some costs and distortions, they "should be targeted, transparent and generally temporary" and therefore lifted once the disruptive capital inflows or outflows had abated (IMF, 2012: 36). For the IMF, liberalization remains the rule, and capital controls a temporary exception subject to obligations set in its Articles of Agreement. In particular, the legality of capital controls would depend on their objective: a country would not be allowed to restrain capital inflows in order to artificially keep its currency undervalued, but would be entitled to do so for macroprudential reasons, or for avoiding excessive currency depreciation or appreciation caused by financial speculation (IMF, 2012).

A selective approach to capital inflows is indispensable if those flows are to be maintained at manageable levels and directed towards productive uses.

Some countries have made specific commitments to opening their capital account. Accession to the EU, in particular, is conditional on full capital account liberalization.[11] Similarly, the 34 OECD members adopted the Code of Liberalisation of Capital Movements, which obliges them to "progressively abolish, between one another… restrictions on movements in capital to the extent necessary for effective economic co-operation". In addition, "members shall endeavour to extend the measures of liberalisation to all members of the International Monetary Fund" (OECD, 2013: 9). Each country may make reservations to free capital flows,[12] and the Code states that it cannot prevent a member from taking action for the maintenance of public order and essential security interests. Furthermore, some measures of liberalization can be withdrawn by a country if they result in serious economic and financial disturbance, or temporarily suspended in case of serious difficulties with its balance of payments. But again, such actions are supposed to be exceptional.

In the increasingly globalized economy, it is impossible to regulate domestic finance when international financial markets are totally liberalized.

The rather stringent capital liberalization rules of the EU and OECD apply mainly to developed countries, although they also involve a number of developing countries, such as Chile, Mexico and Turkey, as well as several former transition economies that have joined the EU. However, the main de jure restrictions on developing and emerging economies in managing their capital accounts are imposed by international trade agreements. Indeed, as already discussed in chapter V of this *Report*, those agreements do not deal only (or mainly) with merchandise trade issues; they also incorporate a large number of provisions related to other areas, including capital movements. The most relevant of such agreements at the multilateral level is the GATS.[13]

Capital management measures should be applied in a preventive way as a normal instrument in the policymakers' toolkit, and not as an exceptional and temporary device for use in critical times.

Since the 1990s, over a hundred countries have committed to obligations to apply a whole series of measures for financial sector liberalization as covered by the GATS and its Annex on Financial Services. Those obligations responded not only to some private sector interests, but also to the general conviction of that time, that markets – including financial markets – could take care of themselves without jeopardizing the functioning of the rest of the economy. Events of the past few years have shown the dangers of such logic, and have spawned efforts to re-regulate finance.

But such efforts at financial regulation – even those agreed at international institutions such as the Basel Committee and the Financial Stability Board – may not be fully compatible with commitments on financial services under the GATS (see *TDR 2011*). Consequently, they could lead to litigation under the procedures established by the GATS which could affect access to markets for other goods and services. Moreover, because of the imprecise language of the GATS – and its Annex on Financial Services – the areas of potential conflict are vaguely defined (for a detailed analysis, see Tucker and Ghosh, 2011). As in other matters related to the WTO, when some regulation is challenged by a third party, WTO dispute panels and the Appellate Body should clarify the meaning of such terms as "restrictions", "regulations" and "prudential".

It is precisely because of the potential for conflict, that some contracting parties have tried to take preventive action by reaching agreement on the interpretation of some terms.[14] On the one hand, under article XI (Payments and Transfers) no restrictions on international transfers and payments on the current account (section 1) or on the capital account (section 2) may be applied if "inconsistent" with specific commitments. This means that capital controls could be challenged under this article.[15] Furthermore, under paragraph 2 of article XVI (Market Access), once commitments about market access have been entered, it is no longer possible to set limits on such aspects as the size of the service, number of branches, types of products offered, legal character, and foreign capital participation. Most of these considerations could clash with attempts, for instance, to prevent banks from becoming "too-big-to-fail", to impose "ring-fencing" between deposit-taking and investment banking activities, or to function as a locally incorporated firm – with its own capital – rather than as a branch of a foreign institution. These are all areas of financial regulation currently being debated, and in some countries already being implemented.

When negotiating trade and investment agreements, governments wishing to re-regulate their financial systems should reject clauses requiring full capital flow liberalization and deregulation of financial services.

On the other hand, the GATS does contain provisions that reaffirm the right of countries to apply regulations. The fourth paragraph of the Preamble to the GATS reads: "Recognizing the right of members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right…". More specifically, in the Annex on Financial Services, art. 2 on Domestic Regulation contains a general reservation that allows countries not to comply, for some specific reasons, with their commitments on services liberalization, particularly that of financial services: "(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement".[16]

Despite the ambiguity of the last sentence, this "prudential carve-out" clause gives a legal basis for governments to undertake capital management measures in a preventive way; in other words, *before* undesired capital flows generate macroeconomic disturbances. Capital controls would therefore be a normal instrument in the policymakers' toolkit, not an exceptional and temporary device for critical times.

More generally, beyond GATS interpretations, governments willing to re-regulate finance should abide by that goal when they negotiate new trade and investment agreements. In many cases, they introduce clauses calling for full liberalization of capital flows and deregulation of financial services, in direct contradiction to the policies they apply or intend to apply in their own financial systems. In addition, as hinted above, the term "international investment" is sometimes broadened to include all sorts of capital flows, so that commitments not to restrict such flows would be much more stringent than what may have been initially intended. In such cases, legitimate efforts at capital management risk accusations of "murky investment protectionism".

3. *Macroprudential regulation and capital management*

(a) The need for capital management

In conditions of growing macroeconomic volatility caused by international capital movements, and given the relative inability of so-called "market confidence-enhancing policies" to bring about stability and long-term growth, developing-country policymakers resorted to managed exchange rates, lower interest rates and countercyclical fiscal policy. Since the global financial crisis, these growth-supporting measures started to find increasing acceptance in international policy circles, including among the international financial institutions.[17]

A number of countries managed to gain some room for manoeuvre in policymaking as a result of their accumulation of international reserves, reduction of external public debt and creation of fiscal buffers, made possible by a benign international economic environment in the 2000s. They responded to the global financial crisis by adopting a countercyclical fiscal policy and liquidity expansion, which helped stimulate their economies and support sectors that were more exposed to the external shock. They were able to use their international reserves to prevent excessive currency depreciation, thus helping to reduce inflationary pressures and protect sectors from currency mismatches in their balance sheets. They could also use those reserves to finance the larger current account deficits arising from expansionary policies and to counter any sudden contraction of external demand.

However, even these developing countries, along with their less fortunate counterparts who did not have the buffers described above, still face serious obstacles to more active macroeconomic policies in support of catch-up growth and structural transformation. An open capital account can present a severe constraint on autonomous monetary policy, which, for instance, could be used countercyclically when the economy is booming as a result of capital inflows, even when a floating exchange rate regime is in place.[18] Under these booming conditions, the alternative, as recommended by institutions such as the IMF, and supposedly favoured by financial markets, is to adopt a tight fiscal policy to manage aggregate demand. However, this policy choice can be problematic, since it implies spending cuts, generally in public investment. Yet, such spending is necessary to support sectors of the economy that are important for catch-up growth, structural transformation and social inclusion.

The pursuit of the policy goal of a competitive exchange rate is equally difficult. When a large volume of capital is flowing in, the central bank might have to intervene in the foreign exchange market to prevent currency appreciation by accumulating international reserves and undertaking sterilization operations to avoid an excessive increase in liquidity. However, these operations may be fiscally costly if domestic interest rates paid on issued bonds are much higher than those obtained on reserves.

These macroeconomic management difficulties suggest that a more effective approach to the management of capital flows would be to target them directly and up front, rather than just trying to mitigate their effects. For sure, it would be unrealistic to seek a complete delinking from the global financial cycle, and anticyclical and pro-growth policies in both the fiscal and credit spheres will remain of the utmost importance. However, reducing the volume and negative impact of unwanted capital flows would improve macroeconomic management and create the requisite space for pro-growth policies. Therefore, proper consideration should be given to establishing a framework for effective capital account management.

(b) Recent experiences with capital account management

Developing countries' experience with capital account management is nothing new, dating as it does back to the nineteenth century. Only a few months after many countries in Latin America had accumulated massive arrears on their debt service, and with some of them not being party to the Brady Plan – and running serious macroeconomic imbalances – a new cycle of massive private capital flows started. This was a result of the United States Federal Reserve's policy of near-zero interest rates as a solution to the fragile situation in this country's banking system. Many developing countries, not learning from their previous experience, again reacted to the easy supply of funds by introducing financial liberalization measures in the late 1980s and early 1990s. A few countries, however, created a specific mechanism of capital management to regulate the volume of capital inflows and their maturity. The ultimate goal of these controls was to mitigate the negative macroeconomic effects of inflows, such as exchange rate appreciation and the need for sterilization to address excess liquidity, which carried fiscal costs (Massad, 1998). Chile's experience with unremunerated reserve requirements (URR) is well known and has been widely discussed in the literature and in policy circles, but other countries also experimented with different sorts of controls during the 1990s. For instance, Colombia employed similar tools as Chile, and in Brazil controls took the form of an entrance tax on certain capital transactions, together with other restrictions, mainly on short-term fixed-income securities (Prates, 1998; Epstein et al., 2004).

Overall, controls on capital inflows proved successful in helping countries regain a certain level of monetary and fiscal policy autonomy, reduce exchange rate pressures and lengthen the maturity of flows. However, most of these controls were removed in the late 1990s, when capital became scarce with the onset of the East Asian crisis in the second half of 1997.[19]

When a new cycle of capital inflows started in 2002-2003, developing countries again had to find ways to manage them. Many countries responded by intervening heavily in their foreign exchange markets to avoid excessive currency appreciation and by building foreign reserves as a self-insurance mechanism. Other countries, such as India, never entirely removed their controls, maintaining restrictions such as ceilings on external borrowing abroad. The 2008 global financial crisis caused a sudden reversal of capital out of these developing countries, but it was short-lived as it was succeeded by a new cycle of large capital inflows, even exceeding pre-crisis levels in countries such as Brazil, Indonesia, the Republic of Korea and Thailand (IMF, 2011). As these flows again started to exert upward pressure on their currencies, in addition to creating excess liquidity, rapid credit growth and asset bubbles, several developing countries imposed new capital controls. Although varying in form and intensity across countries, these controls had the common purpose of taming the inflows in order to mitigate their negative macroeconomic effects.[20]

The measures adopted were related both to prices and quantities, including taxes on certain forms of capital flows, unremunerated reserve requirements, ceilings on different types of capital flows and derivative operations, and minimum stay periods (Ocampo, 2012). Brazil introduced taxes on portfolio inflows and later on derivatives; Peru increased its fee on the purchase of central bank paper by non-residents; the Republic of Korea reintroduced a withholding tax on foreign purchases of treasury and central bank bonds; Indonesia adopted a minimum holding period for central bank paper and a limit on short-term borrowing by banks; Thailand adopted a withholding tax on foreign investors in State bonds; and Turkey changed its withholding tax rate on bonds issued by Turkish corporations abroad, with lower rates for longer maturities. These countries also used macroprudential domestic financial regulations to influence capital flows, including reserve requirements on banks' short foreign exchange positions (Brazil), additional capital requirements for foreign exchange credit exposure (Peru), higher reserve requirements on foreign currency deposits (Indonesia), and ceilings on their banks' foreign exchange positions (the Republic of Korea).[21]

Capital management measures recently applied by developing countries provided greater scope for countercyclical policies in line with macroeconomic stability and sustained growth objectives.

