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Transnational Corporations

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The role of accounting in the East Asian financial crisis: lessons learned?

M. Zubaidur Rahman*

This article begins with an overview of the general characteristics of the East Asian financial crisis. This is followed by an examination of the immediate causes of the crisis and the role that accounting could have played in providing investors and creditors with the necessary information, on a timely basis, that would have allowed them to take pre-emptive measures. A summary is provided of selected international accounting standards relating to the financial transactions that helped trigger the financial crisis. The current accounting practices of 90 of the largest banks and corporations in the Indonesia, Japan, Malaysia, the Philippines, Republic of Korea and Thailand are compared with internationally accepted accounting practices. While many discrepancies were found between national practices and international rules, it is highly probable that these practices conformed to national rules. The purpose of the comparison is to identify room for improvement. Finally, the article considers various recommendations for improved accounting and disclosure, which might mitigate future financial crises by revealing poor corporate performance and excessive risk exposures at an earlier stage.

Introduction

An analysis of the immediate causes of the financial crisis that affected East Asian economies in the second half of 1997 raises serious questions about transparency, disclosure and the role of accounting and reporting in producing reliable and relevant financial information. Before 1997, the trading, industrial and financial

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enterprises in the region had grown fast and had contributed to the “Asian miracle”. After 1997, many of the very same enterprises collapsed and many others have become technically bankrupt.

What appears to have happened is that corporations and banks, operating within a weak reporting and regulatory framework, were unable to generate the necessary cash flows to meet their loan payments. A classic mismatch occurred between their short-term debts and long-term, unproductive investments. There was also the added problem that much of the debt was foreign short-term debt. The defaults sent warning bells to investors and creditors who looked for ways to protect their own interests, and panic ensued. Overseas banks refused to renew their loans; mutual fund investors sold their shares and converted their funds back into dollars. Both local and foreign investors were reluctant to continue to invest. This put tremendous pressure on local currencies, causing devaluations that in turn compounded the difficulty of debt repayment and gave rise to a vicious cycle of more capital flight, more panic, and contagion.

It is an accepted fact that an enterprise’s transparency to outsiders is determined by the information it discloses in its financial statements. The information produced by the accounting system of an enterprise enables external parties to know about the financial performance of that enterprise. Investors, creditors and other stakeholders use accounting information as an input into their decision-making. If a policy of complete and objective disclosure is not followed while preparing the financial statements, the users of accounting information are likely to be misled and therefore they may not be able to take the appropriate decisions in a timely fashion. This assessment is consistent with normal market behaviour as recently described by Arthur Levitt, Chairperson, United States Securities and Exchange Commission:

“The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news” (Levitt, 1998, p. 2).

It seems that, as a result of the lack of proper disclosure in the accounting reports of East Asian enterprises, the users of accounting information did not receive the early warning signals about deteriorating financial conditions and were therefore not able to make adjustments accordingly. It is difficult, if not impossible, to say to what extent disclosure deficiencies and non-transparency of financial statements were responsible for triggering the East Asian financial crisis, but there is general agreement that they played a crucial role. There is a general consensus amongst researchers, policy makers and practitioners that the East Asian financial crisis was mainly triggered by micro-level problems that remained undetected for a long time. Although the international lenders and investors had access to various macro-level information and aggregate data, lack of adequate disclosure in the financial statements made a proper assessment of the risk exposures of the fund-seeking enterprises in the region impossible.

James D. Wolfensohn, President of World Bank, while analysing the causes of the East Asian financial crisis, summarized disclosure problems as follows:

“The culture in the region has not been one of disclosure. If you go back further it was a culture of a smallish number of wealthy people. It was an agrarian society with a lot of people in the country and some significant factors of power. It is reflected in the chaebols. It is reflected in groups that come together. There were centers of power. There was little disclosure, and there was a familial structure in the industrial and in the financial sector just as there was in the ordinary sector” (Wolfensohn, 1998, p. 3).

This view is shared by the Japanese Finance Minister, Kiichi Miyazawa, who has said: “Transparency is a must ... [this] meanse sometimes a very brutal confrontation, which is not part of our culture.” (Hitchcock, 1998, p. 1).

An overview of the crisis

The East Asian economies do not fit the profile of those countries that experienced financial crises in the past. Demirgüç-Kung and Detragiache (1997) found that the most important predictors of

the banking crises are: macroeconomic factors (low GDP growth and high inflation), high real interest rates, vulnerability to capital outflows, domestic financial liberalization, and ineffective law enforcement. Some of these factors (high real interest rates, vulnerability to capital outflows and domestic financial liberalization) were present in the East Asian countries that experienced financial crises, but many others were not. East Asia was growing strongly, had low inflation and, according to the *International Country Risk Guide*, had high-quality law enforcement (Stiglitz, 1998). Moreover, unlike the crisis-ridden Latin American countries, East Asian countries had balanced budgets or budget surpluses.

The fundamental economic conditions of East Asian countries provided no indications about the timing and magnitude of the financial crisis. The sudden eruption of the crisis throughout the region caught the world by surprise because the East Asian economies had been highly successful for two generations. Between 1965 and 1995, average income in Indonesia, Malaysia and Thailand more than quadrupled, and average income in the Republic of Korea rose seven-fold. In these four countries, average income climbed from 10 per cent of the United States average in 1965 to around 27 per cent in 1998, life expectancy at birth rose from 57 years in 1970 to 68 years in 1995, and the adult literacy rate jumped from 73 per cent to 91 per cent. In Indonesia, the share of population living under the poverty line fell from 60 per cent in the 1960s to under 15 per cent in 1996 (Radelet and Sachs, 1998).

High economic growth and political and economic stability gave confidence to foreign investors and, as a result, massive capital inflows were attracted into the East Asian region during the 1990s. Capital inflows into Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand averaged over 6 per cent of GDP between 1990 and 1996 (Radelet and Sachs, 1998). Liberalization of the financial sector made it much easier for banks and domestic corporations to tap into foreign sources for debt and equity capital. The most important question asked by many people after the start of the crisis was why the crisis had not been predicted by the market, and foreign capital continued to flow in as usual for a long time. Several reasons have been given for the persistence of large-scale inflows of capital to the region, including:

-
- the apparently firm commitment by the authorities of the East Asian countries to preserving the external value of their currencies, which maintained the attractiveness of local assets;
 - the ongoing process of deregulation, which, in the short term, acted as an incentive to continuous inflows of foreign funds;
 - the progressive broadening of the range of foreign investments in the region in the context of excessive global liquidity;
 - the inability of foreign investors and creditors to assess properly the actual risks of foreign exchange exposure.

As long as money continued to flow in and asset values rose, banks had no liquidity problems. Until the crisis started in mid-1997, the rankings of the five East Asian countries most affected by the crisis,¹ according to the *Euromoney Country Risk Assessment*, had changed little or had even improved (in the case of the Philippines and the Republic of Korea). Even in September 1997, after the start of the crisis, the ranking of the Philippines continued to improve, and Indonesia and Malaysia had steady rankings. Credit rating agencies such as those of Standard & Poor and Moody did not provide any indication of the crisis in their ratings of sovereign debt of the five countries. Between 1996 and 1997, the ratings of the long-term sovereign debt of Indonesia, Malaysia, the Republic of Korea and Thailand remained unchanged, and that of the Philippines was upgraded in early 1997 (Radelet and Sachs, 1998, p. 11). However, for those who tracked and heeded the data on external financing published by the Bank for International Settlements, it was clear that some countries had accumulated sizeable foreign currency exposures.

In spite of their healthy economic track record and large-scale capital inflows over many years, East Asian countries fell victim to the financial crisis. The crisis started in Thailand, where large capital inflows allowed domestic banks to expand lending rapidly, fuelling imprudent investments and unrealistic increases in asset prices. The

¹ In this article, reference to “five East Asian countries” means the following countries: Indonesia, Malaysia, the Philippines, Republic of Korea and Thailand.

first major assault on the Thai baht occurred in May 1997, when speculators, seeing the slowing economy and political instability, decided it was time to sell. Following sustained downward pressures in the subsequent weeks, the Thai authorities abandoned the pegging of their currency on 2 July 1997. Immediately the baht was devalued by about 15-20 per cent. The Thai currency crisis spilled over to other East Asian countries during the summer of 1997, and gained further momentum in the latter part of the year. During the second half of 1997, capital flows reversed and asset prices plunged, collateral values collapsed and banks were caught with substantial amounts of uncollectable loans.²

In 1997, the inflow of foreign capital to the five East Asian countries abruptly reversed, leaving a net outflow of around \$12.1 billion. The remarkable and unexpected swing of capital flows – a swing of \$105 billion from \$93 billion net inflows in 1996 to \$12.1 billion net outflows in 1997 – represents around 11 per cent of the pre-crisis GDP of the five East Asian countries (Radelet and Sachs, 1998, p. 2). The withdrawal of foreign funds put more pressure on the national currencies of the affected countries. Further devaluations of the national currencies associated with the outflow of capital motivated domestic borrowers with unhedged currency positions to rush to buy dollars. As a result, the currency values further deteriorated. A chain reaction was observed in each of the five East Asian countries. At the same time, many large corporations and financial institutions collapsed in each of the five countries. In the Republic of Korea and Thailand, initial announcements of substantial international support failed to break the downward spiral in asset prices and halt the outflow of private capital.

Accounting disclosure and the crisis

There is now general agreement that the failure and near failure of many financial institutions and corporations in the East Asian region resulted from a highly leveraged corporate sector, growing

² In 1996, the Japanese banking sector faced a crisis due to huge amounts of uncollectable loans resulting from the collapse of a speculative bubble in real estate. Japan took little action to resolve the banking crisis until the country was hit again by the Asian financial crisis.

private sector reliance on foreign currency borrowing, and a lack of transparency and accountability. This is not to say that inadequate disclosure was a major factor; rather, it was a contributing factor to the depth and breadth of the crisis. Since financial statements act as the most reliable and easily accessible vehicle for dissemination of enterprise-level information, the lack of adequate accounting disclosures prevented investors and creditors from receiving the timely information they needed to choose between successful and potentially unsuccessful enterprises. It is a known fact that the very threat of disclosure influences behaviour and improves management, particularly risk management. It seems that the lack of appropriate disclosure requirements indirectly contributed to the deficient internal controls and imprudent risk management practices of the corporations and banks in the crisis-hit countries.

Accounting disclosure by financial institutions and corporations in most of the East Asian countries did not follow or comply with international accounting standards. For a long time, these deficiencies were mostly ignored by the international investor community and large amounts of foreign capital (debt and equity) continued to pour into the East Asian countries. Investments and loans were made on the basis of expected high returns, notwithstanding the fact that the financial statements were incomplete or faulty. Creditors assumed that, if a loan went bad, someone (the Government, or the International Monetary Fund (IMF)) would cover the losses. In addition, the money was often channelled through bank loans, bond issues and stock offerings to borrowers who were not operating by strict rules of efficiency or profit and loss (Samuelson, 1998). This unprofitable use of money was not evident to the external parties. The foreign investors simply believed that they could benefit from the economic success of the “rising Asian tigers”. During the 1990s, investors seemed willing to buy the stocks and bonds of firms about which they knew next to nothing — except that everybody else was investing in them.

The bankruptcy of a few powerful corporations and financial institutions in the Republic of Korea and Thailand during the first half of 1997, coupled with the unexpected currency devaluation in the summer, alerted the international investor community (mainly portfolio investors and creditors) to disclosure deficiencies in

financial accounting reports. Generally, investors assume the worst when companies are perceived to be withholding information. This perception motivated international portfolio investors and creditors to withdraw capital from the region and contributed to the deepening of the crisis. When the crisis started, and the market participants tried to assess fundamental financial conditions of the enterprises, the lack of accounting information prepared according to international accounting standards hindered a proper fundamental analysis.

If international accounting standards had been followed by the enterprises in the region, international investors could have properly analyzed and understood the fundamental conditions of those enterprises, and could have adjusted their investment decisions according to incremental increases in micro-level risk exposure. However that did not happen because financial statements did not reflect the extent of risk exposure that resulted from the following disclosure deficiencies:

- the actual size of very high-level enterprise debts was hidden by frequent related-party transactions and off-balance sheet financing;
- the very high level of foreign exchange risk exposures by corporations and banks due to large short-term borrowings in foreign currency was not evident at the micro level;
- detailed information reflecting concentration in specific activities (such as real estate) that were prone to speculative pressures was absent;
- the contingent liabilities of the parent of a conglomerate, or of the financial institutions, for guaranteeing loans (particularly foreign currency loans) taken by related and unrelated parties were not reported;
- appropriate levels of loan/loss provisions were not made, and pressure on the liquidity position of banks due to non-performing loans was not evident.

If adequate information on risk exposure had been provided or required periodically, banks and corporations might have exercised better risk management, or allowed international investors and creditors to register their concern over time, and thus avoided the sudden withdrawal of capital from the region.

Disclosure deficiencies in accounting reports are not confined to East Asia. However, the consequences of these deficiencies in East Asia were severe because the financial institutions and corporations in the region were operating in the same global economy as their counterparts in the West which complied with sophisticated disclosure requirements. In order to be able to survive and compete successfully in the international market place, the East Asian countries will need to follow a policy of transparency and accountability. The system of financial accounting and reporting that incorporates adequate disclosures in accordance with international accounting standards can ensure such transparency and accountability.

The debt problem of the private sector

A survey of the literature on the immediate causes of the financial crisis in the East Asian countries reveals that the corporations and financial institutions in these countries borrowed heavily from abroad. Moreover, they displayed an excessive propensity for short-term debt. Finally, when the day of reckoning arrived, the region's export earnings shrunk as a result of the appreciation of the United States dollar, faltering competitiveness and other reasons. That meant the region's economies could not generate the cash flow needed to service their foreign debt. Alan Greenspan, Chairperson of the United States Federal Reserve System, in his testimony on the Asian financial crisis before the Committee on Banking and Financial Services of the United States House of Representatives, on 30 January 1998, highlighted debt problems as follows:

“Certainly in Korea, probably in Thailand, and possibly elsewhere, a high degree of leverage (the ratio of debt to equity) appears to be a place to start. While the key role of debt in bank balance sheets is obvious, its role in the efficient functioning of the non-bank sector is also important. Nevertheless exceptionally high leverage often is a symptom of excessive risk taking that leaves financial systems and economies vulnerable to loss of confidence... The concern is particularly relevant to banks and many other financial intermediaries, whose assets typically are less liquid than their liabilities and so depend on confidence in the payment of liabilities for their continued viability. Moreover, both financial and non-financial businesses can employ high leverage to mask

inadequate underlying profitability and otherwise have inadequate capital cushions to match their volatile environments... As I have testified previously, I believe that, in this rapidly expanding international financial system, the primary protection from adverse financial disturbances is effective counter-party surveillance and, hence, government regulation and supervision should seek to produce an environment in which counter-parties can most effectively oversee the credit risks of potential transactions. Here a major improvement in transparency, including both accounting and public disclosure is essential ...” (Greenspan, 1998, pp. 4-7).