During the period 2009−2010, these measures helped countries moderate capital inflows, at least for some time. In addition, continued interventions in the foreign exchange markets reduced upward pressures on their exchange rates. More broadly, the measures provided greater possibilities for macroeconomic policy management in line with countries' policy objectives of macroeconomic stability and sustained growth. For instance, a few countries, such as Indonesia, kept their interest rates unchanged despite strong capital inflows and possible overheating, and South Africa and Turkey even lowered their rates, although this was intended to deter even more flows rather than to maintain a pro-growth policy stance. In the fiscal area, Brazil and Turkey continued their expansionary fiscal policy, while Indonesia, the Republic of Korea and Thailand abstained from pursuing a more proactive fiscal policy to curb the inflationary effects of the inflows (IMF, 2011).

However, this new cycle of capital flows is proving shorter than previous ones. Between May 2013 and February 2014, turbulence in the international financial markets hit developing countries twice as a result of announcements of (and later initial steps towards) changes in United States monetary policy. These recent shocks have shown that developing countries remain vulnerable to sudden reversals of capital flows. This is despite capital account management and other precautionary measures that many of them undertook during the 2000s to restrain speculative capital inflows and reduce possible fallouts from their subsequent reversal. Those precautionary measures included the accumulation of international reserves, a reduction of the external public debt as a proportion of GDP, a lengthening of debt maturity and larger local-currency-denominated debt, as well as more stringent macroprudential regulation targeting currency mismatches in the domestic financial system (UNCTAD, 2014).

During these latest financial shocks, some developing countries have been using their reserves to try to neutralize their impact on the exchange rates, but others, lacking or not willing to use their reserves, have been adopting standard policy responses such as sharp increases in interest rates in order to halt currency depreciation and contain inflationary pressures, as well as fiscal tightening to restore or maintain market confidence. These policy responses demonstrate, once again, that implementation and maintenance of pro-growth policies are extremely challenging in the current international environment. This difficulty is aggravated by the frequency of financial shocks, which has limited the ability of affected countries to fully recover from previous shocks and rebuild their foreign currency buffers.[22]

This latest cycle of capital flows indicates that developing countries still have a way to go before they have fully effective capital account management. Indonesia's minimum holding period for central bank paper led non-resident investors to increase their holdings of government bonds, since the latter were not subject to the same holding requirement restriction. Brazil increased its tax on portfolio inflows twice, and extended its coverage to derivative transactions; it also introduced reserve requirements on resident banks' foreign exchange short positions to increase the effectiveness of controls (IMF, 2011). Indonesia's experience shows the difficulties that arise when controls are not extensive enough to contain inflows. Similarly, Brazil was initially timid and slow in introducing controls, and it was only after its policymakers adopted a wider range of controls that they succeeded in curbing inflows. However, the delay in strengthening controls meant that, by the time they gained teeth, substantial capital had already entered the country, so that it remained vulnerable to sudden outflows.

Capital account management should be strong, comprehensive and dynamic enough to plug possible loopholes that investors could exploit to their advantage.

The lessons to be learned from these country experiences are that capital account management should be strong, comprehensive and dynamic enough to cover possible loopholes that investors quickly exploit to their advantage. Moreover, capital account management measures should be supported by an administration that has the power and capacity to implement them effectively. Indeed, based on recent empirical analysis, Eichengreen and Rose (2014) argue that adjusting controls in response to cyclical needs is easier if the countries already have controls and the necessary associated bureaucratic apparatus. Furthermore, controls should apply to both inflows and outflows, and discriminate between different groups of financial actors, so that they target specific investors as well as specific types of flows in order to be effective (Gallagher et al., 2012).

These recommendations for capital management go beyond those made by the IMF (2012). This is because capital account management is not just a means of crisis management; it also has a fundamental macroprudential, and thus preventive, role to play. This is particularly true in view of the limited effectiveness of more conventional policy tools, such as flexible exchange rates and austere fiscal policy, to prevent growing macroeconomic imbalances resulting from capital flows.

Thus, in the current international economic environment, the short-term challenge for countries is to develop a macroeconomic management framework that is sufficiently strong and effective to deal with volatile private capital flows. The long-term challenge is for them to develop the capacity to deploy a wider range of instruments to ensure not just reduced volatility, but also sustained catch-up growth. In addition to a coherent macroeconomic framework, development and industrial policies need to use other instruments and mechanisms of capital management policies.

(c) Channelling capital to productive uses

Reducing instability arising from volatile capital flows may improve the capacity to use macroeconomic tools for growth-oriented policies and social inclusion; however, it does not guarantee that inflows will be used productively. To ensure their productive deployment, this has to be made an explicit policy objective. Capital account management should be used to try to influence the composition and maturity of flows. Thus long-term flows should be sought, and those of a speculative nature discouraged. Similarly, efforts should be made to attract flows that are more likely to finance investment rather than consumption. Several instruments are available to policymakers for managing the capital account for this purpose, including unremunerated reserve requirements and minimum stay periods aimed at lengthening the maturity of flows, or forbidding certain types of flows, such as investments in derivatives markets. Domestic banking regulations can also be used for encouraging or discouraging different kinds of foreign borrowing.

Still, although such capital account measures may indeed yield positive results, their power to influence the end use of external capital probably is somewhat limited. Due to the growing complexity of financial markets, it has become difficult to establish, *ex ante,* which flows are short- or long-term, and which will be used productively. This difficulty applies to all sorts of capital, including FDI, which is commonly viewed as more long term and often perceived exclusively as greenfield investment. However, FDI may also involve short-term bank loans as well as potentially destabilizing hedging operations, and it may be associated with mergers and acquisitions rather than with greenfield projects.

Apart from uncertainty about the nature of capital flows, capital account management has only a limited capacity to direct capital towards productive ends because, above all, the ways capital feeds into an economy and how it is ultimately employed largely depend on how a country's financial system is structured and regulated. After all, most of the capital that enters a country is mediated by the domestic financial system at some point or another.

Economic liberalization and reforms, which the majority of developing countries have undertaken during the past 35 years, have consisted mainly of deregulation of markets and privatization. These, have deprived their governments not only of macroeconomic policy tools, but also of financial resources and other policy instruments and levers necessary for growth and development. In the financial sector, deregulation of financial markets and, in many countries, privatization of State-owned banks have substantially reduced the number of instruments of industrial, financial and social policies. Productive investment has been particularly affected by these changes.

The hope was that privatization of financial activity would spur productive investment, structural change and growth through a more efficient allocation of capital, that is, by channelling capital to the most productive uses. But this has not happened: the private financial sector emerging from these reforms has not, by and large, filled the gap left by the withdrawal of the public sector from this area. Indeed, generally, the outcome has been just the opposite. Banks and other financial institutions have increasingly focused their activities on the provision of mainly short-term finance – largely consumption lending – instead of the long-term finance needed for infrastructural and industrial projects.

Thus, given how financial systems distribute domestic credit it cannot be expected that external capital channelled through them will be deployed for productive purposes either. It would therefore be necessary to reform national financial systems and policies in order to restore a country's capacity to provide finance for productive activities (*TDR 2013*, chap. III). These should include the following: measures by central banks and governments aimed at encouraging maturity transformation operations by commercial banks so that they provide more long-term credit; credit allocation policies in the banking system to support specific productive sectors or areas that are vital for development, such as basic infrastructure and research; and establishing institutions, particularly development banks, specialized in the provision of long-term finance. Development banks are critical institutions for developing countries because they provide long-term financing not offered by private banks, mainly for projects that are development oriented and generate positive economic and social externalities. Since they have clear mandates to fulfil this role, their capital and funding structure is designed to enable them to meet these expectations effectively.

Brazil is among the few developing countries with a strong network of development banks. At the centre of this network is the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), which provides loans and invests in firms' equity, as well as engaging in on-lending to other development banks. Funding for these loans and investments comes in different forms, including compulsory savings from Brazilian workers,[23] transfers from the treasury, government deposits derived from funds from privatization, bond issues and resources from multilateral organizations. Loans and investments are made in support of a wide range of industrial sectors (Chandrasekhar, 2014).

Like Brazil, the Republic of Korea counts on a number of development-oriented financial institutions, including the Korean Development Bank, which provides long-term credit for industrial activities drawing on funds derived from borrowing from the government, international financial institutions and foreign banks, as well as by issuing bonds. In Turkey, the Turkish Industrial Development Bank

(TSKB) is among the country's main development finance institutions. It is privately owned, as its equity capital base comes from the country's private financial institutions, but other sources of its funding also include the government and international financial institutions, such as the World Bank, the European Investment Bank and the International Finance Corporation. The TSKB is thus able to make loans and equity investments across a wide range of sectors of the Turkish economy. It also supports access by Turkish companies to credit from both domestic and foreign banks (Chandrasekhar, 2014).[24]

Examples of national development banks can also be found in some LDCs. Ethiopia, for instance, has three State-owned banks. One of them, the Development Bank of Ethiopia (DBE), provides long-term finance to priority sectors, as identified by the Government, such as commercial agriculture, agro-processing activities and manufacturing. Its funding base includes loans from the Commercial Bank of Ethiopia (another State-owned bank), concessional loans from donors and funds from the central bank, the National Bank of Ethiopia (NBE), which are raised through bond issues. The NBE, in turn, derives its resources from bills issued by it for purchase by the private banking system on a compulsory basis (Alemu, 2014).

These are examples of national development banks that have a funding base that carries long-term liabilities, or that are supported by government guarantees, which then permit these banks to finance long-term projects. A World Bank survey covering 90 development banks from around the world found that 64 per cent of those banks benefit from government guarantees for their debts and other liabilities, allowing them to borrow at lower costs and transfer this lower cost to their own borrowers (Luna-Martínez and Vicente, 2012). Moreover, these institutions have the ability to borrow abroad and then channel the resources to productive activities, or, like the Turkish development bank, they can help firms obtain resources abroad to finance real sector activities.

C. Policy space with regard to foreign investment

Attracting foreign capital is not a goal in itself. As discussed above, it may have positive or negative effects on both macroeconomic stability and economic development depending on its volume, its nature and its use. It is not surprising, then, that different authors have not found any positive relationship between capital inflows and growth (Bhagwati, 1998; Prasad et al., 2003; Stigltiz, 2004; Prasad et al., 2007), or, for that matter, a negative relationship (Aizenman, 2005). It is therefore clearly essential to have national policies for managing these flows, not only portfolio and short-term flows, but also longer term capital, including FDI. How much (or how little) TNCs contribute to economic dynamism and diversification, environmental conservation, technology transfer, tax revenues and a healthy trade balance depends critically on the macroeconomic and regulatory framework in the different locations in which they operate. Influencing their performance in some of those aspects has been a key ingredient of industrial policies, as observed in chapter V and previous UNCTAD research (see, for instance, UNCTAD, 2003 and 2012).[25] However, these tools have been progressively limited by the URAs, as well as by a large number of bilateral and plurilateral trade and investment agreements.

> The contribution of TNCs to economic dynamism and diversification depends critically on the macroeconomic and regulatory framework in the different locations in which they operate.

This section examines how policy space is being restricted by those agreements, and explores some possible ways to help overcome such restrictions.

1. Investment protection rules

(a) Rules governing investor-State relations

Traditionally, the main legal framework for foreign investment in every country has been provided by domestic law, which specifies the permissible investments by foreign companies, the procedures for their admission and implementation, and the obligations of investors. Domestic law also governs contractual relations between foreign investors and host countries. It normally guarantees to foreign investors settled in the country the same treatment by public authorities and legal guarantees as those accorded to domestic investors. In addition, several developing countries that give high priority to increasing inward FDI have passed specific investment promotion laws which provide various incentives to foreign investors, particularly tax incentives. In so doing, States are able to determine the content of their domestic laws governing investor-State relations and to resist, to a large extent, the jurisdiction of foreign courts (according to the principle of State immunity). In case of a legal dispute, foreign firms can resort to domestic courts, just like domestic firms (principle of national treatment).

This legal framework has seemed insufficient to potential foreign investors. Consequently, they have pushed for investment liberalization and supplementary guarantees for their property rights and expected profits. With the increase in FDI flows to developing countries and to several newly independent countries in the 1960s, international investors (almost exclusively from developed economies) sought the creation of a judicial body that would supplement or replace domestic laws and national courts in developing countries, which, in their view, did not meet high standards of independence and impartiality. The resulting North-South debate saw developing countries subscribing to the Calvo Doctrine that advocated the principle of national treatment, and the United States and European countries supporting the doctrine of an "international minimum standard" that required the protection of foreign investors under international law (independent from national laws).[26]

While the OECD conducted long discussions which eventually failed to create a judicial body that would supplement or replace domestic laws and national courts in developing countries,[27] the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, negotiated in parallel under World Bank auspices, was adopted in 1965. This Convention still governs investment protection today. It does not contain substantive provisions in this regard, but provides procedural rules for the settlement of disputes through arbitration. To that end, it created the International Centre for Settlement of Investment Disputes (ICSID), which is one of the five institutions constituting the World Bank Group.

A key ingredient of industrial policy has been to influence TNCs performance, but it has been progressively limited by the URAs and many other trade and investment agreements.

The lack of agreement on a common international legal framework for foreign investment despite several attempts since the 1960s has meant that there is no uniform regime governing investor-State relations. Different legal rules are found in a variety of bilateral and multilateral agreements concerning investment liberalization and investment protection (Schill, 2014).

Some rules on investment liberalization (e.g. rules reducing barriers to market access for foreign investors) can be found in international trade law. The TRIMs Agreement and the GATS contain investment-related regulations, as discussed in chapter V of this *Report* and in section B of this chapter. Provisions on investment liberalization, namely the right of establishment and free movement of capital, can also be found in EU law. Likewise, the OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations contain non-discrimination commitments by OECD member States, and thereby aim at investment liberalization in specific sectors.

However, most of the new international rules are embedded in bilateral agreements among States, which incorporate mechanisms for investment protection. By the end of 2012 there were 2,857 BITs and more than 339 investment chapters in free trade agreements (FTAs) (UNCTAD, 2013a). These agreements are based on similar general substantive principles, such as property protection and the rule of law, and generally include investor-State dispute settlement mechanisms (ISDS), which enable investors of signatory countries to demand the enforcement of the rights granted under the agreements by host countries. The above-mentioned ICSID and the United Nations Commission on International Trade Law (UNCITRAL) are the two most active arbitration centres. (When more than one possibility is allowed in the bilateral treaty, the choice is generally made by the investor.)

Since the 1960s, international investors have sought the creation of a judicial body to replace domestic laws and national courts in developing countries and obtain supplementary legal guarantees.

(b) Growing restrictions on policy space

By creating a dispute settlement mechanism in the absence of a comprehensive body of law, investment tribunals have gained a singularly important role: instead of applying pre-existing rules to the facts of individual cases they have generated the rules themselves.[28] This strategy has given an extraordinary power to arbitrators, especially because the terms of bilateral agreements protecting investments are generally vague and the legal framework in which they operate are extremely loose.

Indeed, few standards of protection in international investment treaties are crafted as specific rules that have a clear scope of application and target specific behaviour. Instead, they are crafted as loose and open-ended standards. The concept of "indirect expropriation", and the standards of fair and equitable treatment, national treatment, most-favoured-nation treatment, full protection and security, and free capital transfer are all formulated in a manner that leaves considerable scope for discretion by arbitral tribunals. Case law has shown that they can also be applied to measures taken by a host government, even when those measures are in the public interest, including implementation of a national development strategy. In fact, States may find that they are subject to commitments they never thought they were making when signing those treaties.

To begin with, the very definition of "investment" is not unequivocally made explicit in many treaties. What exactly is protected is therefore left to the judgement of arbitrators. A government may think it is giving special guarantees only to FDI, only to find out that other kinds of capital movements, in particular portfolio investments and sovereign debt, are also covered by a BIT. Therefore, in case it needs to restructure a foreign debt, holders of debt instruments (including vulture funds) may resort to ISDS to request the entire face value of the original debt instead of participating in the restructuring process (UNCTAD, 2011).[29]

Furthermore, the vagueness of investment treaty standards can unduly restrict the freedom of host governments to regulate in the public interest, and gives considerable power to tribunals. For example it is up to tribunals to determine what constitutes compensable indirect expropriation and non-compensable general regulation, the scope of national treatment, the content of fair and equitable treatment (FET), and the amount of flexibility it grants to government decision-making. In the latter case, the accepted interpretation of FET under customary international law (CIL) provides for compensation for denials of justice, understood as "denial of due process in court or administrative proceedings or denial of police protection". However, arbitrators have frequently adopted a broader interpretation of FET to include the right to a "stable and predictable regulatory environment", and therefore consider any changes in regulatory or tax policies as violating IIA provisions.[30] As a result, governments might find their normal functions circumscribed by the threat of having to compensate foreign investors if they introduce policy measures designed to respond to changing circumstances (such as financial crises[31] or new scientific findings) or to public demand with laws of general application (Wallach, 2012). The sole possibility of breaching an investment treaty can be sufficient to deter a State from taking any measure that might alter the business environment, even if this is necessary for economic, social or environmental reasons (so-called "regulatory chill").

A number of cases can be cited in this context, such as arbitrations in connection with Argentina's economic crisis in 2001-2002, water concessions in Bolivia, Argentina and the United Republic of Tanzania, an affirmative action programme aimed at remedying injustices remaining from the apartheid system in South Africa, banning of harmful chemicals in Canada and the United States, protection of the environment in Canada, Germany and Mexico, anti-tobacco legislation in Uruguay and Australia, and Germany's nuclear energy phase-out.[32] In these cases, the many vague legal terms used in BITs raise concern that arbitration tribunals may use them to curtail government measures aimed at protection of the environment, human rights and labour and social standards, or when dealing with financial crises, for the sake of investor protection, without considering the public interests involved.

The general idea behind the establishment of ISDS was to put "procedure before substance" with the expectation that this process would generate an accepted legal framework for international investment. However, this "procedure" has not been transparent and balanced enough for generating an accepted body of law. To begin with, this principle in itself transfers enormous power to a body of non-democratically elected arbitrators whose ruling often has been criticized (Eberhardt and Buxton, 2012).

Investor rights, such as receiving fair and equitable treatment, full protection and security of their investment, national treatment or protection from indirect expropriation, leave a wide margin of discretion to tribunals in determining the normative content of those principles and in applying them to the specific facts of a case. In fact, the principles of international investment protection are often so broad that it is appropriate to compare them with "general clauses" in civil codes that delegate substantial rule-making powers to dispute settlement bodies. Consequently, arbitral tribunals emerge as important lawmakers in international investment law when transforming the broad principles of investment protection into more precise rules which govern the way the executive, legislature and judiciary of a host State must conduct activities affecting foreign investors (Sornarajah, 2008). They are often able to do so, not primarily by applying the principles of treaty interpretation as enshrined in the Vienna Convention on the Law of Treaties (VCLT) or by having recourse to customary international law, but rather by turning to and relying on arbitral precedent.

Critiques of the investor-State arbitration mechanism focus on its consistency, transparency and pro-investor bias, and on its adequacy to address matters of public policy.

Such law-making through precedent raises concern because it enables investment treaty tribunals to take over a function that, in international law, is usually allocated to States, and that normally takes place through the conclusion of international treaties or the decision-making processes of international organizations. It is also problematic because there are usually only a few control mechanisms States can use to undo the decisions of the tribunals with which they do not agree and restrict the effect of those decisions as precedents for future cases. Sometimes, investment treaties provide for institutional mechanisms through which contracting parties to IIAs can issue joint interpretations of the underlying agreements that have binding effect on future arbitrations, but such mechanisms are still the exception. What is more, there is an imbalance between the potential system-wide effect of arbitral decisions as precedent and the bilateral structure of investment treaties in which States cannot generally be expected to monitor arbitrations to which they are not parties, or that take place under treaties to which they are equally not parties. This structure favours the interpretative power of arbitral tribunals to the detriment of the interpretative powers of States under international law. As these tribunals tend to treat the cases from the point of view of commercial arbitration, they cannot be expected to take into account the public law aspects of those disputes related to the scope of the host State's regulatory powers, including, for example, disputes concerning limits of emergency powers, regulatory oversight over public utility companies and the tariffs they charge, control or banning of harmful substances, the protection of cultural property or the implementation of non-discrimination policies. Therefore, they can hardly be expected to consider the interests of an economy as a whole and aspects of an overall development strategy.

(c) Increasing criticism of current arbitration procedures

Problems relating to arbitration procedure became more visible as more countries adhered to the system and more cases were brought by investors (Schill, 2011). Between 1965 and 2000, ISDS arbitrage centres registered only 50 cases (less than 1.5 cases per year on average), whereas by the end of 2013, the cumulative number of known cases had climbed to 568 (almost 40 cases per year on average since 2000) (UNCTAD, 2014). The most frequent critiques of ISDS procedure focus on its consistency, transparency and pro-investor bias; more generally, its legitimacy and adequacy to address matters involving public policies are increasingly challenged (see for instance Franck, 2005; Van Harten, 2007; and Van Harten et al., 2010).