From the perspective of this article, it seems important to shed light on the severity of the debt problem, which was not revealed until the crisis started in the East Asian region. It is worth noting that accounting information presented in the financial statements of corporations and financial institutions is supposed to provide clear indications of the magnitude of debt problems. Unfortunately, that did not happen in the case of East Asian countries.

During the 1990s, corporations and banks in East Asian countries borrowed heavily. Although the outside lenders to these organizations evaluated credit risk taking into account the reported debts, the size of the actual debt of an individual company or a conglomerate was often difficult to ascertain, because the borrowing companies used innovative mechanisms to camouflage a large part of their debt. They were able to do this on a large scale because of the close connections between the borrowers and the lenders created by corporate ownership structures. The debt problem appeared to be particularly serious in corporations and financial institutions with large interlocking ownership interests.

Most of the large companies in East Asian countries have either subsidiaries or affiliates in the financial sector. As a result, it was never a problem to borrow money. Close relationships with financial institutions enabled companies to receive new loans even if they defaulted on interest payments and repayments on earlier loans. Loan repayments were often rescheduled and interest remissions were given for the convenience of the borrowers. Moreover, non-banking group members and associates always helped each other by extending

short- and long-term credits through arrangements which unrelated parties would not enter into. The disclosure of information in financial statements regarding related-party “receivables”, “payables” and “borrowings” would have revealed the size of the “non-arm’s length” lending and borrowing activities of corporations and financial institutions. This would have helped outside lenders to properly assess the risk of providing loans to these organizations.

Table 1 shows the reported debt burden of the largest conglomerates of the Republic of Korea. On average, the conglomerates had a debt-to-equity ratio of about 350 per cent; whereas in Canada, the United Kingdom and the United States, a debt-to-equity ratio higher than 100 per cent is generally not acceptable. Historically, French, German and Japanese companies preferred to have much higher debt/equity ratios, but in the recent past, they have started to reduce these ratios (Davis, 1992, chapter 2).

Table 1. The debt burden of the leading chaebols of the Republic of Korea, at the end of 1997

Rank	Group	Number of subsidiaries	Debt-to-equity ratio (Per cent) ^a
1	Hyundai	62	578.7
2	Samsung	61	370.9
3	Daewoo	37	471.9
4	LG	52	505.8
5	SK	45	467.9
6	Hanjin	25	907.8
7	Ssangyong	22	399.7
8	Hanwha	31	1,214.7
9	Kumho	32	944.1
10	Dong Ah	22	359.9
11	Lotte	28	216.4
12	Daelim	21	513.6
13	Doosan	23	590.2
14	Hansol	19	399.9
15	Hyosung	21	465.1

Source: Fair Trade Commission of the Republic of Korea (reproduced in Far Eastern Economic Review, 30 April 1998, p. 12).

^a On average, the conglomerates in the Republic of Korea had a debt-to-equity ratio of about 350 per cent.

As part of a reform programme, the Government of the Republic of Korea required all conglomerates to carry out restructuring. Each of the conglomerates, in its restructuring plan submitted to the Government in May 1998, made commitments to reduce debt with funds from spin-offs and asset sales; the divestment of a number of subsidiaries, and the injection of new equity capital from controlling-family assets. The plans presented by the large chaebols are intended to achieve a step-by-step reduction in the debt-to-equity ratio to below 100 per cent by the year 2002.

To examine whether there was an excessive lending boom in the 1990s in the five East Asian countries, Corsetti, Pesenti and Roubini (1998) have measured the rate of growth of bank-lending to GDP between 1990 and 1996. They found that the lending boom was the largest in the Philippines (152 per cent), Thailand (51 per cent) and Malaysia (27 per cent); the lending boom was also large (but more modest) in the Republic of Korea (17 per cent) and in Indonesia (12 per cent). In Thailand, the lending boom of finance and securities companies was significantly larger than that of banks (133 per cent as opposed to 51 per cent). In Malaysia, the growth rate of the credit of non-bank financial institutions appears to be similar to that of commercial banks. In the Philippines, lending to the private sector by non-bank financial institutions appears to be a fraction of that of banks.

It is worth noting that these statistics do not take into account related-party lending through various mechanisms within a corporate group. In this regard, in the Republic of Korea, the conglomerates (“chaebols”) never fully report their results. Some use strong companies to subsidize weak ones. For example, the outside shareholders of SK Telecom, the Republic of Korea’s leading cellular phone operator, persuaded the phone company to stop subsidizing its sister companies in the SK Group. The SK Group had been using the telecom operator’s handsome cash flow as a piggy bank for its other separately owned companies — a standard practice in that country. SK Telecom, for instance, backed a \$50 million loan to its sibling SK Securities, which suffered heavy losses in derivative trading in 1997.

The foreign debt problem of the private sector

Probably the most crucial factor that triggered the East Asian financial crisis was the foreign debt problem. In the 1990s, credit to the private sector expanded rapidly, with much of it financed by offshore borrowing by the banking sector. Moreover, corporations in the East Asian countries directly borrowed money from foreign sources. The domestic banks borrowed heavily in foreign exchange but lent mostly to domestic investors in local currency. Although a significant part of this borrowing was of short-term maturity, a large part of it was employed for financing long-term investments. Financing non-current domestic assets with current foreign liabilities made corporations and banks very vulnerable.

Foreign-currency borrowings by the private sector reached such a level that debt-servicing became a critical issue. The signs of financial crisis were evident when large-size corporations in the Republic of Korea and Thailand defaulted on debt-servicing and declared bankruptcy, and so foreign lenders quickly moved to collect whatever they could from their East Asian borrowers. The borrowers failed to roll over short-term debts to long-term maturity. Such rolling over may be common practice under normal circumstances, but it was not an option for borrowers in East Asian countries with large short-term and long-term debts, because foreign lenders panicked and wanted to reduce their risk exposure as soon as possible.

In the short run, an otherwise solvent country, is likely to suffer serious liquidity problems when its debt-servicing burden is above its ability to borrow new external funds and/or its stock of foreign reserves. Statistics of the Bank for International Settlements (BIS) show that the affected East Asian countries not only had large foreign debt liabilities, but also that their foreign assets were significantly low. More specifically, according to the BIS, in mid-1997, foreign assets as a percentage of foreign liabilities were as follows for the five East Asian countries: Thailand, 8.98 per cent; Indonesia, 18.09 per cent; the Republic of Korea, 31.33 per cent; the Philippines, 46.67 per cent; and Malaysia, 52.12 per cent.

This information about the magnitude of net foreign-currency liabilities confirms that the affected East Asian countries exceeded

the prudent limits on foreign-currency borrowings. Further evidence show that most of these net foreign liabilities were generated by the private sector. Unfortunately the financial information provided by the private sector enterprises in their financial statements did not capture the severity of the foreign-currency debt problems.

The sharp increase in foreign-currency borrowings by domestic banks and private corporations is evident from the BIS data shown in table 2. The total foreign currency obligations to BIS-reporting banks of the five East Asian countries increased from \$210 billion to \$260 billion in 1996 alone. By mid-1997, these foreign currency obligations

Table 2. International claims on five Asian economies, held by foreign banks, 1995-1997

Year	Total outstanding (Billion dollars)	Banking sector (Per cent)	Public sector (Per cent)	Non-bank private sector (Per cent)	Share of short-term debt in total debt (Per cent)
<i>Republic of Korea</i>					
End of 1995	77.5	64.5	8.0	27.6	70.0
End of 1996	100.0	65.9	5.7	28.3	67.5
Mid-1997	104.1	65.3	4.2	30.4	68.1
End of 1997	94.2	59.4	4.2	36.3	63.1
<i>Thailand</i>					
End of 1995	62.8	41.1	3.7	55.3	69.4
End of 1996	70.1	36.9	3.2	59.6	65.2
Mid-1997	69.4	37.6	2.8	59.5	65.7
End of 1997	58.8	30.2	3.0	66.6	65.9
<i>Indonesia</i>					
End of 1995	44.5	20.0	15.1	64.7	62.0
End of 1996	55.5	21.2	12.5	66.2	61.7
Mid-1997	58.7	21.1	11.1	67.7	59.0
End of 1997	58.4	20.1	11.8	68.1	60.6
<i>Malaysia</i>					
End of 1995	16.8	26.2	12.5	60.1	47.0
End of 1996	22.2	29.3	9.0	61.8	50.3
Mid-1997	28.8	36.4	6.4	57.1	56.4
End of 1997	27.5	35.8	6.3	57.8	53.1
<i>Philippines</i>					
End of 1995	8.3	26.5	32.5	41.0	49.4
End of 1996	13.3	39.1	20.3	39.8	57.9
Mid-1997	14.1	39.0	13.0	48.0	58.9
End of 1997	19.7	45.1	12.2	42.6	60.4

Source: BIS (various years), *Consolidated International Banking Statistics*.

had risen to \$275 billion. Foreign-currency obligations by the banking sector of these countries jumped from \$91 billion to \$115 billion during 1996, even after foreign bank lending to Thai banks had levelled off because of growing concerns about the Thai financial system. A significant increase in short-term foreign borrowings was observed in Indonesia, the Republic of Korea and Thailand.

Short-term borrowing as a percentage of total foreign currency debt to BIS reporting banks was between 60 and 65 per cent in the five East Asian countries. The acuteness of the foreign debt problem created by short-term foreign borrowing is demonstrated by the ratio of the total short-term foreign liabilities (towards BIS banks) to the foreign reserves of the five East Asian countries. According to the BIS, this ratio, showing the deficiency of foreign reserves for meeting short-term liabilities, was as follows at the end of 1996: the Republic of Korea, 213 per cent; Thailand, 169 per cent; Indonesia, 118 per cent; the Philippines, 77 per cent; and Malaysia, 47 per cent. This shows that, in the event of liquidity problems and a complete unwillingness by foreign banks to roll over short-term loans, the amount of foreign reserves of three of the countries was insufficient to pay short-term foreign liabilities, even before considering the need to service the principal on long-term debt and interest on all debt. The problems created by known short-term liabilities of the affected countries was compounded by the fact that the actual amount of short-term liabilities was even larger, since BIS statistics do not include offshore issues of commercial papers and other non-bank liabilities.

The most interesting picture that is shown by the BIS statistics is that it was the private sector, not the public sector, that relied heavily on foreign borrowing in the five East Asian countries. In mid-1997, direct borrowing by private sector corporations stood as follows: the Republic of Korea, \$ 31.7 billion; Thailand, \$ 41.3 billion; Indonesia, \$ 39.7 billion; Malaysia, \$16.5 billion; and the Philippines, \$ 6.8 billion.

Although the banking sector of the five East Asian countries borrowed from foreign banks to a larger extent than private corporations, the banks acted as intermediaries for financing corporate business activities. As a result, banks in the affected countries became

increasingly vulnerable for at least two reasons. First, by borrowing in foreign currencies and lending in local currencies, the banks were exposed to the risk of foreign exchange losses from currency devaluation. Even if the domestic loans were denominated in foreign currency, borrowers that were not earning foreign exchange, such as real estate companies and securities dealers, faced bankruptcy in the event of currency devaluation. Second, since banks used most of their short-term foreign debt for lending to domestic borrowers under long-term arrangements, they were exposed to the risk of an extreme liquidity crunch and a possible run on the bank.

It is believed that the actual foreign debts of the affected countries, created by their private sector corporations and banks, are much larger than the figures shown in BIS statistics. A large part of the foreign debt was masked by offshore borrowings. For example, in the case of Indonesia, it was only late in the crisis, on 24 December 1997, that a report was published estimating that total Indonesian debt was likely to be closer to \$200 billion, as opposed to an earlier estimate of \$117 billion. The report estimated that at least \$44 billion in offshore bond borrowings were not included in the earlier reported official government figures, nor were short-term offshore borrowings were not included either. Total foreign borrowing by the Indonesian corporate sector was discovered to be above \$67 billion, a much larger figure than previously known (Corsetti, Pesenti and Roubini, 1998, p. 58). As time passed, these figures were continually being revised upwards.

Derivative financial instruments

The frequent use of non-traditional financial instruments for off-balance sheet financing enabled corporations and financial institutions in East Asian countries to run up large-size debts without revealing their impact in their financial statements. The use of such off-balance-sheet financing mechanisms was facilitated by a surge in the issuance and trading of new financial instruments such as derivatives in the international financial markets. East Asian corporations and financial institutions took advantage of the availability of credit facilities by using these highly sophisticated financial instruments without properly comprehending the ramifications of these debt burdens and without recognizing them on

the balance sheet. As a result of this, a complete picture of the debt-risk exposure of individual corporate groups or financial institutions was not available from the information disclosed in financial statements. If corporations and financial institutions had disclosed in their financial statements the extent of their use of financial instruments for off-balance sheet debt financing, that would have assisted the users of financial information in taking decisions on whether or not to provide further debt finance to these organizations.

A product of sophisticated mathematics and computer software, derivative contracts are designed to help banks and corporations hedge against financial uncertainties, such as changes in interest rates. But the possibility of high profits from the use of such instruments motivated many international banks to design more exotic derivatives that were effectively betting on the future direction of interest rates, foreign exchange, commodities and stock indexes. Accounting rules in many countries made derivatives very attractive because the contracts did not have to show up on balance sheets and thus were beyond the prying eyes of investors, analysts and other users of financial statements. The potential problem from derivative defaults throughout the world is great. When companies are in trouble, these types of financial instruments are the first to lead to default. Because companies do not generally view a default on derivatives as losing face, they can always say they did not understand the consequences of derivative contracts.