The core of the criticism is that, while investment treaty disputes often involve matters of public policy and public law, the dispute settlement mechanism, namely investor-State arbitration, follows a model that has been developed for the resolution of disputes between private commercial actors.[33]

Such rules do not take into consideration the public interests that may be affected in investment treaty arbitration (Kingsbury and Schill, 2009). One procedural maxim is the confidentiality in investment treaty arbitration.[34] Confidentiality is a problem because those affected by arbitrations, in particular the population of the host State – including citizens and competitors of TNCs – cannot receive information about proceedings that impact their interests and their government's conduct.[35] Moreover, confidentiality restricts the possibility for domestic democratic processes to monitor arbitration proceedings and to assess whether they deliver a balanced and fair decision in foreign investment disputes. Confidentiality is also contrary to how disputes involving the government are usually settled in domestic courts, namely through open and accessible proceedings.

Closely related to the lack of transparency, is the issue of access of non-parties to arbitration, in particular those that intend to voice a specific interest relevant to the dispute. While such *amicus curiae* submissions are occasionally accepted by arbitral tribunals, the idea that arbitration is a party-owned process is at odds with opening up the proceedings to outsiders. This issue is increasingly often addressed in newer investment treaties and also in the 2014 UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration, but it remains problematic in a great number of cases.

Another major area of criticism by several governments, academics and civil society organizations concerns the standards of independence and impartiality of investment arbitrators and their professional ethics. In this context, a problem is that there are no rules that strictly separate the roles of arbitrator and counsel within investment dispute settlement system. Thus, except in cases of so-called issue conflicts, serving as arbitrators in one case, and as counsel in another is largely accepted in the practice of investment arbitration. Similarly, the ethical standards applicable to arbitrators and counsel are often rather open-ended and vague, leading to standards of independence and impartiality that are well below those applicable in domestic court proceedings. A recent study showed that the most prominent arbitrators had accumulated several roles, simultaneously or successively, including those of counsel, academic, government representative, expert witness and senior corporate positions. From their different positions, they have been able to promote a system from which they benefit (Eberhardt and Buxton, 2012). Moreover, arbitrators have pecuniary and career interests in accepting cases on behalf of investors, and therefore in making an expansive interpretation of investment rules, which leads to more cases. An empirical study by Van Harten (2012) analysed how investment arbitrators resolved the admissibility of claims in cases on which an investment treaty is ambiguous or silent. He found that, in the resolution of contested issues, they tended to favour claimants by a broad interpretation of the investment treaty and by allowing more claims to proceed.[36]

> Arbitration tribunals follow a model developed for resolving disputes between private commercial actors, and thus have no reason to consider the broader interests of a host country and its development strategy.

The ease of suing a State before the ISDS gives the investor strong leverage against the host State. Even if it does not result in a final resolution, the mere possibility of a case being taken to the ISDS alters the terms of any negotiated settlement. In several instances, settlements have included some payments or commercial advantages given to investors in exchange for their withdrawal of the claim which the host government would probably not have granted without the threat of an onerous fine.

The pro-investor bias of ISDS schemes can be partly explained by the incentives structure for arbitrators, but, more generally, it may also result from the very nature of the ISDS: it has been designed for providing supplementary guarantees to investors; not for making them respect host-country laws and regulations. Investors, not States, are the ones that can therefore initiate a case, and can even choose the arbitration centre. Therefore, TNCs with a presence in several countries can also choose the treaty they will invoke by establishing their residence accordingly.

Hence, international investment law does not include any enforceable obligations on the part of the investor with respect to, for instance labour standards, human rights or environmental protection. Rather, obligations that directly bind foreign investors are mainly contained in the domestic law of the host State. However, it is not always easy for a State to obtain reparation from a foreign investor due, for instance, to tax avoidance (case of Mali against Randgold; see chapter VII, section D) or to environmental damage (e.g. the case of Ecuador against Chevron). Indeed, sometimes ISDS mechanisms have been used by TNCs to retaliate against prosecution for their alleged wrongdoing.

This shows an asymmetry of governance in international relations: while investment protection is deeply enshrined in the current investment framework based on IIAs, competing interests, both public and private, rights of States and obligations of foreign investors are not enforced at the international level through comparable institutions. Moreover, while human rights are protected under human rights treaties and environmental concerns are protected under international environmental law, these international regimes have much weaker dispute settlement and implementation mechanisms than the investment treaty framework.[37] This also has a direct implication for policy space: governments that attempt to introduce policies in the direction of a progressive realization of the various human rights of their citizens, including the right to development, or to prevent their rights from being violated by the actions of international investors, may face problems related to the stipulations of investor protection in various trade and investment treaties.

Only a few years after the first investment treaty arbitrations started, the problem of inconsistent decisions and parallel proceedings became apparent. It arose after two arbitral tribunals constituted under two separate BITs heard different disputes related to the same facts, and arrived at opposite judgements.[38] Similar inconsistencies in arbitral jurisprudence also arise in relation to interpretations of identical, or essentially comparable, clauses in different BITs or to the same rule of customary international law by different tribunals. Notorious examples are the inconsistent interpretations of most-favoured-nation clauses − in particular arising from arbitral procedure and arbitral jurisdiction − the interpretation of umbrella clauses, the application of the defence of necessity and non-precluded-measure clauses in IIAs, as well as the treatment of procedural access to arbitration requirements.

The lack of consistency is an obvious obstacle to the strategy of generating the "substance" of international investment law through convergence in the jurisprudence of arbitral tribunals. Nevertheless, it seems that precedent is increasingly used by arbitral tribunals in different ways, such as adopting relatively cautious approaches, where precedent serves as an indication of the ordinary meaning of a treaty provision[39] or as a "source of inspiration"[40] for interpretation; or for more imposing uses, whereby precedent becomes a standard-setting device or even an instrument of system-wide law-making.[41] Nonetheless, the danger of inconsistent decisions persists because of the applicable law enshrined in bilateral treaties being couched in vague terms, whose interpretation is left to one-off arbitral tribunals rather than to a permanent and centralized judicial system.[42] More fundamentally, following precedents does not mean improving the fairness and rationality of the system if some past rulings were themselves flawed, and were neither annulled nor corrected by the ICSID annulment committee even after having identified "manifest errors of law" (UNCTAD, 2014: 3).[43]

2. The current debate on investment protection rules and policy proposals

(a) The need for change

As already mentioned, during the 1990s, there was a proliferation of investment treaties, including the ISDS, at a time when FDI was seen as the key to unlocking a country's development potential, and indeed was viewed almost as a goal in itself. At that time, the dominant economic thinking opposed active intervention by the State in the economy. In that context, it was believed that losing policy space was not a high price to pay for an expected increase in direct investment inflows.

This perception began to change in the 2000s. In particular, the impact of FDI on economic performance – including fixed investment, technology transfer, provision of public utilities, fiscal revenues, employment, exports and balance of payments – proved to be less significant and more contingent than expected in countries where it was not accompanied by strong industrial policies. However, it also became apparent that investment-related rules could obstruct the policies aimed at improving the impact of FDI on the economy. This was reflected in the sharp rise in the number of cases brought to arbitration mechanisms as a response to government policies in a number of countries. At the same time, econometric studies on the impact of BITs on FDI flows reached ambiguous results,[44] with several studies finding that the existence of BITs or other arrangements that incorporated investment protection had a minor influence – if any at all – on bilateral FDI inflows from developed to developing countries (see annex to this chapter).

While benefits from BITs became less evident, the financial costs they could involve clearly appeared, and they were sometimes exorbitant and difficult to justify.[45] From governments' point of view, the perceived cost-benefit equation of IIAs, involving the loss of policy space on the one hand and encouraging FDI flows on the other, began to change, prompting a general re-examination of such agreements – particularly of their main juridical instrument, ISDS mechanisms.

Somewhat paradoxically, new negotiations of investment treaties which mostly replicate the features of the old ones are under way at the same time as vigorous discussions are taking place about the net usefulness of such treaties, the serious problems they present for contracting governments, and the fact that they may not comply with some basic principles of international law. Those principles can be found in United Nations constitutional law and in comparable domestic constitutional laws. One basic principle is the protection of *self-determination* which reflects the right of host governments to set their development strategies independently and implement them accordingly.[46] The principle of self-determination therefore provides the basis for a claim for sufficient policy space and for allowing host governments to control and regulate foreign investors in the public interest and in line with overall economic policy and longer term development strategies.

The principle of *sovereign equality* requires that investment rules should not be asymmetrical or one-sided to the detriment of certain States.[47] This not only excludes treaties that impose obligations on just one class of contracting parties (i.e. capital-importing developing countries); it also excludes treaties that one-sidedly benefit one class of contracting parties and their investors, namely capital-exporting countries, without recognizing at the same time the duties of investors and their home States to ensure that both capital-importing and capital-exporting countries should be able to benefit from their sovereignty by being allowed to introduce regulations in the public interest.

The protection of *human rights* is a further principle of United Nations constitutional law that should inform international investment relations.[48] Together with the protection of property, due process and access to justice to all investors, national or foreign, this principle stresses the responsibility of host States to regulate foreign investors effectively in order to protect the human rights of their populations, including for instance, the right to a safe environment, drinking water and public health. This responsibility should also be extended to the macroeconomic and industrial policies needed for *development*, which is another essential objective of United Nations constitutional law.[49]

While problems arising from the current international investment framework based on IIAs are increasingly recognized (even by actors that previously championed those agreements), there is less consensus on how to resolve them. Some observers who believe the system should be substantially reformed propose a variety of changes, and methods to implement them; others believe that countries should avoid even entering into such treaties, and indeed should consider exiting from those they may have already signed, as discussed below.

(b) Reforming international investment rules, an arduous task

An essential characteristic of a good legal system is that it can be amended to correct its shortcomings or to be adapted to the changing preferences in the community it applies to. This points to another problem of the present investment law system: it is difficult to reform.

In the last few years, there have been a number of initiatives and proposals for reforming the current rules on international investment to better safeguard policy space for host States (see in particular UNCTAD, 2013b). Proposed reforms suggest that substantive standards in future treaties be clarified and improved, and the procedures relating to investor-State arbitration changed to ensure that investment treaties are interpreted in a way that is acceptable to all stakeholders involved.

> Recognizing the problems arising from the current international investment framework based on IIAs, some observers believe the system should be substantially reformed…

Regarding the first issue, clarifications of investment protection rules could include considering the breadth of what kinds of investment are protected under the treaties and who is protected as an investor.[50] Changes could specify whether sovereign debt should be protected as direct investment, or whether there should be special rules with regard to debt, as is the case in some more recent investment treaties.[51] Treaties could also reaffirm States' right to regulate in order to protect the environment, public health and safety, social concerns and cultural diversity, and clarifications to this effect could be introduced in the key provisions on indirect expropriation, and FET. These considerations were incorporated, for instance, in the investment chapter of the Canada-EU Comprehensive Economic and Trade Agreement, which stressed the intention of both contracting parties to conclude a treaty that respects the parties' right to regulate.