Derivative financial instruments are powerful and highly complicated agreements designed to offset certain financial risks. Under stable conditions they work well, but when things go wrong, they can have a devastating impact. For example, in early 1997, SK Securities (an enterprise of the SK Group in the Republic of Korea), entered into a currency swap with J.P. Morgan, the fifth largest bank in the United States. Under this deal, in effect, three companies from the Republic of Korea, under the leadership of SK Securities, borrowed dollars and invested that money in the Thai baht. By the end of 1997, the Thai baht had plunged in value by about 50 per cent, and as a result the companies of the Republic of Korea failed to repay J.P. Morgan about \$500 million. They subsequently sued J.P. Morgan in New York and in Seoul, claiming they were not properly advised

of the risks associated with derivatives. J.P. Morgan, in its financial statements for the year 1997, made provisions for the loss arising from this transaction, and in turn sued SK Securities in New York and in Seoul.³

It is only fair to mention that neither the banks nor the regulators in North America and Europe fully understood the activities of hedge funds such as Long Term Capital Management (LTCM). In September 1998, the Federal Reserve Bank of New York was forced to bring together a group of Wall Street investment houses to assemble a rescue package of \$3.5 billion when it appeared that the heavily leveraged LTCM was going to collapse. In describing the situation of three large German banks suffering from LTCM exposure, one senior banker stated: "They got involved in the risk business, but they didn't know enough about it." Another official described hedge funds as the "wild animals of the international financial markets, because all of them are running around off the leash" (Barber, 1998). The hedge fund industry is notoriously bad about informing its investors where its exposures lie because it is outside the traditional bank and securities regulation. Thus, it appears that inadequate oversight of domestic finance and international speculators can cause financial crises in developed countries as well.

In 1996, the Basle Committee on Banking Supervision⁴ (Basle Committee) and the Technical Committee of the International Organization of Securities Commissions⁵ (IOSCO Technical Committee) undertook their third survey of the public disclosure of trading (on-balance-sheet instruments and off-balance-sheet derivatives) and non-trading derivatives activities. The survey covered 79 large banks and securities firms located in Belgium,

³ This information was confirmed, during a telephone interview, by Joe Evangelisti, Head of Public Relations of J.P. Morgan in New York.

⁴ The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank governors of the Group of Ten countries in 1975. It usually meets at the Bank for International Settlements in Basle, where its permanent secretariat is located.

⁵ The IOSCO Technical Committee is a committee of the supervisory authorities for securities firms in major developed and developing countries. It consists of senior representatives of the securities regulators from Australia, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, the United States and Hong Kong, China.

Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and Hong Kong, China. The results of the survey showed that the disclosure practices of 1996 annual reports had improved over the previous year. However, the type and usefulness of the information disclosed by different banks and securities firms varied, and some firms continued to disclose little about their trading and derivatives activities. The following remark published in the survey report highlights this concern:

“Therefore, institutions are strongly encouraged to consider the recommendations for quantitative and qualitative disclosures issued by the Basle Committee and the IOSCO Technical Committee; as well, firms should consider disclosure initiatives by other national and international bodies, and the types of disclosures provided by their peers at the international level” (Basle Committee on Banking Supervision and Technical Committee of the International Organization of Securities Commissions, 1997, p. 4).

Concentration in risky sectors

In today’s business world, corporations and financial institutions attempt to reduce risk-exposure through diversification of investment activities. When investors and creditors, tempted by the possibility of earning high returns from risky activities, commit a large part of available funds to these activities, this makes them vulnerable to unexpected problems. If large funds are concentrated in potentially highly risky sectors of an economy, a macroeconomic shock affecting those particular sectors can cause severe financial problems, not only for the investors and creditors but also for the entire economy.

If corporations and banks provide segmental information in their financial accounting reports, the users of accounting information can properly understand the concentration of the reporting organization’s activities in specific sectors of an economy. From such segmental information, the readers of financial statements can judge whether or not an organization is exposed to a high degree of financial risk due to concentration in a particular sector. Moreover, segmental

information provides a picture of profitability and productivity of the assets engaged in various segments of a diversified organization. Segmental information on an organization enables its potential investors and creditors to make their own risk-return analysis and to decide whether or not to expand exposure to risks inherent in the sector in which the organization in question has a high concentration.

Evidence shows that in the five East Asian countries most affected by the crisis, large sums of money were committed by investors with borrowed funds from local and foreign banks, for high-cost real estate projects and for stock market activities. Both of these areas were prone to speculative pressures. For several years prior to the financial crisis, real estate investment was booming in the East Asian region. Because of the steady increase in property value, both constructors and their financiers ignored the possibility of a bubble bust in the real estate sector. Due to an oversupply of very costly properties in the market, demand started to decline from 1996. However, that did not deter constructors and bankers from committing huge funds in the real estate sector. When investment in residential and commercial buildings collapsed in 1996-1997 because of an oversupply of real estate and the collapse of the land value bubble, firms and individuals that had borrowed funds in both local and foreign currencies (and/or the banks that had borrowed foreign funds and in turn lent these funds to domestic firms and households) were unable to generate cash for the payment of interest and the repayment of loans. This added fuel to the fire that started the East Asian financial crisis. Similarly, over-investment in speculative stock market activities caused the failure of many investment companies, and at the same time loan defaults of these companies to banks was one of the main reasons for the significant losses (and liquidity crunch) in the banking sector.

While in Indonesia, Malaysia and Thailand excessive lending to the real estate and non-traded industries was the driving force behind excessive foreign borrowing and non-performing loans, in the Republic of Korea the financial system was in a severe crisis because of excessive lending to large conglomerates, a large number of which experienced liquidity problems before the financial crisis hit the region. In Thailand, Lippo Bank faced a bank run in November 1995, following reports that it had not disclosed its exposure to sister

companies in the Lippo group which had been involved in highly speculative real estate ventures. In 1996, Malaysia experienced an overall increase in bank lending of 27.6 per cent, but with a sharp switch from lending to the manufacturing sector in favour of lending for equity purchases. Growth in lending for manufacturing fell to 14 per cent in 1996 (from 30.7 per cent in 1995), while growth in lending for share purchases accelerated to 20.1 per cent (from 4 per cent in 1995) (Cosetti, Posenti and Roubini, 1998). Property and equity financing continued to grow very strongly in Malaysia in early 1997. In March 1997, the Malaysian central bank intervened with a ceiling imposed on banks concerning lending to the real-estate and stock market sectors. According to an estimate, reported in the *Euromoney* (April 1998, p. 47), total lending of Malaysian banks as at 31 December 1997, for speculative stock market activities stood at 39 billion ringgit (M\$)—45 per cent of which was given to a few investors. At the same time, consumption credit (hire-purchase lending) was M\$ 54 billion, and real estate financing was M\$ 140 billion. *Euromoney* further reported that the lending for stock market activities, consumer credit and real estate financing together constituted about 58 per cent of the total outstanding credit of the Malaysian banking sector. About 65 per cent of loans given by Malaysian banks were collateralized by overvalued property—which in the wake of the financial crisis could only be sold at very high discounts.

In January 1998, J.P. Morgan Bank provided the following estimates of real-estate exposure of banks in affected East Asian countries: lending to the real-estate sector as a percentage of total assets of banks at the end of 1997 was 25-30 per cent in Indonesia, 30-40 per cent in Malaysia, 15-20 per cent in the Philippines, 15-25 per cent in the Republic of Korea and 30-40 per cent in Thailand. Non-performing bank loans to the real estate sector in these countries accounted for 30 to 40 per cent of the total non-performing loans.

Contingent liabilities

A contingent liability is a potential future liability that may arise as a result of an event or transaction that has already occurred, the conversion of which to an effective liability is dependent upon the occurrence of one or more future events or transactions. Generally,

a major source of contingent liabilities is a guarantee provided by one organization in favour of another organization to ensure security of a loan taken by the latter organization. If the borrowing organization defaults on the loan, in a typical case the lender holds the guarantor liable for the loan. A contingent liability is not recorded in the accounts unless there is a high probability of loss. Rather it is reported in a note to the financial statements. The management of an organization is responsible for deciding whether or not there is a high probability of loss from a contingent liability. In order to lower the reported liability of an organization, the management may avoid recognizing a contingent liability even if there is a high probability of loss. Even if the management of an organization believes that a contingent liability does not give rise to a high probability of loss and accordingly it is not recognized on the balance sheet, its disclosure in the notes to financial statements is helpful in evaluating the potential liabilities of the organization.

In the East Asian region, it is a common practice in corporate groups to issue guarantees from financially strong entities within the group in order to raise loan capital for weaker group members. Moreover, some sources believe that a number of corporate groups often help each other by providing guarantees for loans from outside sources. This latter case is a matter of quid pro quo. This mechanism works as follows. Group A and group B operate as competitors in an economy. An entity of group A borrows money for a financially non-viable project from a bank. The bank asks for a third-party guarantee for the loan. An entity of group B provides a guarantee in favour of the borrower. In return, an entity of group B borrows money from a bank and the guarantee for this loan is given by an entity of Group A. In most cases these cross guarantees are given with full knowledge of the top management of the lending bank. Through this practice, projects that are not financially viable, productive or profitable can be financed without the knowledge of the shareholders.

Non-performing loans

In the ordinary course of business, banks suffer losses on loans, advances and other credit facilities as a result of their becoming partly or wholly uncollectable. Users of the financial statements of a bank need to know the impact that losses on loans and advances have had

on the financial position and performance of the bank; this helps them judge the effectiveness with which the bank has employed its resources. If banks keep providing loans and credit facilities to parties who do not pay back on time, and if the uncollectable loans and interest on loans remain in the balance sheet as assets of the bank, the actual financial position of the bank will remain hidden. Under such circumstances, the bank balance sheet will contain illiquid assets (without real value) and liquid liabilities. Outside parties will not be able to understand clearly the deteriorating financial position of the bank.

Neither private investors nor bank supervisors will be able to monitor and discipline errant banks without accurate, current, comprehensive and transparent information on their creditworthiness, as well as on the creditworthiness of their customers. In the affected East Asian countries, the accounting practices for classifying bank assets as non-performing are not on a par with internationally accepted practices. As a result, bankers in these countries make bad loans look good by lending more money to troubled borrowers. Because of the weakness of accounting and disclosure requirements, bankers and their loan customers easily collude in concealing losses by various restructuring, accrual and interest capitalization devices. If non-performing loans are systematically understated, loan loss provisioning will be inadequate, and the reported measures of bank net income and bank capital will be systematically overstated. In a number of developing countries in the Asia-Pacific region, loans are classified as non-performing only after a loan has been in arrears for at least six months, and in some cases the bank management itself—rather than bank supervisors—sets the classification criteria. Such distortions in the identification of true non-performing loans may also explain why bank capital by itself does not have higher predictive ability for identifying subsequent bank failures.

In the affected East Asian countries, banks lent money heavily to borrowers who failed to repay on time; a large part of such loans and advances should have been recognized as non-performing loans according to internationally accepted practices. Since that was not done, bank financial statements hardly reflected the true worth of loans and advances. Because of this, the vulnerability of banks remained undetected for many years until the financial crisis started

and banks' borrowers started declaring bankruptcy. Estimates of non-performing loans in five East Asian countries at the onset of the financial crisis show that a significant part of the loans provided by banks were of bad quality. By mid-1998, due to the bankruptcy of a vast number of enterprises, the size of uncollectable loans was much higher than the level of non-performing loans in the previous year (table 3).

Table 3. Non-performing loans as a percentage of total outstanding loans (early 1998)

Country	Per cent
Indonesia	30-35%
Malaysia	15-25%
Philippines	8-10%
Republic of Korea	25-30%
Thailand	25-30%

Source: J.P. Morgan (1998).

In the affected East Asian countries, the procedure of loan classification did not follow internationally accepted practices; as a result, the loan portfolios of banks contained large amounts of non-performing loans. Professional accountants who provide audit services to banks in East Asian countries find that the financial statements of banks generally take into account only a fraction of actual (according to international standards) non-performing loans. This practice in East Asia provided distorted information in financial statements regarding the performance and the financial position of banks. The following quote from Daly and Choi (1998, p. BU1 3) highlights this concern:

“The argument over whether to bail out ailing Asian economies has diverted attention from basic, if less seductive, issues: the need for transparency in international transactions and the crucial role that financial accounting standards play in meeting that goal.

Consider the area of basic loan accounting. American bankers make allowances for possible loan losses to properly measure their income and expenses. In the United States, these adjustments are based on experience. If, on average, X percent

of outstanding loans have proved uncollectible in the past, this same percentage is used to estimate expenses for uncollectibles in the current period.

Likewise, when interest on an outstanding loan has been delinquent for 90 days or more, past accruals of interest income are adjusted and, thereafter, interest income is recognised only when received.

No small part of the current crisis engulfing the Korean financial system has arisen from the neglect of such practices in that nation's banks. Periods of nonpayment significantly longer than 90 days are permitted before loans are regarded as delinquent. In Japan, as in Korea, historical experience plays little, if any, role in estimating the adequacy of loan loss reserves and, hence, current income and expenses.

Under such circumstances, an international creditor has substantial difficulty analyzing banks financial statements and, especially, the meaning of published loan loss reserves and measures of asset quality”.

Distinguishing healthy from unhealthy banks in emerging industrial economies is often hindered by the absence of financial statements on the consolidated exposure of banks. The hindrance is created by the lack of uniform reporting requirements for banks within a country, by differences in accounting standards across countries, and by the lack of adequate disclosure of key financial information.

Selected international accounting standards concerning the factors that contributed to the crisis

It is widely believed that the lack of proper use of international accounting standards in affected countries hindered “transparency” in the financial statements of corporations and banks. As a result of this, financial statements failed to provide useful information, on a timely basis, regarding various important factors that appear to have contributed to the triggering of financial crisis. The international accounting standards that could help in disclosure of useful information in the financial statements of corporations and banks in

the affected countries are discussed below. These standards as summarized below, were effective up to the end of 1997. Since July 1998, revised versions of some of these standards have been issued. The accounting and disclosure requirements in the revised version do not materially differ from the requirements in the earlier version. For the purpose of this article, the accounting policies of corporations and banks in comparison with the requirements in the international accounting standards in force at the end of 1997 are analyzed.

Related-party lending and borrowing

International accounting standard (IAS) 5 “Information to be disclosed in financial statements” (effective up to mid-1998), required separate disclosure (amounts) of various items. These disclosures can provide an understanding of the magnitude of lending to, and from, related parties. These items are:

Receivables (long-term and current):

- intercompany receivables; and
- receivables from associates.

Liabilities (long-term and current):

- intercompany loans and payables; and
- loans from, and payables to associates.

The term “intercompany” used in this standard refers to the presentation in the financial statements of balances or transactions between: a parent firm and its subsidiaries, and between a subsidiary and its parent firm or other subsidiaries in the group.

It is worth mentioning here that IAS 5 was superseded as of 1 July 1998 by revised IAS 1, “Presentation of financial statements”. In order to fully comply with the requirements of revised IAS 1, an enterprise needs to disclose the information on related party lending and borrowing.

Foreign currency debt

IAS 21, “The effect of changes in foreign exchange rates”, included the following disclosure requirements, which can provide

useful information on the impact of foreign currency debt on the financial conditions of an enterprise:

- For a foreign currency debt, the carrying amount shall be shown in the reporting currency by translating the foreign currency amount using the exchange rate prevailing on the balance sheet date. It is necessary to disclose the amount of “gain” or “loss” arising from a change in exchange rate on the date of the balance sheet.
- Disclosure is also encouraged of an enterprise’s foreign currency risk management policy.

According to the general disclosure requirement under IAS 5, “all material information should be disclosed that is necessary to make the financial statements clear and understandable”. Following this, one could argue that, if it is material, the extent of the foreign-currency debt exposure of an enterprise should be disclosed in such a way that the foreign-currency risk exposure of the reporting entity is transparent.

It seems necessary to disclose the amount of debt repayable in foreign currency, both short- and long-term, showing its relative size in comparison with local currency debt. If the foreign currency debt is disclosed separately (not only the translated amount, but also the foreign currency amount), this would make the information provided in financial statements “clear and understandable”.

Although the revised IAS 1 supersedes IAS 5 with effect from 1 July 1998, the disclosure requirement stated above does not seem to have been abolished.

Derivative financial instruments

- IAS 32, “Financial instruments: disclosure and presentation”, includes requirements for the disclosure of terms, conditions and accounting policies for financial instruments, interest rate risk and credit risk data, and the fair value of on- and off-balance sheet financial instruments.

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- In November 1995, the Basle Committee and the IOSCO Technical Committee jointly issued a report on the public disclosure of trading and derivatives activities of banks and securities firms. It contained a series of recommendations for further improvement of qualitative and quantitative disclosure about how trading and derivatives activities contribute to the overall risk profile and profitability of large banks and securities firms with significant involvement in trading and derivatives activities, combined with information on their risk management practices and actual performance.

Segment information

IAS 14, “Reporting financial information by segment” (effective up to mid-1998), required the disclosure of financial information by segments of an enterprise – especially, the different industries and geographical areas in which it operates. For each reported industrial sector and geographical segment, the following financial information should be disclosed:

- sales or other operating revenues, distinguishing between revenue derived from customers outside the enterprise and revenue derived from segments;
- segment result;
- segment assets employed, expressed either in money amounts or as percentages of the consolidated totals; and
- the basis of inter-segment pricing.

The revised IAS 14 that is effective from 1 July 1998 provides for more stringent disclosure requirements regarding segment information.

Contingent liabilities

IAS 10, “Contingencies and events occurring after the balance sheet date”, required that the amount of a contingent loss should be recognized as an expense and a liability if:

-
- it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability incurred at the balance sheet date; and
 - a reasonable estimate of the amount of the resulting loss can be made.

If a contingent liability does not meet one of the above two conditions, and therefore it is not recognized in the accounts, the existence of a contingent liability should be disclosed in the notes to the financial statements. The following information should be provided:

- the nature of the contingency;
- the uncertain factors that may affect the future outcome; and
- an estimate of the financial effect, or a statement that such an estimate cannot be made.

Disclosures in bank financial statements

IAS 30, “Disclosures in the financial statements of banks and similar financial institutions”, requires that a bank should follow all the disclosure requirements of other international accounting standards, and in addition should follow the requirements set by this standard. The specific disclosures, in addition to the ones discussed earlier, that concern the subject matter of this study, are presented below.

Losses on loans and advances

A bank should disclose the following:

- The basis on which uncollectable loans and advances are recognized as an expense and written off.
- Details of the movements in the provision for losses on loans and advances during the reporting period. It should disclose separately the amount recognized as an expense in the period for losses on uncollectable loans and

advances, the amount charged in the period for loans and advances written off, and the amount credited in the period for loans and advances previously written off that have been recovered.

- The aggregate amount of the provision for losses on loans and advances at the balance sheet date.
- The aggregate amount included in the balance sheet for loans and advances on which interest is not being accrued and the basis used to determine the carrying amount of such loans and advances.

The amount of losses that have been specifically identified as uncollectable is recognized as an expense and deducted from the carrying amount of the appropriate category of loans and advances as a provision for losses on loans and advances. The amount of potential losses not specifically identified (but which experience indicates are present in the portfolio of loans and advances) is also recognized as an expense and deducted from the total carrying amount of loans and advances as a provision for losses on loans and advances. The assessment of these losses depends on the judgement of management; it is essential, however, that management applies its assessments in a consistent manner from period to period.

Other relevant disclosures

A bank should disclose any significant concentration of its assets, liabilities and off-balance sheet items. Such disclosures should be made in terms of geographical areas, customer or industry groups or other concentrations of risk. A bank should therefore disclose:

- the amount of any significant net foreign currency exposures;
- the market value of dealing securities and marketable investment securities if these values are different from the carrying amounts in the financial statements;
- an analysis of assets and liabilities in relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date;
- the aggregate amount of secured liabilities and the nature and carrying amount of assets pledged as security.

Review and analysis of accounting practices

In order to review and analyse the accounting practices that seem to have affected the disclosure of useful information regarding the financial transactions that contributed to the Asian financial crisis, an empirical study was conducted on the basis of published financial statements for the most recent year; in most cases this was 1997. Using information available in UNCTAD and in consultation with the representatives of stock exchanges and securities market regulatory bodies (securities and exchange commissions or equivalent bodies), a list of 20 large publicly traded local companies was prepared (10 corporations and 10 banks) for six countries (the five East Asian countries plus Japan). Table 4 shows the number of financial statements finally collected and reviewed in the case of each of the countries.

Table 4. Number of sample companies covered by the study

Country	Financial statements of corporations	Financial statements of banks	Total number of financial statements
Indonesia	5	2	7
Malaysia	7	8	15
Philippines	14	6	20
Republic of Korea	3	8	11
Thailand	10	10	20
Subtotal for the five East Asian countries	39	34	73
Japan	8	9	17
Total	47	43	90

Source: UNCTAD survey of accounting practices.

Available financial statements were used as the primary source of information for the empirical study. In addition to this, telephone interviews were conducted with a large number of specialists in the following organizations in the countries covered by the survey: securities market regulatory bodies, stock exchanges, central banks, associations of securities analysts, leading international accounting firms, and educational institutions.

For the purpose of the analysis, the published financial statements were reviewed (including the notes to the financial

statements of each of the sample companies), and actual accounting and disclosure practices in the following areas identified:

- related party lending and borrowing;
- foreign currency debt;
- derivative financial instruments;
- segment information;
- contingent liabilities; and
- additional disclosures in the financial statements of banks.

The actual accounting and disclosure practices of all the sample companies of the five East Asian countries were used to obtain an overall picture of compliance with international accounting standards. Also, compliance with these standards in individual countries was assessed. To determine compliance, a checklist of benchmark practices in line with the reasoning of this article was prepared. Table 5 includes, in the right-hand column, information about the overall compliance with these standards by all the sample companies (corporations and banks) in the five East Asian countries. This information shows the percentage of the total sample companies complying with the benchmark practices. It should be noted that national accounting practices were compared with the international accounting standards and not with national accounting standards. This is because one objective of the study was to identify what improvements could be made in accounting disclosure from the point of view of both national requirements and national practices. It is likely that in most cases the corporations surveyed were in compliance with their national regulations.

The information in table 5 is based on the most recent financial statements of the large corporations and banks that survived the financial crisis. Following the outbreak of the crisis in mid-1997, there has been a greater demand for better accounting information in the East Asian region. Therefore, one can assume that large corporations and banks tried to make their 1997 financial statements more informative than they had been in the past. However, even with this improvement, the degree of compliance of the surviving corporations and banks with international accounting standards was rather disappointing.

Overall findings for the five East Asian countries

The results shown in table 5 indicate that most of the corporations and banks in the five East Asian countries did not follow international accounting standards in reporting those financial transactions that appear to have been responsible for triggering the financial crisis. The lack of compliance with the standards affected transparency in the financial statements. This hindered the dissemination of useful financial information through financial statements. As a result of this, the users of financial statements failed to note their weakening condition and performance well in advance of the outbreak of financial crisis in the affected countries.

About one-third of the total sample companies in the five affected countries disclosed information regarding related-party lending and borrowing. This finding reveals that the need for disclosing this vital information is not unknown in the region. Adequate enforcement efforts could therefore ensure greater compliance with this disclosure requirement throughout the region.

Although more than 60 per cent of the sample companies disclosed foreign currency debt in local currency, only 45 per cent disclosed the amount of foreign debt in the currency of repayment. Whereas 64 per cent of the sample companies mentioned the use of the closing rate of exchange for translating foreign debt on the balance-sheet date, only 15 per cent recognized and disclosed foreign-currency translation gains and losses according to international accounting standards. Disclosure of the amount of foreign-currency debt in the currency of repayment would have provided a better picture on the risks associated with foreign currency debt financing. Moreover, this information would have enabled the readers of financial statements to understand the concentration of foreign debt in any one or more foreign currencies. When the foreign debt of an enterprise is highly concentrated in the currency of a particular foreign country, volatility in that currency is likely to affect adversely the financial conditions of the borrowing enterprise. According to international accounting standards, enterprises should disclose their foreign currency risk-management policy. Unfortunately, none of the sample companies disclosed such information in their financial statements.

Table 5. Checklist of accounting practices according to international accounting standards and overall compliance in five East Asian countries^a

Desired accounting practice	Compliance in total sample (per cent)
I. <u>Related-party lending and borrowing</u>	
1.1 Intercompany receivables, amount disclosed.	37
1.2 Receivables from associates, amount disclosed.	26
1.3 Intercompany loans and payables, amount disclosed.	36
1.4 Loans from and payables to associates, amount disclosed.	22
II. <u>Foreign currency debt</u>	
2.1 Foreign currency debt in equivalent local currency, amount disclosed.	62
2.2 Foreign currency debt in currency of repayment, amount disclosed.	45
2.3 Foreign currency debt translated at closing exchange rate, policy disclosed.	64
2.4 Foreign currency translation gains/losses recognized according to international accounting standards and amount disclosed.	15
2.5 Foreign currency risk management policy described.	0
III. <u>Derivative financial instruments</u>	
3.1 Issuance of derivative financial instruments, amount disclosed.	37
3.2 Existence of foreign currency denominated derivative financial instruments, foreign currency amount disclosed.	18
3.3 Interest amount and losses incurred relating to derivative financial instruments, amounts disclosed.	15
3.4 Terms, conditions and accounting policies regarding derivative financial instruments, described.	12
3.5 Extent of risk associated with the issuance of derivative financial instruments, described and/or amount disclosed.	0
IV. <u>Segment information</u>	
4.1 Industry segments described.	30
4.2 Geographical segments described.	7
4.3 Sales revenues of each of the segments, amount disclosed.	30
4.4 Operating results of each of the segments, amount disclosed.	30
4.5 Segment assets employed, amount disclosed.	27
4.6 Inter-segment sales, amount disclosed.	11
V. <u>Contingent liabilities</u>	
5.1 a) Nature of contingent liabilities described.	
b) Amount of contingent liabilities disclosed.	45
5.2 Guarantees given in support of debt financing transactions, amount disclosed.	32
5.3 Commitments made in support of off-balance sheet debt financing of the enterprise itself or of any other related or unrelated parties, described and/or amount disclosed.	47
	<i>l...</i>

Table 5 (concluded)

VI. <u>Additional disclosures in bank financial statements</u>	
6.1 Accounting policy for loan/loss provision, described.	0
6.2 Loan/loss provision for the accounting period, amount separately disclosed.	97
6.3 Details of movement in loan/loss provision, amount disclosed.	91
6.4 Aggregate amount of loans and advances in balance sheet, for which interest is not being accrued, amount disclosed.	79
6.5 Basis used to determine the carrying amount of loans for which interest is not being accrued, described.	15
6.6 Significant concentration of loan portfolio in specific sectors, amount disclosed.	3
6.7 Significant concentration of sources of liabilities, amount disclosed.	32
6.8 Significant concentration of off-balance sheet items, amount disclosed.	9
6.9 Significant net foreign-currency exposure, amount disclosed.	0
6.10 Market value of dealing securities and marketable securities, amount disclosed.	9
6.11 Analysis of assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date, amount disclosed.	38
6.12 Aggregate amount of secured liabilities, amount disclosed.	21
6.13 Nature and carrying amount of assets pledged as security, described and amount disclosed.	0

^a Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand.

The financial statements of almost half of the total number of sample companies included information about the existence of derivative financial instruments. The disclosure of the amount of derivative financial instruments, as required by international accounting standards was found in only 37 per cent of the cases. Half of the companies that reported the amounts of derivative financial instruments disclosed the foreign currency amount of these instruments. Of the total number of sample companies, 11 per cent reported that they had issued derivative financial instruments denominated in foreign currency without any disclosure of the amount either in local currency or in foreign currency. More than 80 per cent of those companies that reported the existence of derivative financial instruments did not disclose the amount of interest and losses relating to derivative financial instruments or the terms, conditions and accounting policies regarding derivative financial instruments. Also, none of the sample companies disclosed any information about the extent of risk associated with the issuance of derivative financial instruments. These findings suggest that most of the corporations

and banks in the East Asian region do not fully comply with the international accounting standards on derivative financial instruments.

The corporations and banks covered in this study are the largest ones in their respective countries. Almost all of them seem to have operations in different industries and geographical segments. In the survey, limited disclosure of segment information was found. The financial statements of only about 30 per cent of the sample companies provided most of the information on industry segments required by international standards. An insignificant portion of all the financial statements contained disclosure on geographical segment information.

The disclosure of information on contingent liabilities also appeared to be inadequate. Although more than three-quarters of the samples disclosed information on the nature and amount of contingent liabilities, less than one-half provided information on guarantees in support of debt-financing transactions. Those who are knowledgeable about the business environment in East Asian countries know that almost all large corporations and banks frequently give guarantees to help related and unrelated enterprises in obtaining debt financing. However, the information on disclosure of information on guarantees is disappointing. Experience shows that many of the large corporations and banks in East Asian countries make commitments in support of off-balance sheet financing of the enterprise itself or of other related or unrelated parties. Unfortunately none of the sample corporations and banks provided any information on such commitments. This latter finding indicates that either such commitments do not exist, or companies prefer not to talk about any such commitments for off-balance sheet financing.