Regarding dispute settlement, the Canada-EU treaty, as well as the EU's investment policy more generally, includes investment treaty provisions that prevent investors from filing multiple claims at the international and national levels, and rules that allow arbitral tribunals to filter out spurious or frivolous claims at an early stage of arbitral proceedings, thus avoiding high costs of a full hearing. Furthermore, transparency of arbitration proceedings is strengthened through reference to the new UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration that became effective on 1 April 2014. Additionally, stricter rules on professional ethics for investment arbitrators are to be included in future EU investment agreements. In the Canada-EU treaty, the contracting parties have also agreed to a roster of arbitrators, thereby restricting who can act as arbitrator in the disputes under the agreement. This is a key issue, as one of the basic principles in international law is that arbitrators must be explicitly approved by all litigating parties, a principle that procedures in ICSID do not respect.[52] The treaty also states that the contracting parties have agreed to consider creating an appellate mechanism for arbitral awards in the future in order to ensure consistency and increase the legitimacy of the system. Finally, mechanisms for joint interpretation of the governing agreement are included, as are mechanisms for the contracting parties to jointly filter out arbitral proceedings in the financial sector.

This approach faces several limitations. First, even if definitions in new treaties are drafted more clearly and precisely, there is no guarantee that this will translate into actual rulings, as shown in the case of Railroad Development Corporation (RDC) against Guatemala. In that ISDS case involving the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR), the Government of the United States attempted to restrict the possibility of interpretation of "fair and equal treatment" by means of a customary international law annex, but the tribunal ignored the annex, still interpreted the FET broadly and found the Guatemalan Government guilty.[53]

Second, changes would only apply to new agreements, leaving all the previously agreed unchanged – unless they are renegotiated, which would require the agreement of all the governments involved. As the treaties will remain bilateral in form, any improvement will only have effect for the bilateral agreement in question. In this framework, restrictions of the scope of investment protected in some treaties may be circumvented by foreign investors by invoking most-favoured-nation clauses or by structuring their investments to come under a different treaty that provides more favourable provisions on investment protection.

… while others believe that countries should avoid even entering into such treaties, and indeed should consider exiting from those they may have already signed.

To face the problems of such "piecemeal approach", other proposals aim at reforming the arbitration system all IIAs would refer to. Functioning of arbitration centres can be modified. For instance, a reform to ICSID Convention could ask contracting States to pre-approve a number of potential arbitrators from the Panel of Arbitrators established in section 4 of the Convention, limiting the discretionary power the President of the World Bank currently exercises.[54] More ambitious proposals suggest creating an appeals facility, or replacing ad hoc arbitration tribunals with an international investment court, with judges appointed by States on a permanent basis (Van Harten, 2008). Such institutions, it is argued, would give more coherence to international investment law: although they should still interpret hundreds of potentially dissimilar treaties, at least the interpretations would be more coherent than that provided by numerous ad hoc tribunals (UNCTAD, 2013b). But these institutions, while potentially leading to more convergence in international investment law, could also develop the law in directions that states did not foresee and may not control. Centralisation may lead to more coherence, not necessarily to more fairness.

Changes to the current system cannot be limited to processes. As discussed earlier, one of the roots of the present flaws of ISDS was procedure coming before substance. This put in the hands of a reduced number of non-democratically elected arbitrators, working without control, coherence or transparency, the role of generating a corps of law on international investment. It is not only the procedure for dispute settlement that must be improved, it is the whole logic that must be changed: substance must be redefined, in a way that respects the constitutional basis and principles presented in subsection (a) above. It must also recognise that the issues involving governments and a country's policy space are consubstantial to public, not to private law. Public and private laws do not only differ because they apply to different subjects of law, but also because of deep differences in their respective content and inspiration. Private law applies to private individuals that are considered equal before the law, while in public law, what is relevant is the general interest which is pursued by public persons. This is why different solutions are given to problems that in themselves might appear comparable or even identical (de Laubadère and Devolvé, 1986). In a nutshell, general interest prevails in public law interpretations, and private interests in those of private law. Re-examination of the legal principles should lead to a radical reorientation of how these disputes are handled: in particular, "a private model of adjudication (i.e. arbitration) is inappropriate for matters that deal with public law" (UNCTAD, 2013a: 116; see also Van Harten, 2008).

Can a multilateral institution provide an alternative framework based on public law? An answer to this question should examine several unsolved issues, addressing in particular that of the one-sided logic in which investors are always the claimants and governments the respondents. More generally, it should discuss whether it will remain a mechanism for solving disputes between states and private investors, or will need to provide a state-to-state dispute solving mechanism as does, for instance, the WTO. Furthermore, countries may want to preserve their own interpretation of public law, reflecting national values and choices, rather than accepting a uniform corps of law in which definition they may have little say. This has been a key concern, which explains the reluctance of most developing and also some developed countries to accept initiatives like the Multilateral Agreement on Investment (MAI), negotiated in the OECD between 1995 and 1998.

(c) Terminating treaties and reverting to national law

Strictly speaking, ISDS mechanisms do not address the problem that justified their establishment. If the judicial system of a country does not provide independent justice or enforce the rule of law (including the protection of private property), the appropriate response should be to fix those shortcomings, rather than allow a select group of agents (i.e. foreign investors) to seek justice elsewhere. This would tackle the root of the problem without renouncing important aspects of national sovereignty, and without breaching the principle of equality before the law by giving foreign firms an advantage over domestic firms.

For sure, improving the domestic judicial system may be difficult and may take time, but relying on a system based on BITs and other IIAs cannot be considered an alternative to such reforms, because such a system has serious legal flaws, sacrifices national legal sovereignty and can obstruct the pursuit of national policy objectives. Where necessary, filling gaps in the domestic legal system should be given priority over allocating scarce juridical and administrative resources to negotiation of such international treaties and defending the State from subsequent cases presented to ISDS tribunals. In addition, even if policymakers give high priority to attracting FDI, there is no solid evidence that these treaties increase such investment significantly (see the annex to this chapter). And even if entering in IIAs may increase the attractiveness of developing countries for TNCs, it would only complement other more fundamental motivations for FDI, in particular the general performance of the host economy (UNCTAD, 2009). Hence, if the loss of policy space and the financial charge those agreements may involve to governments affect negatively the economic growth, it would not only lessen FDI inflows, but also weaken their potential contribution to faster growth and structural transformation. From the host governments' point of view, they would pay a high price in terms of lost policy space and potential fines in return for few, if any, gains.

On these grounds, it might be sensible not to sign such treaties, a decision already taken by a number of developing countries. But what if a country has already signed? Renegotiating existing agreements may be an alternative, but it presents many difficulties, as already discussed. Most of all, it does not address the "original sin" of IIAs, which is reducing governments policy space by applying private commercial law to public matters (and, in addition, in an unbalanced way, since the claimant can only be the investor). The question would not be, then, just to obtain more "balanced" IIAs, but to revolve to public law, which privileges general interests over private ones. Another strategy pursued by some countries is to terminate their investment treaties and/or withdraw from the ICSID Convention. For example, Bolivia, Ecuador, and the Bolivarian Republic of Venezuela have withdrawn from the ICSID Convention; some countries, including the Czech Republic, Ecuador, Indonesia, South Africa and the Bolivarian Republic of Venezuela, have already terminated investment treaties or have announced the widespread termination of their treaty programmes.

The rationale behind such action is to once again have investor-State relations governed by domestic law and domestic courts only. For example, in South Africa protection under investment treaties is intended to be replaced by a Promotion and Protection of Investment Bill. In some countries this does not necessarily eliminate arbitration in forums other than ICSID and the problem of following different legal standards. Ecuador has proposed the creation of a mechanism within the Union of South American Nations (Union de Naciones Suramericanas − UNASUR) that would apply different legal standards.[55] Other countries, such as the Czech Republic and Indonesia, have chosen to retain some investment protection under other international legal agreements (e.g. ASEAN and the EU, respectively).

Terminating investment treaties and/or withdrawing from the ICSID Convention involve various preconditions and limitations (UNCTAD, 2010 and 2013a). First, in order to be effective, a host State has to withdraw from all of its investment treaties; otherwise, investors will be able to structure or restructure their investments so that they come under the scope of protection of one of the remaining investment treaties. Second, the termination of investment treaties affects new investments but does not usually immediately end the protection of existing investments, since most investment treaties have survival or sunset clauses that extend such protection to between 10 and 15 years. In order to circumvent the survival clauses in investment treaties, the Czech Republic has chosen a somewhat different approach to terminating investment treaties with the consent of some of its investment treaty partners. In a first step, its treaty partners have agreed to amend the survival clauses to state that they no longer apply; in a second step, the treaty partners have agreed to jointly terminate the investment treaty with immediate effect. Finally, concerning withdrawal from the ICSID Convention, most investment treaties contain the host State's consent to various arbitral forums, including arbitration under the UNCITRAL rules, or ad hoc arbitration. Withdrawing from the ICSID Convention only will therefore not signify a complete exit from the investment treaty and from the investor-State arbitration system, although it may reduce an investor's choice by eliminating the institution that has been criticized the most with regard to transparency and fairness.[56]

In any event, retreating from an investment treaty remains an option that a sovereign country may take without depending on the approval of other actors, and it has an immediate impact on all new foreign investments. In addition, terminating a treaty could also be a negotiating strategy for reforming existing ones, pushing for a complete revision of the present system and recovering some policy space in the process.

D. Summary and conclusions

Foreign capital flows to developing and transition economies may support investment, economic diversification and growth, or generate macroeconomic instability, external imbalances and boom-and-bust credit episodes. The effects are highly dependent on their amount, composition and use. Governments need to apply capital management policies in order to establish a suitable macroeconomic framework for investment and growth, influence the amount and type of capital inflows and channel them to productive uses. This is also true for FDI, as its contribution to structural change, technological upgrading, access to world markets, employment generation and output growth depends critically on the regulatory and policy framework in the host country. However, different trade and investment agreements may reduce the scope for host-country governments to regulate capital movements and curtail their ability to influence the behaviour of investors to ensure that FDI supports their development strategy.

This chapter has looked at the ways in which developing and transition economies are affected by a global financial cycle that is mainly driven by developed countries' economic conditions and monetary policy decisions. The resulting capital movements do not necessarily coincide with the needs of developing countries. Besides, given their magnitude and volatility, they tend to generate disruptive macroeconomic and financial effects. Indeed, international capital flows generally create a financial cycle in the receiving countries. Capital inflows tend to result in an increase in domestic banks' credit supply, and an appreciation of domestic assets and the exchange rate. These effects, in turn, tend to increase financial fragility, as growing indebtedness and deteriorating current accounts eventually lead to a reversal of those flows and, possibly, a financial crisis.

For macroprudential and developmental reasons, governments need sufficient policy space to be able to manage foreign capital flows, influence their amount and composition, and channel them to productive uses. In order to create and maintain domestic macroeconomic and financial conditions that support growth and structural transformation, governments should have at their disposal suitable policy instruments for managing capital flows and for preventing or coping with the recurrent shocks they could provoke. This requires the preventive use of capital management measures as a normal instrument in policymakers' toolkit, rather than as an exceptional and temporary device to be employed only in critical times. Several developing countries have recently applied capital account management measures that, despite some shortcomings, can be credited with reducing their financial vulnerability and increasing their resilience when the global financial crisis started.