The survey of the disclosures in bank's financial statements reveals that East Asian banks generally do not comply with the requirements of IAS 30, "Disclosures in the financial statements of banks and similar financial institutions". Almost all the sample banks disclosed their accounting policy for loan/loss provision. However, the provisioning in most cases followed the requirements set by the regulatory authorities in the respective countries. It appears from the financial statements of most of the sample banks that provisioning did not follow any strict policy of reporting based on prior experience in collecting loans and advances. This finding is reinforced by the

finding that 85 per cent of the sample banks did not disclose in the balance sheet the aggregate amount of loans and advances for which they stopped accruing interest. It is not surprising that 97 per cent of the sample banks did not disclose any information on the basis used to determine the carrying amount of loans for which interest is not being accrued.

The financial statements of more than two-thirds of the banks covered by this study provided no information on significant concentration in their loan portfolios. This indicates that external analysts did not have access to very important information that would have enabled them to assess properly the lending risks faced by the majority of the banks in the five East Asian countries. Similarly, the lack of disclosure by more than 90 per cent of the sample banks on the significant concentration of liabilities deterred outsiders from clearly understanding the borrowing risks of banks. Information on the exposure of banks to foreign currency risk is very important to external analysts, and for this reason international accounting standards require banks to disclose the amount of significant net foreign currency exposure. Unfortunately, more than 90 per cent of the sample banks did not disclose any information on their net foreign currency exposures. Non-compliance with the relevant standards is further evidenced by the fact that none of the banks covered by this study disclosed any information on the following: the significant concentration of off-balance sheet items; the aggregate amount of secured liabilities; and the nature and carrying amount of assets pledged as security. Moreover, disclosures on other information required by the international accounting standards were not found in the financial statements of a vast majority of the banks covered by this study.

It needs to be re-emphasized here that the financial statements produced by enterprises in each of the countries covered by this study follow the accounting and reporting requirements set by the national standard-setting bodies of the respective countries. Of the five countries, Malaysia has officially adopted the international accounting standards and prepares its national accounting standards in line with them. The national accounting standards of Indonesia, the Philippines, the Republic of Korea and Thailand follow generally accepted accounting principles but do not followed all international accounting

standards. The same is true in the case of Japan, where Japanese accounting standards differ in certain respects from international accounting standards.

The study did not attempt to analyze the differences between national and international accounting standards. The objective was to find out whether or not the actual accounting practices of corporations and banks in the crisis-hit countries differed from the accounting and reporting requirements set by the international accounting standards. It is understandable that even if a country's national accounting standards comply with international accounting standards, without monitoring, there is no way of knowing whether these standards are implemented by enterprises. Experience has shown that, owing to the absence of appropriate enforcement mechanisms, enterprises in many countries ignore national or international standards and follow such accounting practices as suit their own purposes.

A summary of the survey results for each of the countries is presented below.

Indonesia

The sample was very small (seven enterprises), and a more definitive analysis will be done upon receipt of additional financial statements from the Ministry of Finance of Indonesia. Preliminary results show that more than half of the sample companies disclosed information on related-party lending and borrowing. The amount of foreign-currency debt was disclosed in both local and foreign currencies by the vast majority of the sample companies. Most of the sample companies did not comply with international accounting standards in the case of accounting and reporting for foreign-currency gains and losses. Disclosure on foreign-currency risk-management policy was not found in any of the financial statements. The local-currency as well as foreign-currency amounts of derivative financial instruments were disclosed by a majority of the sample companies, and some additional sample companies mentioned the existence of these instruments without specific disclosure of the amount. Most of the sample companies did not disclose any information on the interests

and losses relating to derivative financial instruments, or on the terms, conditions and accounting policies regarding such instruments. No one disclosed the extent of risk associated with the issuance of derivative financial instruments. The majority of the sample companies did not disclose the segment information required by international accounting standards. A vast majority of the sample companies disclosed the nature of contingent liabilities without disclosure of the amount of contingent liabilities. The amount of guarantees given was separately disclosed by a vast majority of the sample companies. As in the case of other countries in the region, no one disclosed information on commitments in support of off-balance sheet financing. The financial statements of none of the sample banks completely complied with the specific disclosure requirements for bank set by international accounting standards.

Japan

The existence of large conglomerates with cross ownership is a common feature of the Japanese economy. There is a general perception that related party lending and borrowing is quite common in Japan, but disclosure in this regard appears to be quite disappointing. The financial statements of almost all the sample companies are silent about related party lending and borrowing. While less than half of the sample companies disclosed the amount of foreign debt in local currency and less than one fifth disclosed the amount of foreign debt in foreign currency, 59 per cent reported the use of the closing rate for translating foreign currency debts on the balance-sheet date. In the case of accounting and reporting for foreign-currency translation gains and losses, only 35 per cent of the sample companies recognized and disclosed the amount in compliance with the requirements of international accounting standards. In the case of derivative financial instruments, more than half of the sample companies appear to have complied with most of the disclosure requirements of international accounting standards; less than one third of the samples disclosed the extent of risk associated with the issuance of derivative financial instruments. The disclosures on all the items of segment information were found in the financial statements of about two-thirds of the sample companies. While 76 per cent of the sample companies disclosed the nature and amount of contingent liabilities,

53 per cent disclosed separately the amount of guarantees given, and no one disclosed information on the commitments in support of off-balance sheet debt financing.

Overall, a discouraging picture was found in the case of compliance with the specific disclosure requirements for the financial statements of banks. While all the sample banks disclosed their accounting policies on loan/loss provisions, only 33 per cent disclosed the amount of loan/loss provisions and the details of movement in loan/loss provisions. While 44 per cent of the sample banks disclosed the aggregate amount of loans and advances for which interest was not being accrued, only 11 per cent provided the basis used to determine the carrying amount of loans and advances for which interest was not being accrued. It is an established fact that the bad loans of Japanese banks caused serious problems for the economy of Japan. Disclosure on significant concentrations in the loan portfolio can help external analysts understand the potential for bad loans. Disclosure deficiency in this regard is evidenced by the fact that only 22 per cent of the sample banks disclosed information on the significant concentration of their loan portfolios. Of the total sample banks, 44 per cent disclosed required information on significant net foreign-currency exposure, 89 per cent disclosed information on the market value of marketable securities, and 11 per cent disclosed information on significant concentrations of off-balance-sheet items. None of the sample banks disclosed information on the following: significant concentrations of liabilities; analysis of assets and liabilities into relevant maturity groupings based on the remaining period until the contractual maturity date; the aggregate amount of secured liabilities; and the nature and carrying amount of assets pledged as security.

During the course of this study, the Security Analysts Association of Japan was asked to give its views on the role of accounting in the Asian financial crisis. The response from Yukiko Ohara (Vice President, Morgan Stanley Japan Limited, Tokyo Branch), dated 7 July 1998, deals in great detail with the disclosure deficiencies in Japan concerning problem loans. Below, excerpts are presented:

“If disclosure correctly indicating actual conditions had been forthcoming earlier, far more appropriate investment decisions with respect to the Far East region could have been made. As for the analysis of Japan’s financial sector in particular, the information most sought after during the past ten years has been that relating to asset quality. But, to our regret, it has been almost impossible to identify the actual situation by examining data disclosed under the [existing] regulatory requirement.

It has been possible for banks to arbitrarily manipulate declared problem loan amounts under the current standards. One example of the manipulation of declared problem loans under current standards [is as follows]:

Suppose there is a loan past due five months and twenty-nine days. If the lender effects new financing, five months and thirty days after the original loan extension and makes the borrower repay part of the principal and interest, the loan concerned is not classified as past due.

The market has seen a lot of independent estimates regarding the amount of problem loans. However, the absence of decisive proof prevented bank stock prices from being instantly adjusted to fair value. In the absence of proper disclosure and on the basis of the announcements by the authorities and banks, investors often held, even temporarily, an optimistic view that the bad asset problem of banks had almost been solved. Investors were therefore unable to make the decision to sell bank stocks until prices fell steeply.

The disclosure of asset quality must be based on proper standards and should be strictly reviewed by an independent supervisory body. In other words, self-assessment [by banks] is not reliable. Besides information on non-performing assets, segmental data are indispensable to analyze Japan’s financial institutions, and which includes income statements, balance sheets, profitability, and asset quality data for retail banking divisions or middle market divisions, and similar data for each country (e.g. Asian countries). More detailed information on off-balance sheet transactions is also desirable.

Disclosure that will facilitate the analysis of contingent risks arising from derivatives-related transactions is called for. Improvement of such data would lead to more rational behaviour of the market, resulting in the earlier recognition of crises. Finally, amid the intensifying globalization of investment activities, what investors need is the disclosure of information eliminating, or at least adjusting, differences in accounting standards, and disclosure standards among different countries.”

Malaysia

Although Malaysia has officially adopted international accounting standards, the mixed findings on compliance with the required accounting and reporting practices suggest insufficient enforcement efforts in that country. A vast majority of the sample companies disclosed the amounts of intercompany receivables and payables, but there was negligible disclosure on lending and borrowing activities with associates. Most of the sample companies did not disclose the amounts of foreign debt either in local currency or in the currency of repayment. All sample companies mentioned the use of the closing rate for translation of foreign-currency transactions. However, the recognition and disclosure of the amount of foreign-currency translation gains and losses by almost all the sample companies was not in compliance with the applicable international standard. None of the sample companies disclosed its accounting policy on foreign currency risk management. While more than a quarter of the sample companies disclosed the amount of derivative financial instruments, none disclosed the extent of risk associated with the issuance of derivative financial instruments, and none disclosed the other relevant information required by international accounting standards. Disclosures were made on various elements of segment information by about two-thirds of the sample companies. While most of the sample companies disclosed the amount of contingent liabilities, a lesser number separately disclosed the amount of guarantees given. There was no disclosure on commitments in support of off-balance sheet debt financing. A high degree of compliance with international accounting standards was found in the case of some of the disclosure requirements in the financial statements of banks. However, some very important items of disclosure were not found in the financial statements of any of the sample banks.

Philippines

While the Philippine financial system has remained stronger than those in other Asian countries, accounting practices in the 1997 financial statements were flawed. Only a tiny portion of the sample companies disclosed the amounts of related-party lending and borrowing. One-half of the sample companies disclosed the amount of foreign debt in both local and foreign currencies, but most of the companies did not comply with the international standards in accounting and reporting for foreign-currency translation gains and losses. Foreign-currency-risk management policy was not disclosed by any of the sample companies. Less than a third of the sample companies disclosed the amount of derivative financial instruments, although some others mentioned the existence of these financial instruments. Almost none of the sample companies disclosed any other element of information required under international accounting standards for derivative financial instruments. In the case of segment information, compliance with international accounting standards was found in the financial statements of only a tiny portion of the sample companies. Disclosures on various items of contingent liabilities were also disappointing. Disclosure of accounting policy for loan-loss provisions, the amount of loan/loss provisions, and details of movement in loan/loss provisions could be found in the financial statements of most of the sample banks. The financial statements of the sample banks did not show any other relevant information specifically required to be disclosed according to the international accounting standards for financial statements of banks. According to the Philippine authorities, significant steps have been taken in aligning regulatory, risk management and disclosure practices with international standards. Therefore, it will be interesting to analyse the 1998 statements to see what improvements have been made.

Republic of Korea

As discussed earlier in this article, large conglomerates known as chaebols dominate the economy of the Republic of Korea. It is a well-known fact that these conglomerates often engage in related-party lending and borrowing. The survey results show that none of the sample companies disclosed the amount of related party lending and borrowing. The financial statements of a little less than one-half

of the sample companies made reference to the existence of related-party lending and borrowing but without disclosure of the amount. While all the sample companies reported foreign currency debt in the local currency, none disclosed the amount of foreign debt in the currency of repayment, and not a single corporation or bank followed international accounting standards in accounting and reporting for foreign currency translation gains and losses. Although the vast majority of the sample companies reported the amount of the issuance of derivative financial instruments, only a tiny portion complied with other disclosure requirements set by the relevant international standards. An almost total non-compliance with international accounting standards was found in the case of segment information. While all the sample companies disclosed the amount of contingent liability, none disclosed information on commitments for off-balance sheet financing activities. Except in the case of a few items of disclosure, overall disclosure in the financial statements of almost all the sample banks did not comply with the specific disclosure requirements for banks set by the international accounting standards.

Thailand

Of the total number of sample companies in Thailand, exactly one-half disclosed the amount of related-party lending and borrowing. The amount of foreign debt in both local and foreign currencies was disclosed in most of the financial statements. In the case of recognition and reporting of foreign currency gains and losses, a vast majority of the sample companies did not comply with the international accounting standards, and, in the case of foreign-currency-risk management policy, there was no disclosure by anyone. While only a quarter of the sample companies disclosed the amount of derivative financial instruments in both local and foreign currencies, an additional one-fifth mentioned the existence of such instruments but without any disclosure of the amount. The amount of interest and losses relating to derivative financial instruments, and the terms, conditions and accounting policies regarding such instruments, were disclosed by only one-fifth of the sample companies. None of the sample companies disclosed any information regarding the extent of risk associated with the issuance of derivative financial instruments. The disclosure of various elements of segment information, as required under international accounting standards, was not found in

the financial statements of a vast majority of the sample companies. A vast majority of the sample companies disclosed the nature and amount of contingent liabilities and guarantees. As in the case of other countries in the region, no one disclosed information on commitments in support of off-balance-sheet financing. The financial statements of banks hardly complied with the specific disclosure requirements for banks set by international accounting standards.

Conclusions and policy recommendations

The continuing lack of compliance with international accounting and reporting standards is likely to increase both the possibility and the severity of future financial crises, because policy makers and investment analysts will still be without reliable micro-level financial indicators which could, along with macroeconomic indicators, provide early warning signals. As a part of the institutional strengthening in emerging market economies, including in East Asian countries, it is necessary to develop accounting regulations on the basis of international accounting standards and establish mechanisms for ensuring the implementation of such standards.

During the past quarter of a century, various efforts have been made to harmonize accounting and reporting practices worldwide. Still, at the threshold of the new millennium, it is unfortunate that the harmonization of accounting practices has not been achieved. This has hindered the stable growth of global capital markets as well as the progress of the world economy. If accounting is to play its proper role in providing useful and timely information for avoiding financial crises like the one that occurred in the East Asian region, it is necessary to have internationally comparable accounting and reporting practices in all countries of the world. The following recommendations are intended to move things forward in this respect.