There may be de facto and de jure obstacles to the implementation of capital management policies. The first is related to the action of financial agents and the second to formal commitments taken in favour of capital liberalization. On the latter, despite some diverging views, it seems that multilateral rules in the IMF's Articles of Agreement and in the WTO's GATS enable governments to manage their capital accounts for prudential reasons, including through capital controls. However, some new bilateral and/or plurilateral agreements that have been signed or are being negotiated introduce more stringent commitments with respect to financial liberalization that might greatly reduce policy space in this context. Therefore, governments that aim to maintain macroeconomic stability and wish to re-regulate their financial systems should carefully consider the risks of taking such commitments.

This chapter also analyses how the rules embedded in IIAs could restrict governments' policy space and how these restrictions may impact on their development possibilities. Such agreements can help policymakers to focus on how best to attract FDI. But taking a historical perspective, it shows the changing perception of these agreements. When most of the IIAs were signed in the 1990s, it was believed that any likely loss of policy space resulting from those agreements was a small price to pay for an expected increase in FDI inflows. This perception began to change in the early 2000s with growing concerns that investment rules could obstruct policies aimed at improving the impact of FDI on the economy. This is reflected in the sharp rise in the number of cases that investors have brought to arbitration as a response to government policies, sometimes entailing high financial costs to States. Moreover, after several decades of operating IIAs, there is no strong empirical evidence that they significantly increase FDI inflows, which has been their main *raison d'être*.

The most controversial aspect relating to IIAs' impacts on governments' policy space is the ISDS, which takes the form of arbitration tribunals aimed at enforcing the general rules stated in those agreements. As those rules are frequently crafted as loose and open-ended standards, the tribunals have a wide margin of discretion in determining their normative content. Consequently, arbitration tribunals have become important lawmakers in international investment law, assuming a function that is usually allocated to States. In addition, the lack of transparency and coherence often observed in the operations of those ad hoc tribunals, and their apparent pro-investor bias, have given rise to concerns about the entire dispute settlement mechanism. This has led to different initiatives related to ISDS with the aim of recovering the space for national development policies. These include: (i) progressive and "piecemeal" reforms, including adding new principles for drafting sustainable development-friendly agreements and renegotiating bilateral treaties one at a time (UNCTAD, 2013b); (ii) the creation of a centralized, permanent international investment tribunal; and (iii) retreating from investment treaties and reverting to national law.

If the reason for establishing ISDS is to respond to failures in national judicial systems that do not provide independent justice or enforce the protection of private property, the appropriate response should be to fix those shortcomings, rather than allowing foreign investors to seek justice elsewhere. The legal framework for international investment based on IIAs and on ad hoc arbitration tribunals has failed so far to provide a legitimate alternative to national courts. As investment disputes often involve matters of public policy and public law, the dispute settlement mechanism can no longer follow a model that was developed for the resolution of disputes between private commercial actors. Instead, it should take into consideration the public interests that may be affected in investment treaty arbitration.

Notes

1 Long-term capital flows that finance capital formation may include greenfield investments and some long-term credit or portfolio investments. However not all FDI flows (e.g. mergers and acquisitions) expand productive capacity, and neither are they all long-term capital flows (e.g. intra-TNC short-term credits).

2 For an earlier discussion of related issues, see *TDR 2006*, chaps. IV and V.

3 Rey (2013) highlights the interdependence between risk perceptions, leverage and global capital flows, evidenced by the fact that receiving countries and regions borrow them at the same time. As noted by Rey, "There is a global financial cycle in capital flows, asset prices and credit growth. This cycle co-moves with the VIX, a measure of uncertainty and risk aversion of the markets." She further observes, "…one important determinant of the global financial cycle is monetary policy in the centre country, which affects leverage of global banks, credit flows and credit growth in the international financial system" (Rey, 2013: 17). Therefore, the volume of cross-border lending/borrowing is determined by events in countries where the big financial institutions channelling the lending are based.

4 Carry trade refers to capital flows motivated by the opportunity for arbitrage profits that can be had from differentials in nominal interest rates in different countries, and by the expectation of exchange rate appreciation in the destination country (see *TDR 2011*, chap. VI).

5 In discussing the interactions between politics, credibility and confidence, Martínez and Santiso (2003) show, for example, how perceptions of Wall Street investors about the sustainability of Brazil's national debt suddenly changed in a matter of days during that country's presidential elections of 2002.

6 See Grabel (2000) for an extensive discussion of the relationship between policy credibility and confidence-building in emerging markets.

7 A good example of this view is that of Domingo Cavallo, Minister of Economy in Argentina in April 1995, at the time of the "tequila" crisis: "Few would dispute that capital inflows of the early 1990s helped the Argentine economy. But I would argue, more controversially, that the capital outflows that Argentina has experienced more recently have helped, too. They helped because, in spite of the Argentine economy's impressive progress toward transparency during the last few years, some politicians still did not get the message (i.e. that fiscal discipline was necessary). (…) Thanks to the pressures exerted by the recent outflows, several important reforms that the executive branch had proposed to the Congress year after year without success have at last been approved" (Cavallo, 1996: 47).

8 For an early account of country experiences with capital inflows and outflows since the early 1990s, see Gavin et al., 1995; for a more recent analysis, see Akyüz, 2013. On the role of confidence-building policies in explaining macroeconomic outcomes, see Bresser-Pereira, 2001.

9 International reserves held by developing countries increased from $1,350 billion to $4,257 billion between the end of 2002 and the end of 2007 (IMF, *International Financial Statistics* database).

10 Developing countries have also adopted new regulatory measures in their banking systems, including supervisory rules and credit orientation. In Argentina, for example, the reform of its Central Bank Charter in 2012 gave that bank the authority to direct bank credit on various grounds.

11 Directive 88/361/EEC, June 24, 1988, art. 63 of the Consolidated Version of the Treaty on the Functioning of the European Union.

12 The most frequent reservations apply to FDI in banking, broadcasting, energy, primary sectors, telecommunications and transportation. Reservations are regularly examined by the OECD with the aim of assisting members to eventually withdraw their reservations.

13 The GATS is a positive-list agreement (i.e. countries list their commitments in terms of mode and the specific services they will liberalize, but retain autonomy over all other sectors (see also chapter V, section B.1)). It defines four different modes of supply for delivery of services: Mode 1 refers to cross-border trade, Mode 2 refers to consumption abroad, Mode 3 refers to the commercial presence in

the territory of another member (FDI), and Mode 4 refers to the presence of the service supplier in the territory of another member.

14 In particular, in 2009 and 2011, the Republic of Ecuador, at the Committee of Trade in Financial Services of WTO, argued for the need to clarify the wording of some articles of GATS and the Annex on Financial Services relating to macroprudential measures and, most specifically, capital flows management. The issue was far from settled but remained on the agenda of the Committee. Subsequently, at its meeting in March 2013, various countries made presentations on their macroprudential framework, but no consensus was reached as to whether their framework was compatible with the relevant GATS provisions.

15 Also, under art. XVI (Market Access), part III, if a Member has granted access to a service provided from the territory of another Member, it must allow the capital movements which are "essentially part" or "related" to the provision of such a service.

16 At first glance, the second sentence seems to cancel the first one, that is, there would be no room to regulate anything going against a commitment previously entered into. But it has been argued that, first, the statement, "notwithstanding any other provisions of the Agreement…", provides an exception for measures taken for prudential reasons, which could mean that even if inconsistent with a member's general obligations and specific commitments, they would still be legally allowed. Second, the list of prudential measures is merely indicative, as revealed by the word, "including". Therefore, any other measure taken for "prudential reasons" could be acceptable. Moreover the measure may not even have to be "prudential", but simply taken for "prudential reasons". Third, as to the second sentence, it has been argued that it only imposes an obligation of good faith in adopting those "measures for prudential reasons", implying that they cannot be ad hoc in order to avoid obligations entered into (see Leroux, 2002; Von Bogdandy and Windsor, 2008).

17 However, this acceptance is not uniform, as mentioned above when discussing the IMF's ambiguous position vis-à-vis such policies.

18 See, for example, Rey (2013), who argues that, in international macroeconomics, countries do not face a "trilemma" but a "dilemma"; that is to say, that "independent monetary policies are possible if, and only if, the capital account is managed".

19 In Chile, capital controls implemented in the early 1990s enlarged not only monetary policy space, but fiscal space as well. As the new elected government intended to expand public expenditure and social transfers, it sought to control aggregate demand and inflation by raising interest rates, and the only way to prevent this from leading to excessive capital inflows that would have affected monetary policy was by means of capital controls on inward FDI. In 1998, Malaysia responded to the crisis in the region by adopting controls on capital outflows − rather than on inflows as other countries had done in the early 1990s − in order to stem these outflows and regain control over macroeconomic policy (Ariyoshi et al., 2000).

20 See, for example, Eichengreen and Rose (2014), who discuss the rationale underlying the adoption of these controls by countries like Brazil, Indonesia, Thailand and the Republic of Korea.

21 Although the focus was on restraining inflows, some countries, such as Peru, the Republic of Korea and South Africa, also changed their regulations aimed at encouraging more capital outflows (IMF, 2011: 30–34).

22 See, for example, IADB (2014), which notes that in Latin America, for instance, both actual and structural fiscal balances have deteriorated alongside the increase in public debt ratios since the 2008 global crisis. This emphasizes the need to rebuild buffers in the region to give countries sufficient fiscal capacity to respond to future shocks.

23 In Brazil, the Fundo de Garantia de Tempo de Serviço (FGTS) is a severance indemnity fund for workers, generated by mandatory contributions by employers of up to 8 per cent of wages, which are deposited in a public development bank, the Caixa Econômica Federal.

24 See also: IDFC, 2014, at: http://www.idfc.org/Members/tskb.aspx (accessed 21 March 2014).

25 According to UNCTAD (2003: 87), "Attracting FDI may not be enough to ensure that a host country derives its full economic benefits. Free markets may not lead foreign investors to transfer enough new technology or to transfer it effectively and at the depth desired by a host country. But policies can induce investors to act in ways that enhance the development impact—by building local capabilities, using local suppliers and upgrading local skills, technological capabilities and infrastructure." More recently, UNCTAD (2012: 102) included among the "key investment policy challenges" the need to "connect the investment policy framework to an overall development strategy or industrial development policy that works in the context of national economies, and to ensure coherence with other policy areas, including overall private sector or enterprise development, and policies in support of technological advancement, international trade and job creation. 'New generation' investment policies increasingly incorporate targeted objectives to channel investment to areas key for economic or industrial development and for the build-up, maintenance and improvement of productive capacity and international competitiveness."

26 The UN Resolution 1803 of the General Assembly of 1962 on Permanent Sovereignty over Natural Resources, UN Doc A/RES/1803(XVII), 2 I.L.M. 223 (1963) represents a compromise on this issue, although it clearly recognizes the ownership of natural resources by the people of the producing countries.

27 Draft Convention on the Protection of Foreign Property and Resolution of the Council of the OECD on the Draft Convention, 7 I.L.M. 117 (1968).

28 When creating the ICSID in the mid-1960s, Aron Broches, then General Counsel of the World Bank, championed the formula, "putting the procedure before substance". In order to overcome the impasse in finding a global consensus on rules of property protection during the times of decolonization and the Cold War, he advocated setting up a framework for resolving investor-State disputes that could work out substantive rules on the go.

29 Three cases against Argentina have been accepted by ICSID, under the Argentina-Italy BIT.

30 Some treaties include partial exceptions for taxation measures, stating that if both home and host governments agree within the specified period that a tax measure is not expropriation, then the investor cannot challenge that tax measure under the ISDS.

31 For instance, Argentina was forced to sharply devalue its currency in early 2002, which resulted in a large number of claims against the country. Similarly, a claim was opened against Cyprus for taking over a bank in 2012 to avoid the implosion of its banking system, and another against Greece due to its renegotiation of sovereign bonds.

32 See respectively: 1) CMS Gas Transmission Co v. Argentine Republic, ICSID Case No. ARB/01/8, Award, 12 May 2005; LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc v. Argentine Republic, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006; BG Group plc v. Republic of Argentina, UNCITRAL, Final Award, 24 December 2007; Continental Casualty Co v. Argentine Republic, ICSID Case No. ARB/03/9, Award, 5 September 2008; National Grid plc v. Argentine Republic, UNCITRAL, Award, 3 November 2008; 2) Aguas del Tunari SA v. Republic of Bolivia ICSID Case No. ARB/02/3, Decision on Respondent's Objections to Jurisdiction, 21 October 2005; Suez, Sociedad General de Aguas de Barcelona SA, and Vivendi Universal SA v. Argentine Republic, ICSID Case No ARB/03/19 and AWG Group v. Argentine Republic, Decision on Liability, 30 July 2010; Biwater Gauff (Tanzania) Ltd v. United Republic of Tanzania, ICSID Case No. ARB/05/22, Award, 24 July 2008; 3) Piero Foresti, Ida Laura de Carli and ors v. Republic of South Africa, ICSID Case No. ARB(AF)/07/1, Award, 4 August 2010; 4) Methanex Corp v. US, UNCITRAL/NAFTA, Final Award of the Tribunal on Jurisdiction and Merits, 3 August 2005; Chemtura Corp (formely Crompton Corp) v. Canada, UNCITRAL/NAFTA, Award, 2 August 2010; 5) Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG & Co KG v. Federal Republic of Germany, ICSID Case No. ARB/09/6, Request for Arbitration, 30 March 2009; Metalclad Corporation v. The United Mexican States, ICSID Case No. ARB(AF)/97/1 (NAFTA), Award, 30 August 2000; SD Myers, Inc v. Canada, UNCITRAL (NAFTA), Partial Award, 13 November 2000; 6) FTR Holding SA, Philip Morris Products S.A. and Abal Hermanos SA v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Notice of Arbitration, 19 February 2010 (pending); Philip Morris Asia Limited v. Australia, UNCITRAL, Notice of Arbitration, 21 November 2011 (pending); and 7) Vattenfall AB and others v. Federal Republic of Germany, ICSID Case No. ARB/12/12, registered 31 May 2012 (pending).

33 In fact, many investment disputes rely on the same dispute settlement rules as those applicable in private-private arbitration, such as the rules of the Arbitration Institute of the Stockholm Chamber of Commerce, or in some cases those of the International Chamber of Commerce, or are modelled on such rules, such as the UNCITRAL Arbitration Rules.

34 Recently, some positive developments have taken place towards more transparency, inter alia in NAFTA and in other more recent investment treaties, in the revisions in 2006 of the ICSID Arbitration Rules and under the new 2014 UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration.

35 The arbitration concerning Germany's nuclear power phase-out, for instance, remains confidential; only the registration of the case and some procedural details about it are known and available on the ICSID website.

36 Van Harten (2012) examined the frequency of expansive and restrictive interpretation of rules on issues on which the text of an investment treaty is ambiguous or silent. Resolutions of an issue from an expansive interpretation tend to favour claimants and allow more claims to proceed. The study found "tentative evidence of systemic bias" resulting from expansive interpretations of the treaties, based on the resolution of four issues: the concept (large or strict) of investment, the acceptability of claims presented by minority shareholders, the acceptability of claims by corporations when the ownership of the investment extends through a chain of companies running from the host to the home State via a third State; and the acceptability of parallel claims. That bias was even greater when the claimant was from a Western capital-exporting State.

37 For instance, human rights complaints, whether before one of the regional human rights courts or

before the committees in the universal regime, are only accessible regularly after the exhaustion of local remedies; in international environmental law, individual access is even more limited. This leads to an asymmetric enforcement of international norms on investment protection to the detriment of other international legal regimes.

38 The case referred to an investment in the telecommunications sector in the Czech Republic. One proceeding was brought by the investor itself, and the other by its shareholders. Even though the applicable BITs were virtually identical, one tribunal held the respondent State liable for approximately $270 million in damages, while the other found no compensable wrongdoing. Compare CME Czech Republic B.V. v. The Czech Republic, UNCITRAL, Partial Award, 13. 13 Sept. 2001, Final Award, 14 March 2003, with Ronald S. Lauder v. The Czech Republic, UNCITRAL, Final Award, 3 Sept. 2001.

39 See, for example, Azurix Corp. V. Argentine Republic, ICSID Case No. ARB/01/12, Award, 14 July 2006, para. 391.

40 AES Corp. V. Argentina, ICSID Case No. Arb/02/17, Decision on Jurisdiction, 26 April 2005, para. 31. A similar approach may be found in Gas Natural v. Argentina, ICSID Case No. ARB/03/10, Decision on Jurisdiction, 17 July 2005, para. 36. Similarly, Romak S.A. v. Republic of Uzbekistan, UNCITRAL, PCA Case No. AA280, Award, 26 November 2009, para. 170; Chevron Corp. and Texaco Petroleum Co. V. Republic of Ecuador, UNCITRAL, PCA Case No. 34877, Partial Award on the Merits, 30 March 2010, para. 164.

41 On the different uses of precedent in international law, see Jacob, 2011.

42 UNCTAD (2014) presents a number of decisions taken in 2013 as examples of contradictory interpretations.

43 See CMS Gas Transmission Company v. the Republic of Argentina, ICSID Case No ARB/01/8, Decision of the ad hoc Committee on the application of the annulment, 25 September 2007.

44 See UNCTAD (2009), Annex: A summary of econometric studies on the impact of BITs on FDI.

45 Up to now, the highest award was ruled against Ecuador, which was sentenced to pay $1.8 billion because it terminated the contract with an oil company that had failed to comply with its conditions. See *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. The Republic of Ecuador* (ICSID Case No. ARB/06/11), Award 5 October 2012.

46 See United Nations Charter Art. 1(2), and Art. 2(7) (regarding non-interference in matters of domestic jurisdiction).

47 UN Charter, Art. 2(1).

48 UN Charter, Preamble, Recital 2, Art. 55(c).

49 UN Charter, Preamble, Recital 3 (“social progress”), Art. 55 ff.

50 To help design investment treaties that strengthen the development dimension, rebalance rights and obligations of States and investors, and that manage the systemic complexity of the IIA regime, UNCTAD (2012) presents a detailed list of alternative model clauses on every issue usually included in an investment treaty, starting with definitions of investment and investor, and including substantive standards, such as indirect expropriation and fair and equitable treatment, and provisions relating to investor-State dispute settlement.

51 For example, the Peru-Republic of Korea Free Trade Agreement which entered into force on 1 August 2011, states (in annex 9d): “The Parties recognize that the purchase of debt issued by a Party entails commercial risk. For greater certainty, no award may be made in favor of a disputing investor for a claim with respect to default or non-payment of debt issued by a Party unless the disputing investor meets its burden of proving that such default or non-payment constitutes an uncompensated expropriation [...] or a breach of any other obligation under this Chapter.” And: “No claim that a restructuring of debt issued by a Party breaches an obligation under this Chapter may be submitted to, or if already submitted continue in, arbitration under this Chapter if the restructuring is a negotiated restructuring at the time of submission, or becomes a negotiated restructuring as per such submission, except for a claim that the restructuring violates Article 9.3 or 9.4 [i.e. national treatment or MFN treatment].”

52 Article 37.2 (b) states: “Where the parties do not agree upon the number arbitrators and the method of their appointment, the Tribunal shall consist of three arbitrators, one arbitrator appointed by each party and the third, who shall be the president of the Tribunal, appointed by agreement of the parties.” Article 38 states: “If the Tribunal shall not have been constituted within 90 days after notice of registration of the request has been dispatched by the Secretary-General in accordance with paragraph (3) of Article 36, or such other period as the parties may agree, the Chairman shall, at the request of either party and after consulting both parties as far as possible, appoint the arbitrator or arbitrators not yet appointed.” Article 5 specifies that “The President of the Bank shall be ex officio Chairman of the Administrative Council (hereinafter called the Chairman).” A reform to ICSID Convention could ask contracting States to pre-approve a number of potential arbitrators from the Panel of Arbitrators established in section 4 of the Convention.

53 See: http://www.citizen.org/documents/RDCvs-Guatemala-Memo.pdf. Various attempts to narrow FET have all been ignored by ISDS tribunals, such

that some investment law experts are beginning to think that no precise wording of FET is possible.

54 See Articles 5, 13.2, 14.2 and 38 of the Convention on the Settlement of Investment Disputes Between States and Nationals of other States, available at: https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf.

55 The main difference between ICSID arbitration and alternative options is the greater control domestic courts can exercise in overseeing non-ICSID arbitrations and in enforcing non-ICSID awards under the New York Convention for the Recognition and Enforcement of Foreign Arbitral Awards, which contains, inter alia, a public policy exception for recognition and enforcement.

56 In addition, art. 72 of the Convention provides that withdrawal from the Convention "shall not affect the rights or obligations under this Convention of that State or of any of its constituent subdivisions or agencies or of any national of that State arising out of consent to the jurisdiction of the Centre given by one of them before such notice was received by the depositary." How this provision is to be interpreted, and whether it only covers the effect of arbitral proceedings that have been initiated by foreign investors before the effects of denunciation of the Convention take place or whether it ensures the survival of all consents to ICSID arbitration contained in any prior investment treaty is a heavily contested and, so far, unresolved issue.

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Annex to chapter VI

DO BILATERAL INVESTMENT TREATIES ATTRACT FDI FLOWS TO DEVELOPING ECONOMIES?

This annex presents an econometric exercise aimed at testing whether bilateral investment treaties (BITs) fostered bilateral foreign direct investment (FDI) flows from developed to developing economies between 1985 and 2012.

Model and data sources

This exercise relies on the standard gravity panel data model, which predicts that FDI between home and host countries is proportional to their market size and inversely proportional to the geographic distance between them:

- The explained variable is FDI as measured by the net bilateral FDI outflows from developed (home) to developing countries (host), in millions of dollars. The main source for bilateral FDI outflows was the OECD *International Direct Investment Database*. Series were completed with data from the United States Bureau of Economic Analysis and from UNCTAD databases.

- Market size was measured by real GDP of the home and host countries in constant 2005 dollars, using United Nations *National Accounts Main Aggregates* database and national sources. A positive sign was expected for the coefficients of both GDPs. The larger the size of the home country, the more FDI should flow from that country; and the larger the size of the host country the greater should be the potential demand for the output of foreign investors.