Addressed to Governments

First, Governments must realize that accounting reform is part of financial reform. Second, they must make an effort to harmonize their national accounting standards with international ones. Third, unless there are efficient and effective legal and institutional mechanisms for monitoring the implementation and use of accounting

standards, the development of the most sophisticated standards cannot help to improve the quality of information disclosed in financial statements. It is therefore necessary for national Governments to make appropriate efforts, not only to adopt internationally comparable accounting and reporting standards, but also to ensure they are properly implemented. In this regard, bank regulators and securities commissions, ministries of finance and ministries of trade and industry in developing and emerging market economies must make greater efforts in enforcement.

Addressed to the World Bank Group (as catalyst for accounting reform)

It is worth noting that, at this moment, no international organization has taken on the responsibility of making concerted and continuous efforts to improve the implementation of international accounting practices worldwide. It is one thing to formulate, adopt and disseminate such standards and another to ensure that they are implemented. The recent experiences of financial crises in different parts of the world have proved that the integration of a particular country's financial market into the global financial market, in the absence of a strong institutional framework in that particular country, can be detrimental not only to the national economy but also to the global economy. Since financial statements act as an information bridge between an economic entity and financial markets, transparent, reliable and comparable financial information disseminated by financial statements can assist market participants in taking appropriate decisions on a timely basis. Moreover, better accounting can ensure the transparency of the financial performance of economic entities, and thus can provide an early warning about micro-level problems in an economy. From this perspective, improved accounting could help to mitigate financial crises like the East Asian one. In view of the importance of better disclosure and accounting, it is necessary that organized international efforts be directed towards improving accounting and reporting countries that lack internationally accepted accounting practices.

The International Accounting Standards Committee (IASC) is responsible for formulating international accounting standards. As these standards are voluntary, this organization lacks the authority to

require their use. In addition, the organization lacks the structure and resources to assist in their implementation. While the World Bank and the IMF have endorsed the use of such standards from time to time, they have not made their use a condition for receiving structural adjustment loans or institutional loans. Nor have they convinced the ministers of finance that accounting reform is part of financial reform. However, both institutions are interested in accountability and financial stability, and these are possible only if there is a system in place that can produce transparent, reliable and comparable financial information. Given their interest in accountability and financial stability, these institutions should take the lead and ensure that accounting reform is part of financial reform. Throughout the developing world, there are many skilled experts in the ministries of finance and the securities and exchange commissions who are ready to adopt and require the implementation of international accounting standards. What is lacking is the signal from the World Bank and the IMF. In view of the urgent need for accounting development throughout the world, the World Bank Group should play the role of catalyst in accounting reform.

Addressed to international accounting firms

In the course of this study, it was found that the local member firms of the six largest international accounting firms in—(two of which have now merged) were involved in auditing most of the large corporations and banks in the East Asian countries. These auditors followed local auditing standards and practices, although they represent international accounting firms. In addition to complying with the local statutory auditing requirements, the auditors could have adhered to internationally accepted auditing standards and practices. Had they done that, they would have delved deeper in their audits, and this would have enabled them to provide indications in their audit reports regarding the potential financial difficulties of many of the corporations and banks that collapsed or became technically bankrupt immediately before or after the outbreak of the Asian financial crisis.

Many East Asian corporations and banks that received a clean bill of health from their auditors proved to be “not a going concern” within a few months of the completion of an audit. When the financial statements of a corporation or bank receive an unqualified audit

opinion from an auditor belonging to one of the largest international accounting firms, the external users of these financial statements tend to feel comfortable about the quality of the audit and the reliability of the information. Therefore, there is an obligation on the part of the international accounting firms to take the necessary steps to ensure that the quality of audit services provided by their national practices all over the world does not fall short of practices in North America and Europe. If the national accounting and auditing standards of a country do not comply with the guidelines and standards set by the International Federation of Accountants (IFAC) and IASC, the international accounting firms should require their national practices to describe the discrepancies between the national and international practices in their audit opinions. Furthermore, the international accounting profession, through the IFAC, should form a public oversight committee to review the way audits are performed by international accounting firms and assess the contribution of auditing practices to the financial crisis.

***Addressed to financial analysts, rating agencies
and fund managers***

If East Asian corporations and banks are blamed for heavy borrowing and spending (and losing) foreign funds, international financial analysts, rating agencies and fund managers need to be equally blamed for allowing large sums of money to be poured into potentially financially weak enterprises in the region. As discussed earlier, all the above made their assessments and investment decisions based on faulty or incomplete information. In the end, because of the deficient information they had on which to base their decisions, they did not charge a premium that was sufficiently high to cover the risk of investing. They ignored the basic fact that productivity and profitability are the most important factors that determine an enterprise's ability to generate the required cash flows for the payment of interest, principal and dividends.

Hindsight reveals that many of the East Asian enterprises were highly exposed to both business risk and financial risk. Large investments went into unproductive, less productive or internationally uncompetitive enterprises. Moreover, most of these enterprises either failed to take (or decided not to take) protective measures against

financial risk, specifically foreign financial risk. Analysts or investors should have taken these facts into consideration. Unfortunately, they did not do so in the case of the massive inflow of foreign capital into the East Asian region in the early 1990s. Since the lack of transparency in financial statements hindered proper analysis of micro-level risks, the international financial analysts and rating agencies could have demanded more disclosure. Such a demand might have motivated fund seekers to improve their financial reporting practices. If they had failed to meet this demand, then the fund seekers might have faced extreme difficulties created by financial analysts through the imposition of higher capital costs and restricted access to funds. However, financial analysts made no such demands for better information, and fund managers invested despite the lack of information on the riskiness of these investments.

At the same time there does appear to be a need to protect the financial market place, particularly in developing countries, from speculators who can move money too quickly in and out of a country, thereby adding to perceived volatility. The champions of unhindered markets insist that the rigours of the market place will eventually weed out imprudent operators. Perhaps they will — but the cost in East Asia has been too great. During the 1990s, financial analysts, fund managers and institutional investors as a whole seemed willing to invest in stocks and bonds of East Asian firms about which they knew next to nothing, except that everybody else was investing in them. Since these investors failed to demonstrate prudent practice, it seems necessary to look for ways and means to ensure that institutional investors that make cross-border investment decisions follow certain rules and regulations as far as investment decision-making is concerned. While international financial services firms could develop self-regulating mechanisms, the experience of East Asia calls for global guidelines (or regulation) on the short-term cross-border investment decision-making process of the international financial institutions.

In the absence of global regulations and their implementation, national Governments might initiate efforts to discipline imprudent operators in the financial services sector. The Government of the United Kingdom, for example, has created the Financial Services Authority (FSA) which is the world's first consolidated regulator with

the power to coordinate the oversight of all the activities of the firms under its jurisdiction. For each financial service firm, the FSA will appoint a regulatory supervisor, who will coordinate the oversight of specific financial activities, such as insurance, banking and investment management. FSA Chairperson Howard Davies said: "In the way that markets are now developing, the old style of functional or institution-based regulation is going to become out of date. These big [financial] institutions no longer respect the old regulatory boundaries.... The reason we are doing this is rooted in the Barings' problem, where what looked otherwise like a small bit of Barings in Singapore actually brought the bank down" (*Time*, 1998).

In order to avoid future financial meltdowns, financial analysts, rating agencies and fund managers need to pay attention to the fundamental financial conditions of fund-seeking enterprises. If this is not done through a self-regulatory mechanism, national and international regulations are desirable.

Addressed to international standard setters

Efforts are needed at the level of international accounting standard-setters to develop more detailed disclosure requirements concerning the factors that appear to have triggered the East Asian financial crisis. The continuous growth of innovative financing mechanisms and the fast expansion of the international capital market call for more detailed disclosure requirements for new financial instruments and for foreign-currency risk exposures of banks and corporations, particularly in the developing and emerging market economies. It seems necessary to develop such an accounting and reporting procedure for financial institutions so that an effective self-regulating mechanism will deter manipulations in accounting for problem loans. Moreover, international accounting and auditing standard-setters need to analyze the factors that were responsible for the inability of the auditors to properly apply the "going concern" concept in the East Asian region and their failure to report related-party transactions. Such an analysis could help in the development of improved standards that would facilitate the avoidance of future financial crises.

Conclusion

The lack of transparent, reliable and comparable financial information did not cause the financial crisis in East Asia: a weak financial infrastructure, ill-conceived liberalization and speculation were all to blame. What is argued here is that if reliable accounting information had been available, excessive financial exposures would have been detected earlier, allowing corrective action to be taken by the banks and corporations themselves, as well as by market participants and regulators, thus diminishing the magnitude of the crisis. Accounting disclosure should have provided useful and timely information – early warning signals – on the weakening financial condition of enterprises. The main recommendation of this article is therefore that concerted national and international efforts should be made to develop and implement international accounting and reporting standards, compliance with which should be monitored and enforced. ■

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Investment protection in the era of globalized firms: the legal concept of “transboundary harm” and the limits of traditional investment treaties

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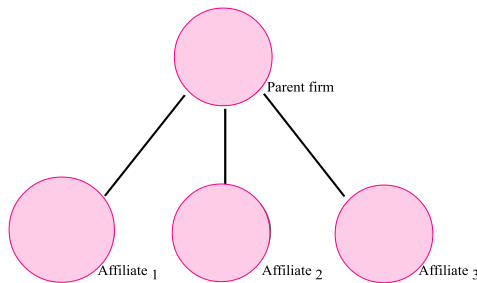
The globalization of investment activities has led to the establishment of transnational corporate networks. Companies increasingly divide work between their various entities in such a manner that each affiliate can maximize its competitive advantages in delivering the end-product. While the emergence of these highly integrated international production networks has increased the efficiency and competitiveness of transnational corporations, it has also made them more vulnerable to cross-border harm in cases where a host country violates its obligations under an investment agreement. Damage might no longer be limited to the foreign affiliate located in a host country, but may spread to other affiliates of the transnational corporation that are part of the corporate network. This raises the issue as to whether international law protects foreign investors from transnational harm in cases of violation of an investment agreement. This article argues that neither customary international law nor existing investment treaties adequately deal with this matter. The principle of compensation for transboundary harm could be established in future investment agreements. Intra-firm production networks deserve protection under international law as these new corporate structures are increasingly replacing the traditional model of highly autonomous production units, on the basis of which the existing rules of international law were developed.

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Introduction

The globalization of investment activities goes along with major changes in the strategies of transnational corporations (TNCs) and the way in which they organize themselves.¹ Traditionally, TNCs were structured in a strictly hierarchical manner, with one parent company at the top and one or several foreign affiliates in the host country or countries (figure 1). TNCs thus consisted of a multitude of bilateral intra-firm relationships.

Figure 1. The traditional structure of TNCs



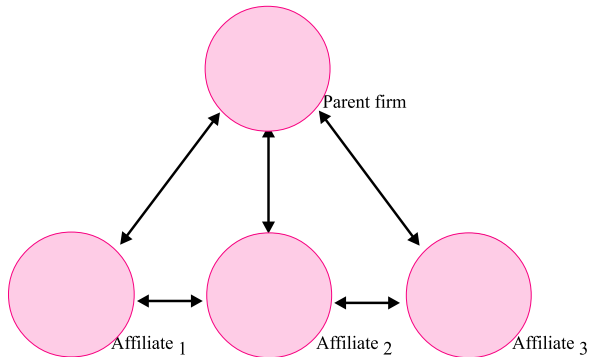
Source: adapted from UNCTAD, 1993, p. 119.

This rather simplistic model of a TNC is becoming obsolete, as trade barriers fall, technology improves and international competition intensifies. With the tendencies of markets to converge, the lowering of trade barriers and the ever more pressing need to seek cost savings, companies are organizing their activities in a much more complex manner (Zampetti and Sauvé, 1994, p. 15). This development has intensified recently, as evidenced by some spectacular cross-border mergers and acquisitions (M&As).² The result is the emergence of regional or global corporate networks with numerous links not only between the parent and each individual affiliate, but among the entire corporate system, and the establishment of a sophisticated international intra-firm division of labour (figure 2).

¹ The following observations are based on UNCTAD (1993). See also UNCTAD (1998), p. 108.

² In 1997, total cross-border M&A transactions worldwide amounted to some \$342 billion; their value in relation to total inflows of foreign direct investment rose to 58 per cent (UNCTAD, 1998, p. 19).

Figure 2. The complex structure of TNCs



Source: adapted from UNCTAD, 1993, p. 123.

The establishment of regional or global networks and the great variety of ways in which they are structured affect the impact of laws and regulations on TNC operations in host countries. On the one hand, the fact that the activities of a TNC are distributed in several countries may make it less vulnerable to national measures, because production can shift from one place to another. TNCs could prevent or minimize further negative effects by relocating their activities to other host countries. On the other hand, the closer the various activities of a TNC are interwoven, the more the regulatory measures adopted by one host country may affect the TNC as a whole. In particular, this would be the case if the measures of the host country specifically address the relationship between affiliates located in its territory and other entities of the TNC.

National measures can affect other entities of the same TNC in third countries in many ways. For example, an export prohibition might have the effect of preventing an affiliate from providing other entities with certain raw materials or other components that those entities need for their own production process. The absence of financial aid for certain research and development (R&D) activities that an affiliate can claim might weaken a TNC's overall competitive position. If an affiliate is in charge of the accounting operations of the entire TNC, an expropriation of this entity by the host country might have the consequence that the activities of the TNC as a whole are temporarily interrupted until another entity has assumed this function or it has been outsourced. In the worst-case scenario,

measures adopted by a host country can disrupt the activities of the entire TNC system.

This article examines the legal consequences of national measures that are contrary to international law, and that cause damage to the affiliates of a TNC or to a TNC as a whole. More specifically, it deals with situations in which national measures violate obligations under an investment agreement. In this case, the question arises as to whether international law entitles TNCs to compensation for the damage that they suffer as a result of the treaty violation. If the answer is positive, one may further ask whether international law obliges a host country to compensate a foreign investor only with regard to damage that it inflicts upon the affiliate located in its territory, or whether compensation also includes damage that the host country has caused to other entities of the TNC in third countries.

Compensation rules in existing investment treaties

Bilateral investment treaties

The most common international instruments for the protection of foreign investors are bilateral investment treaties (BITs) (Parra, 1995, p. 28). By the end of 1997, about 1,600 such agreements had been concluded worldwide, involving 169 countries (UNCTAD, 1998, p. 59). These treaties protect the affiliates of foreign investors in host countries from discrimination. To this end, they oblige the host country to grant national treatment and most-favoured-nation treatment. Furthermore, BITs usually deal with cases of expropriation, capital transfer restrictions, and losses resulting from war, civil disturbance and similar events. In addition, many BITs contain a provision according to which the contracting parties commit themselves to respect any other obligation they have entered into in an individual investment contract with a foreign investor of the other contracting party (UNCTAD, 1999).

To some extent, these provisions also contain compensation rules:

- First and foremost, BITs provide for compensation in case of expropriation. If the host country expropriates the assets of an

affiliate, the foreign investor has the right to claim prompt, adequate and effective compensation. Adequate compensation means that it has to be equivalent to the fair market value of the expropriated assets.

- BITs also deal with compensation in case of losses due to war, civil disturbance and similar events (protection from strife). The relevant treaty article does not usually provide for mandatory compensation. The investor can only claim non-discriminatory treatment if the host country decides to compensate its own investors.³

However, these two compensation rules do not fit well into the present context because they do not require that the host country should have violated its treaty obligations. The duty to compensate exists for any lawful expropriation.⁴ Likewise with regard to losses from strife, the obligation to grant non-discriminatory treatment as regards compensation does not presuppose that the host country has caused the damage by an act that was contrary to international law.

Furthermore, neither of the two provisions deals with the issue of transboundary harm:

- As far as the article on expropriation is concerned, the explanation is that a host country can only take property that is located within its own territory. Compensation therefore is limited to the value of the assets of a TNC in the host country. The situation could only be different in case of an *illegal* expropriation –that is, an expropriation that is discriminatory, that is not accompanied by payment of prompt, adequate and effective compensation, or that does not respect due process of law. In this case, a foreign investor could claim damages — not compensation — according to customary international law.

³ Some BITs, however, provide for mandatory compensation if the loss results from the requisitioning of all or part of such investments by the party's forces or authorities, or from the destruction of all or part of such investments by the party's forces or authorities that was not required by the necessity of the situation (see, for example, article IV, para. 2, of the United States model BIT).

⁴ For illegal expropriations see the following paragraphs.

These damages might include transboundary harm.

- With regard to protection from strife, the relevant treaty provision would not, in theory, exclude the possibility that the host country might compensate the foreign investor for harm beyond its border. Such harm might occur if, for instance, the war-related destruction of an affiliate causes production losses for the parent company abroad because the affiliate can no longer supply it with raw materials. However, as the foreign investor can usually claim only non-discriminatory treatment under this article, compensation would require that the host country decide to pay damages to its domestic companies for harm caused beyond its borders. Only then could a TNC claim that it is in the same situation as a domestic company as far as compensation for transboundary harm is concerned.

With regard to other key elements of BITs, such as the obligation to grant national treatment and most-favoured-nation treatment, to ensure the free transfer of capital, or to respect any other contractual commitment with regard to an investment, BITs usually contain no compensation provision at all. Nonetheless, a violation by the host country of any of these commitments can have severe negative consequences for the foreign investor. For instance, discrimination which is not allowed under a BIT could disadvantage an affiliate vis-à-vis its domestic competitors, and could even drive the foreign investors in the host country out of business. Such discrimination could likewise affect the operations of other affiliates of the TNC involved.

Damage may also be caused by restrictions on the transfer of capital. If, for instance, a host country prohibits a foreign affiliate from transferring profits to the parent company or from repaying a debt contrary to a treaty obligation that ensures free transfer, the damage caused to the parent company would become obvious.

Likewise, the breach of an individual investment contract that a host country had concluded with a foreign investor might cause damage. If, for example, a host country agreed by contract to provide a foreign affiliate with certain infrastructural support (for instance, the construction of a new road), the non-fulfilment of this obligation

may seriously hamper the operations of the affiliate, and even result in a complete breakdown of its activities. This might have further detrimental effects on other affiliates of the parent TNC located in third countries that maintain business relations with that affiliate.

Regional and multilateral investment treaties

The legal situation is similar with regard to recent efforts to develop regional or multilateral rules on investment. Prominent examples are the investment-related World Trade Organization (WTO) agreements (the General Agreement on Trade in Services, the Agreement on Trade-Related Investment Measures and the Agreement on Trade-Related Aspects of Intellectual Property Rights), the North American Free Trade Agreement (NAFTA), the Energy Charter Treaty, and the unsuccessful negotiations on a multilateral agreement on investment (MAI) in the Organisation for Economic Co-operation and Development (OECD)(OECD, 1998). To the extent that these new treaties and projects contain provisions on the protection of foreign investment, they are built on the same concepts and principles as the BITs.

The only major exception to this rule concerns prohibitions on trade-related performance requirements. They are usually not part of BITs, but have been included in the Agreement on Trade-Related Investment Measures (TRIMs), NAFTA (article 1106), and the Energy Charter Treaty (article 5). They were also envisaged in the MAI. These requirements can be another source of damage for foreign investors. If, for example, a host country requires an affiliate to source inputs only from local producers — who sell at a higher price than foreign competitors — the resulting extra costs would constitute a damage. Similarly, an affiliate may lose profits if a host country prohibits exports, or imposes a certain percentage of domestic sales, when it could achieve a higher price abroad.

Nonetheless, these new investment-related treaties do not provide for compensation rules beyond the cases of expropriation and protection from strife, and they do not deal at all with the issue of transboundary harm. This is all the more astonishing as a multilateral investment agreement could, in principle, cope better than BITs with the regional or global structure of TNCs. In particular, it

could protect the internal corporate networks of TNCs. To the extent that these networks cut across more than two countries, a BIT alone could not provide this kind of protection in any event. Dealing with the issue of compensation for harm beyond the border in a multilateral investment treaty would be a substantial value-added compared with the level of protection achieved at the bilateral level.

One can only wonder why BITs and the new regional and multilateral investment-related treaties lack explicit compensation rules beyond the cases of expropriation and protection from strife. One reason might be that the parties did not want to undertake explicit obligations in this respect. Given the complexity of the matter and the potential large amounts of damage involved, it may be that the parties deliberately decided not to touch upon such a delicate issue in their negotiations. Another explanation might be that they simply forgot to deal with the matter. A further possibility would be that they thought the issue was already sufficiently dealt with under customary international law.⁵

Especially when it comes to losses in third countries, an additional reason for the limited approach of BITs and the new investment treaties may be that they are only concerned about the well-being of an affiliate in a given host country. The structure of all investment treaties reflects to a large extent the original model of foreign direct investment (FDI), where one parent company establishes one or several affiliates abroad that are highly autonomous (“stand-alone” affiliates), and where there is little or no interaction between the various entities (UNCTAD, 1993). In such a situation, it is, in principle, sufficient that the treaty protects the foreign investor only with regard to a damage occurring to the affiliate in the host country. There would be little or no risk of the damage spreading to other affiliates located in third countries, or to the parent company itself.

Taking into account the substantial changes in the corporate strategies of TNCs, one may doubt whether this narrow approach is still appropriate. In general, the present legal debate takes little account of the emergence of integrated international production

⁵ See the following section.

networks of TNCs. BITs and the other investment treaties leave the foreign investor virtually unprotected if the damage suffered by an affiliate in one host country causes losses to other entities of the corporate network located in other countries. This is all the more unsatisfactory as the loss suffered in third countries can surpass the initial damage caused to a foreign affiliate. For example, if a host country, contrary to its treaty obligations, prohibits an affiliate from transferring data to the parent company, the financial loss to the affiliate might be zero, provided that it transfers these data to the parent company for free. Conversely, the damage caused to the parent company might be enormous, if these data are essential for the continuation of its business operations. Moreover, if the affiliate exercises a vital function for several entities of the corporate network located elsewhere (perhaps as regional headquarters), or if this entity has a global task to fulfil within the entire corporate network, the overall effects of a treaty violation may far exceed the local damage.

The rules of customary international law

The present legal situation

Explicit compensation rules in an investment treaty might not be necessary if customary international law already provided for sufficient protection and clarity. In the leading case on the law of international state responsibility, the International Court of Justice (ICJ) held that “it is a principle of international law, and even a general conception of law, that any breach of an engagement involves the obligation to make reparation”.⁶ The ICJ then went on to observe that “reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed”.

This very broad formula might, at first sight, appear to imply that if a host country violates its obligations under an investment agreement, it has to compensate the foreign investor for all harm that it causes to a TNC, including damage outside its own territory. The foreign investor would only have to demonstrate that there is a causal link between the treaty violation and the damage to the various entities

⁶ “Chorzow Factory Case“, *PCIJ*, Series A, No. 9 (1923), p. 21.

of the TNC system. This link would be the institutional and contractual relationship between the various entities of the company. Through these links, the damage initially suffered by the affiliate in the host country can generate additional damage elsewhere.

However, it has long been recognized that such a broad responsibility would go too far, as any State act may have innumerable and unforeseeable consequences. One way to limit State responsibility would be to exclude compensation for “indirect” damage.⁷ While a host country could be held responsible for the direct damage to an affiliate located on its territory, additional transboundary harm would never have to be compensated, because damage that occurred outside the host country would always be considered as an indirect consequence of the treaty violation by the host country.

Such a strict limitation of State responsibility — no matter in what context — seems inappropriate. In the words of the German–United States Mixed Claims Commission: “A distinction sought to be made between damages which are direct and those which are indirect is frequently illusory and fanciful, and should have no place in international law. The legal concept of the term ‘indirect’, when applied to an act proximately causing a loss is quite distinct from that of the term ‘remote’. This distinction is important”.⁸

Thus, today, for the purpose of determining the causal connection between an act or omission and a loss allegedly flowing therefrom, other criteria are applied. The damage must be the “normal”, “natural”, “necessary” or “inevitable” consequence of the original injury (Garcia-Amador, Sohn and Baxter, 1974, p. 123). This is the so-called rule of “proximate cause”. Therefore, in the above-mentioned example, the German–United States Claims Commission held that “it matters not how many links there may be in the claim of compensation connecting Germany’s act with the loss sustained, provided that there is no break in the chain and that the loss can be clearly, unmistakably, and definitely traced, link by link, to Germany’s act”.⁹ Conversely, there is no obligation to pay compensation if the

⁷ “Alabama Arbitration Case”, cited in Garcia-Amador, Sohn and Baxter (1974), p. 123.

⁸ “War risks insurance claims”, United Nations, *Reports of International Arbitral Awards*, vol. VII, pp. 62-63.

loss is far removed in the causal sequence from the original act. Sometimes, a somewhat subjective test is applied in this respect, to the effect that unforeseeable consequences of the initial act do not give rise to responsibility.¹⁰

A concrete example is the sinking of the vessel *Lusitania* by a German submarine in the first World War. The insurance companies of the victims held Germany responsible for the damage, deriving from the fact that the former had to pay pensions to the dependants according to the terms of the insurance contract. The claim was dismissed on the grounds that this damage was no “natural and normal” consequence of the war act.¹¹

Another important limitation to State responsibility derives from the fact that the violation of a legal right must be at stake. By contrast, the mere suffering of a damage or a loss does usually not result in an international responsibility. For instance, an act violating the rights of an individual or a company may, at the same time, have unfavourable repercussions to the interests or expectations of another, connected with the former by contractual or other legal ties. However, unless the act affects directly and simultaneously the legal rights of both persons, no valid claim may be made by or on behalf of the latter. An impairment of interests, or the mere fact that damage has been caused, is not sufficient to produce international responsibility (Graefrath, 1984, p. 95). For example, in an international arbitration case, it was held that a state does not incur international responsibility from the fact that a national of a foreign state suffers damage as a corollary or result of an injury which the defendant State has inflicted upon one of its own nationals, or upon someone of a nationality other than that of the claimant State, with whom the claimant State’s national is bound by ties of family relationship.¹²

There is an exception to this rule in cases where the wrongdoing takes the form of confiscation of someone’s entire property (White,

⁹ United Nations, *Reports of International Arbitration Awards*, vol. VII, pp. 29-30.

¹⁰ “Angola Case”, Portuguese-German Arbitral Tribunal, Decision of 31 July 1928, United Nations, *Reports of International Arbitration Awards*, vol. II, p. 1031.

¹¹ “Life Insurance Claims” (1924), United Nations, *Reports of International Arbitration Awards*, vol. VII, pp. 112-113.

¹² “Dickson Car Wheel Company Case”, United States versus Mexico, *Review of International Arbitration Awards 1931*, pp. 669 and 681.

1983, p. 175). For example, creditors of a company whose assets have been taken would be entitled to compensation although their legal rights have not been affected. The reason is that, as a result of the taking, they would be no position to claim their money back. Similarly, in investment matters, foreign investors would be entitled to compensation if a host country took the assets of an affiliate, although their property rights would not formally have been violated.

The application of these rules in the present context

What are the implications of the above-mentioned rules for the compensation of foreign investors in a case in which a host country violates its obligations under an investment treaty?

- First, the host country would have an obligation to pay compensation with regard to a damage that it causes to the foreign affiliate. This damage would be the direct and normal consequence of the treaty violation by the host country.
- Second, as regional and global company networks are becoming a normal feature of economic life, it is difficult to argue that damage caused to other entities of the TNC could not be a “natural” or “normal” consequence of a treaty violation by the host country. The obligation to compensate could thus include cases of transboundary harm.

However, this outcome is far less clear than in a case in which damage occurs only to the foreign affiliate in the host country itself. One reason is that applicable investment treaties themselves may contain a limitation to State responsibility to the effect that only damage in the host country has to be compensated. Explicitly, these treaties do not provide for remedies in case of a breach of an international obligation at all.¹³ Also, the Vienna Convention on the Law of Treaties has no rules on the subject. While the absence of any explicit treaty provision does not necessarily mean that the contracting parties wanted to exclude recourse to customary international law, it might imply that this law has to be interpreted in a narrow manner.

¹³ Except in the case of an expropriation and losses due to war and similar events, neither of which include cases of transboundary harm as explained above.

The fact that these treaties are only concerned with the protection of the affiliate in the host country may be an indication that the contracting parties wish to confine their responsibility to domestic harm.

Another issue to be considered is whether or not the compensation of transboundary harm would be in conformity with the above-mentioned rule of international law according to which a claim usually only exists if a legal right has been violated. The direct consequence of the violation by the host country of the investment agreement — for instance, through a prohibited discrimination against the affiliate — could be that the legal rights of the *affiliate* under the investment treaty are violated. This would require that the investment agreement should grant rights to the affiliate itself. In general, these treaties give rights only to the foreign investor and its home country. There is an exception to this rule as far as the principle of non-discrimination is concerned. A number of BITs entitle not only the parent company, but also the affiliate to non-discriminatory treatment.¹⁴ To the extent that the affiliate holds assets abroad, it could have a right to claim transboundary harm as a result of discrimination.