- Geographical distance between the capital cities of the home and host countries was obtained from the *CEPII GeoDist database* (Mayer and Zignago, 2011). It is used as a proxy for transaction and transportation costs as well as for the institutional and cultural distances between two countries. The sign of the coefficient is indicative of the prevailing kind of FDI. A positive sign would suggest exports and FDI are substitutes, because enterprises will serve customers by investing in the host country rather than by exporting from the home country. A negative sign would indicate complementarity between FDI and bilateral trade, typically in investments related to an international production network involving the home and host countries.

A set of dummies representing time-invariant variables taken from *CEPII GeoDist* data were included. They capture geographical, cultural and historical similarities of country pairs, which increase economic ties or reduce transaction costs. Corresponding dummies are equal to one when both countries share a common land border, language or colonial history. A positive sign was expected for the coefficients of these variables.

The standard gravity model was modified to introduce the variables related to BITs and other determinants of FDI to complete the estimable equation:

- A dummy variable equals one after the country pair has signed a BIT, as reported by UNCTAD. Given than BITs are supposed to reduce investment risks, they can be viewed as providing an incentive to investors, therefore the expected sign is positive. Three alternative variables representing BITs were used in the estimations: two dummy variables (a signed BIT and the entry into force of a BIT) and one variable which measured the number of years that had passed since the signing of the BIT.
- Labour skill was measured by the average years of secondary schooling in the adult population (over 25 years of age) of host countries. Data were taken from Barro and Lee (2010), which provide the educational attainment data at five-year intervals from 1950 to 2010. A linear interpolation was used to obtain data by year. A positive sign was expected for this coefficient.
- The difference in average years of schooling was used as a proxy for the absolute skill difference between the home and host country.[1] If FDI is motivated by market access, a negative sign should be expected, as "absolute skill differences reduce affiliate sales" (see Blonigen et al., 2002); however, if FDI is motivated by lower wage costs in the host country, a positive sign was expected.
- Openness was measured by the ratio of imports to GDP. Data were extracted from UNCTAD databases and national sources. A positive relationship was expected, as it could be interpreted as a measure of overall openness.
- Regional trade agreements (RTA) was a dummy variable equal to one after both countries had signed a bilateral free trade agreement or a regional trade agreement. Data were derived from a database in de Sousa (2012). A positive relationship was expected, given that RTAs lower trade barriers and facilitate the movement of intermediate and final goods between firms in home countries and foreign affiliates in host countries. Moreover some RTAs include other conditions such as investment regulations that facilitate the mobility of funds and capital flows. Since some RTAs include FDI-related clauses, RTAs were excluded from the estimable equations to isolate the impact of BITs. In that case, the coefficient of the BIT variables was expected to be biased upwards.

Estimation methods and results

A large panel data of bilateral FDI outflows to 119 developing economies from 27 developed economies over the period 1985−2012 was used to examine the effect of BITs on FDI to developing economies. The modified gravity equation was estimated based on two estimation methods: ordinary least squares (OLS) and Poisson pseudo-maximum likelihood (PPML). All time-variant explanatory variables were lagged by one period to reduce endogeneity problems.

Ordinary least squares (OLS)

- Given the multiplicative form of the gravity equation, the usual method is to take the natural logarithms of the explained and explanatory variables (excluding dummies) and apply ordinary least squares to the resulting log-linear equation.[2]

- To control for omitted variable bias, home and host fixed effects were included through dummy variables which control for all time-invariant home or host country characteristics.[3] Also included were time fixed effects to account for any shocks that affect all countries.

- Columns 1 to 5 of the table 6.A.1 present the results of the estimations obtained by OLS, along with robust standard errors and three types of fixed effects (year, host country and home country). Overall, this specification explains about 50 per cent of the variation of bilateral FDI outflows. Results show that except for openness and common border, coefficients are all statistically significant. In particular, "geographical distance" has a strong effect: its negative sign indicates either that FDI is related to bilateral trade or high operating costs due to geographical distance, and cultural and institutional differences. The coefficient of "labour skill" in host countries has a positive sign, suggesting a more important role of domestic markets. All other variables have the expected sign. In this specification BITs coefficients are significant and positive. However, the proportion of FDI that can be attributed to BITs is very low, as reflected in negligible change in R-squared when including a BIT variable.

Poisson pseudo-maximum likelihood (PPML)

- Santos Silva and Tenreyro (2006) showed that due to Jensen's inequality[4] the use of log-linearized gravity models by OLS can generate biased[5] estimations and produce misleading conclusions. They suggested that the coefficients in the gravity equation should be estimated in its multiplicative form, and proposed using the Poisson pseudo-maximum-likelihood (PPML) estimation method. PPML is consistent in the presence of heteroskedasticity, and provides a way to deal with zero values (unlike logarithm specifications).

- Columns 6 to 10 show results obtained by PPML, along with robust standard errors and three fixed effects. The coefficient of skill difference is statistically significant, and its positive sign provides support for FDI that is motivated by lower wage costs in the host country. Market size, labour skill, openness and RTA are all statistically significant and have the expected sign, whereas coefficients of BIT variables are not significant. The coefficients of the four time-invariant variables – geographic distance, common border, common language and colony – are all statistically significant.

- Ruiz and Vilarrubia (2007) argue that because cultural and historical factors are difficult to measure, gravity models should be estimated by using time and country-pair[6] fixed effects. Columns 11 to 15 show the results of the estimations by PPML, with year and country-pair treated as fixed effects. Except for BIT variables, all time-variant coefficients are statistically significant. Sizes of coefficients are, in general, higher than those obtained by PPML with year, home and host country fixed effects.

- When comparing results with those obtained using the OLS specification, OLS estimates tend to be much larger than those estimated by PPML. This shows that results are quite sensitive to the specification. For this reason, the results of previous studies using OLS should be interpreted with caution.

- To check for robustness, the gravity equations were also estimated by including alternatives definitions of variables such as openness (i.e. total trade over GDP), skill difference (i.e. absolute value, positive and negative values), and BIT (i.e. number of years since ratification of a BIT). Moreover, various transformations of the FDI variables were tried.[7] In all these specifications the PPML estimates of the coefficients of BIT remained statistically insignificant.

Table 6.A.1

REGRESSION RESULTS, 1985–2012

(Bilateral FDI, millions of dollars)

	OLS: ln FDI					Poisson-Pseudo-Maximum Likelihood (PPML): FDI									
Explanatory variable	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*	*15*
ln GDP - host	0.93***	0.96***	0.90***	0.88***	0.94***	1.16***	1.19***	1.16***	1.15***	1.16***	1.22***	1.23***	1.22***	1.21***	1.22***
ln GDP - home	2.40**	2.33**	2.42**	2.41**	2.40**	0.97**	0.93*	0.97**	0.98**	0.97**	1.40**	1.40**	1.41**	1.40**	1.40**
ln labour skills - host	3.94***	3.89***	3.90***	3.87***	3.95***	1.58***	1.48***	1.60***	1.57***	1.58***	1.93***	1.91***	1.88***	1.88***	1.93***
ln skill difference	2.57***	2.58***	2.48***	2.39***	2.59***	0.95**	0.96**	0.98***	0.90**	0.94**	1.44***	1.46***	1.36***	1.32***	1.40***
ln openness	-0.10	-0.11	-0.13	-0.14	-0.10	0.36**	0.40**	0.36***	0.35***	0.36***	0.45***	0.47***	0.44***	0.43***	0.43***
Regional trade agreement		0.35**					0.42***					0.20**			
BIT - signature			0.25**					-0.04					0.09		
BIT - entry				0.44***					0.06					0.14	
BIT - years since signature					0.00					0.00					0.01
Time-invariant variables															
ln distance	-2.61***	-2.57***	-2.59***	-2.58***	-2.62***	-0.73***	-0.68***	-0.73***	-0.73***	-0.73***					
Common border	-0.06	-0.10	-0.00	0.00	-0.06	0.53**	0.47**	0.52**	0.54**	0.52**					
Common official language	2.54***	2.54***	2.56***	2.56***	2.53***	0.92***	0.88***	0.92***	0.94***	0.93***					
Colony	1.51***	1.51***	1.48***	1.46***	1.51***	0.26**	0.31***	0.27***	0.24**	0.25**					
Number of observations	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573	12 573
R-squared[a]	0.500	0.500	0.500	0.500	0.500	0.734	0.737	0.734	0.734	0.734	0.825	0.826	0.825	0.825	0.825
Fixed effects															
Year	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Host country	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes					
Home country	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes					
Country pair											Yes	Yes	Yes	Yes	Yes

Note: *** Significant at 1 per cent. ** Significant at 5 per cent. * Significant at 10 per cent.
Home: developed economies. Host: developing economies.

a Pseudo R-squared is reported for PPML.

Concluding remarks

This econometric analysis shows that standard gravity models permit a meaningful explanation of FDI bilateral flows from developed to developing countries. However, when the BITs variable is included, the results are ambivalent. Using one methodology (OLS estimation of log-linear regression), results indicate that BITs have a positive impact on bilateral FDI, although the estimated magnitude of this impact is small. Since, according to recent literature, this methodology produces biased estimates, an alternative method (PPML) was also used. This method showed that BITs appear to have no effect on bilateral North-South FDI flows: the magnitude of the estimated coefficients is close to zero. Moreover, the BIT coefficients are not statistically significant; in other words, results do not support the hypothesis that BITs foster bilateral FDI.

These results are consistent with the existing literature, which observes that the current state of the research is unable to fully explain the determinants of FDI, and, in particular, the effects of BITs on FDI. Thus developing-country policymakers should not assume that signing up to BITs will boost FDI. Indeed, they should remain cautious about any kind of recommendation to actively pursue BITs.

Notes

1 Skill difference is measured as the logarithm of the ratio of the highest to the lowest average years of schooling in the two countries.

2 The FDI data used here contain 15,983 observations of which 2,844 are zero and 3,410 are negative. As it is usual in the literature to avoid deleting observations when applying logarithms, the value of FDI was increased in 1 dollar and negative values were deleted.

3 In panel data estimations, coefficients may be subject to omitted variable bias; that is, the estimated coefficient of an explanatory variable is biased when important variables that are unknown or difficult to measure are not included in the equation and are correlated with the above explanatory variable. See Anderson and van Wincoop (2003) for a discussion of omitted variables bias in the trade gravity literature.

4 According to Jensen's inequality, the mean value of a logarithm is different from the logarithm of a mean value.

5 They showed that in a gravity model, even controlling for fixed effects, the presence of heteroskedasticity can affect the consistency of estimators. This is because, due to Jensen's inequality, the log of the explained variable changes the properties of the error term in a way that renders the coefficients biased.

6 Country-pair dummies absorb the effects of all omitted variables that are specific to the country pairs but remain constant over time, including the standard gravity variables (geographical distance, common border, common language and colony).

7 The first robustness check considered only a strictly positive value for FDI. The second included the negative value by applying the Levy-Yeyati et al. (2007) transformation, i.e. replacing the original FDI variable by sign (FDI)*log(abs(FDI)+1). Finally, nominal FDI values were deflated by the GDP United States deflator.

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