The violation of the investment agreement by the host country would simultaneously affect the ownership rights that the *parent company* (i.e., the foreign investor) holds in the affiliate. Would this be sufficient for the foreign investor to claim compensation also for damage that the treaty violation caused to its own business operations or to other affiliates of the TNC located in third countries?

According to the above-mentioned principle, a claim to compensation for a damage outside the host country could only exist if the host country had likewise violated the legal rights of the parent company or any other affiliate located outside its own territory — their property rights concerning their assets in their home country.

¹⁴ See, for example, the model agreements of Germany (article 3, paras. 1 and 2), Switzerland (article 4, paras. 2 and 3), and the United Kingdom (article 3, paras. 1 and 2), where the contracting parties grant non-discriminatory treatment both to foreign investors and their investments. Note, however, that as far as dispute settlement is concerned, only the foreign investor has the right to sue the host country under these treaties.

The violation of the legal rights that the parent company holds in the affiliate in the host country would not be sufficient to make the host country responsible also for damage outside the local operations. By causing damage to the affiliate located within its territory, the host country does not violate the property rights of other entities of the TNC that are located outside. The reason is that the measures of the host country cannot have legal effects beyond its borders.

On the other hand, the concept of compensation for transboundary harm is not completely unknown in international law. Probably the most prominent example is environmental law where it has long been recognized that a country may — under certain conditions — be held responsible for damage caused in another country by the former country's actions or its failure to act. The leading international law case in this respect is the Trail Smelter award. The question to be decided by the court was whether Canada could be held responsible under international law for damage in the state of Washington resulting from the sulphur dioxide emitted from the Trail Smelter Company in British Columbia. The tribunal held that “under the principles of international law, no state has the right to use or permit the use of its territory in such a manner as to cause injury by fumes in or to the territory of another or the properties or persons therein, when the case is of serious consequence and the injury is established by clear and convincing evidence.”¹⁵ A country violating this obligation has to compensate the victim for the damage suffered.

It needs to be underlined that this rule has been developed in the area of environmental law. One might therefore ask whether one can draw some analogies to the case in which a TNC suffers transboundary harm due to the violation by a host Government of an investment agreement.

There are some reasons why the two cases may have to be treated differently. First, only in the environmental case is there a physical link between the illegal action of one State and the damage

¹⁵ United States versus Canada, Arbitral Tribunal 1941, cited in United Nations, *Reports on International Arbitration Awards*, vol. III, p. 1905.

caused in another State, in the sense that the pollution is physically transported across the border. By contrast, in the present context, the damage caused to an affiliate in a third country, including damage to the parent company, is only the indirect result of the damage that the host country caused to the affiliate located in its own territory. Second, economic or regulatory actions that potentially have transboundary effects are much more pervasive than situations in which cross-border harm to the environment occurs. Even such purely economic — and undoubtedly lawful — activities as devaluations, customs controls or monetary policy might have serious consequences for TNCs (Magraw, 1986, p. 310). Moreover, transboundary harm to the environment would in most cases be limited to one or a few neighbouring countries whereas the economic consequences of a governmental measure against an affiliate of a TNC could be felt worldwide, depending on the overall size of the corporate network. In addition, the internal structure of the TNC may be very complex. This may render it difficult, if not impossible, for host countries to assess implications for the entire corporate system. Consequently, it would be hard for them to get a clear picture of the extent of any international responsibility they might bear if they violated an investment agreement.

For all these reasons, it is impossible to identify a rule of customary international law that would oblige host countries to compensate foreign investors for transboundary harm if they violated an investment agreement (Oliver, 1983, p. 81). It seems therefore necessary, in order to establish international responsibility in this area, to obtain the explicit agreement of the contracting parties. Such agreement would be needed not only to specify the claim, but also to determine its kind and extent (Graefrath, 1984, p. 90).

Investment protection against transboundary harm: a possible model

The lack of a rule of customary international law on State responsibility for cross-border harm in case of the violation of an investment treaty could be overcome by agreeing on an explicit provision on the subject in investment treaties.

The willingness of States to agree on new compensation rules

Before exploring the possible content of a new compensation rule, the issue of whether Governments should support a rule that might subject them to potentially far greater liability than exists at present needs to be examined. Governments would, for budgetary reasons, certainly hesitate to take such a step. Furthermore, times are currently not favourable for the establishment of new investment rules in general. As the failure of the OECD negotiations on the MAI shows, not even the industrialized countries are at present in a position to agree upon a new set of investment rules. It remains to be seen whether WTO will be ready to launch its own negotiations on an investment agreement at its next Ministerial conference in November/December 1999. The collapse of the MAI negotiations was all the more surprising as one of the main purposes of the project was to confirm and harmonize already existing international rules and principles concerning the treatment and the protection of foreign investors. As far as investment liberalization is concerned, the MAI would have respected the status quo in individual member countries, while allowing for a review mechanism of existing restrictions.

One of the reasons why the MAI negotiations failed is probably that public opinion at large is concerned that investment liberalization has already gone too far. People are worried that foreign investors may increasingly use their mobility to shift production units. Moreover, there is a strong view, in particular amongst non-governmental organizations, that if one were to strengthen the rights of foreign investors, one would simultaneously have to subject them to international obligations, in particular with regard to labour rights and environmental protection. Otherwise, in this view, the balance of power between foreign investors and host Governments would be upset. Against this background, one can imagine how difficult it might become to add a new concept, such as the one on compensation of foreign investors for transboundary harm, to their already existing rights in investment agreements.

On the other hand, as the process of globalization intensifies, there will probably be more and more cases in the future in which TNCs are exposed to the risk of transboundary harm. The traditional treaty approach, which deals with the issue of compensation only in

the context of expropriation and losses resulting from strife, and which does not address the issue of cross-border harm, could become increasingly inappropriate and unsatisfactory. One could argue that the investment treaties continue to concentrate on risks — such as expropriation or transfer restrictions — that have largely diminished during the last two decades,¹⁶ while they ignore the new challenges resulting from globalization. Consequently, demand from business and foreign investors' home countries to improve upon the existing compensation rules is likely to increase. One can assume that this demand would not be limited to the industrialized countries, as the number of developing countries that are becoming capital-exporters is growing.

With regard to the concerns expressed that TNCs might obtain too many rights, one could respond that the new compensation rule would be built upon a general principle of law according to which a State can be held responsible for the damage that it causes. Although no explicit rules exist so far concerning the compensation of a foreign investor for transboundary harm in the case of a violation of an investment treaty, the general concept of compensation for damage is not new. Furthermore, the purpose of the new compensation rule would not be to grant foreign investors an undeserved extra benefit, but rather to allow them to restore — as far as possible — the situation that existed before a host country violated an investment treaty.

In addition, a new compensation rule could also indirectly benefit the employees of a TNC. Without a right of compensation, a TNC may be forced to lay off workers in order to make up for the financial loss. It may even go bankrupt. It seems that these indirect effects are sometimes ignored by critics of international investment rules.

One could expect that compensation rules for cross-border harm would have a strong deterrent effect, in discouraging actions against TNCs in contradiction of international investment treaties, given the potential large claims that a host country might face in this case. This may alleviate some of the concerns with regard to the financial implications for host countries of explicit compensation rules.

¹⁶ This does not mean, however, that these risks have disappeared.

Furthermore, countries that accept transboundary liability could considerably improve their position in the worldwide competition for FDI. The general policy framework for FDI is becoming less important as a means for host countries to distinguish themselves from their competitors, as convergence towards the same basic principles concerning the treatment of foreign investors in most countries is taking place. Adequate core FDI policies are nowadays simply taken for granted (UNCTAD, 1998, p. 98). In addition, with the rapid proliferation of traditional BITs in the 1990s, their distinctive influence as a signal to attract FDI may have been eroded, as compared to a period when such treaties were still comparatively rare (UNCTAD, 1998, p. 117). In contrast, a host country that is willing to take on responsibility for transnational harm would stand out among the countries competing for investment. Moreover, it could have a good chance of attracting those TNCs that are economically powerful and technologically advanced. These companies in particular tend to have extensive integrated corporate networks, and may thus have a keen interest in the protection afforded by a new international compensation rule on transboundary harm.

Just as BITs were something new after the Second World War and have since then become a standard feature of investment protection, it might be that one day compensation rules for transboundary harm will become a normal part of a state-of-the-art investment agreement. In order to give host countries time to become familiar with the new concept, and to make it more acceptable to them, a gradual approach could be adopted. As a first step, investment treaties could include an explicit provision on compensation only with regard to a treaty violation that causes harm to an affiliate located in the territory of the host country. Later on, this rule could be extended to include cross-border harm.

Furthermore, one could first introduce the new concept into BITs, as agreement might more easily be reached between two contracting parties. In a BIT, it would be sufficient to deal with a transboundary harm that is inflicted on the parent company in the home country. There would be no need to find immediate solutions to the more complicated situation in which damage also occurs to other entities of a TNC located in third countries.

Most important of all, one would have to develop rules for the proper limitation of State responsibility.¹⁷ An open-ended compensation rule would in all likelihood have very little chance of being accepted.

The principle of compensation

The core of the new compensation rule would be an explicit obligation of host countries in investment agreements to compensate foreign investors for damage they suffer as a result of a violation of the treaty. It could specify the situations in which compensation would be obligatory (for instance, in the case of damage caused by prohibited discrimination). Furthermore, it could clarify whether compensation would be limited to damage suffered by an affiliate in the host country only, or whether it would extend to transboundary harm. One could therefore develop a gradual approach towards compensation as outlined above.

The major change *vis-à-vis* the existing bilateral, regional and multilateral treaties would be that a host country would have an explicit obligation to compensate not only in cases of expropriation and — possibly — in cases of war and similar events, but also in any situation in which it violates its treaty obligations, thereby causing harm to an affiliate or to the TNC as a whole.

The purpose of such a provision would be threefold:

- As far as damage to a foreign affiliate is concerned, it would confirm the existing rules of customary international law;
- It would refine these rules by clarifying in what situations they apply;
- If agreement on compensation for transboundary harm is reached, it would go beyond customary international investment law, as no clear rule in this respect has been identified so far.

The underlying rationale for a new compensation rule that includes transboundary harm would be to protect the integrity of a

¹⁷ See the section on limits to State responsibility.

TNC's entire network.¹⁸ It would take into account the fact that a foreign affiliate in a host country may be only one part of the whole corporate system. The host country would commit itself not only to protect the affiliate located in its territory and the rights that the foreign investor holds therein, but also to respect the various linkages that may exist between the affiliate and other entities of the TNC. It would recognize the interest of the TNC in having its internal business relations untouched by governmental interference that is contrary to international law.

It needs to be stressed that a new compensation rule that includes transboundary harm would not mean that one allows a host country to take actions against a TNC with extraterritorial effects. The principle of international law according to which measures taken by country do not have *legal* effects beyond its borders remains unchanged. For example, a host country cannot expropriate the assets that a TNC holds outside its territory. The new compensation rule would, however, acknowledge that a host country causing damage to a foreign affiliate located in its territory may at the same time cause damage to other entities of the TNC located in third countries.

Limits to State responsibility

Once the basic principle of compensation has been established, perhaps including compensation for cross-border harm, it would become necessary to set limits on State responsibility. Without such limitations, there would be the possibility of an endless backtracking in the causal chain. While it could be argued that all damage caused to a TNC through its internal corporate links was a natural effect of the violation by the host country of its treaty obligations, contracting parties would be reluctant to accept such a broad responsibility. It therefore seems necessary to find a balance between the interest of a TNC in having all the negative consequences of a host country's act taken into account (including damage beyond the borders of the host country that violates an investment treaty) and the interest of the latter in limiting its responsibility in a reasonable manner.

¹⁸ The corporate network may include external contractual relations that a TNC maintains with independent firms (outsourcing activities). While damage caused to an affiliate might also produce negative consequences for them, this would not be an investment issue.

Treaty provisions giving rise to compensation

In general, any violation by a host country of an obligation in an investment treaty may cause damage to the affiliate or to the TNC as a whole. Therefore, it would seem appropriate that the compensation rule should apply in respect of the whole treaty. This means that compensation would be due in the case of damage resulting from a violation of the treaty provisions on national treatment, most-favoured-nation treatment, the free transfer of capital, or the breach of an individual investment contract between the foreign investor and the host country. If the treaty also includes a prohibition of certain performance requirements, compensation could also apply in this respect. In addition, as far as the provisions on expropriation and protection from strife are concerned, compensation would not require that an investment treaty has been violated.

If a host country finds it unacceptable to agree on an obligation to compensate with regard to all these substantive treaty provisions, it would be possible to limit compensation to only a selected number of obligations.

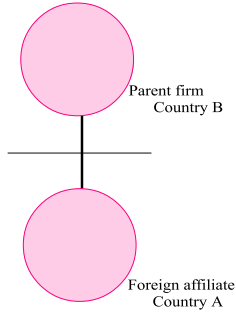
Compensation for transboundary harm?

Contracting parties would have to decide whether the host country could be held responsible only for damage that it caused to the affiliate located in its territory, or whether it would also have to compensate for any additional damage inflicted upon the parent company or other entities of the TNC located in third countries. In the latter case, it is difficult to define the scope of coverage of any claims. In general, several scenarios could be considered:

- Damage is suffered by the parent company only;
- In cases where a TNC consists of several vertical layers, damage could be traced back to the parent firm of the affiliate affected;
- Damage might occur on a horizontal level, that is, it would be suffered by other units of the TNC that are not the parent company of the affiliate in the host country.

Damage caused to the parent firm

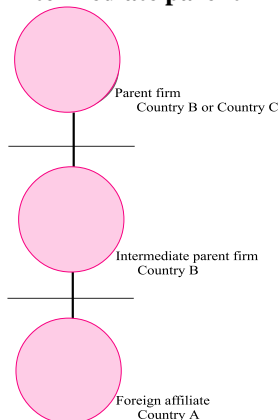
Figure 3. Damage caused to the parent firm



One way to limit compensation in cases of transboundary harm would be to cover only damage caused through direct links between an affiliate and the parent company (figure 3). Compensation would therefore be limited to damage that occurs in the bilateral relationship between the parent company and its affiliate. For example, if a host country prohibited the affiliate from exporting supply materials to the parent company, in violation of an investment treaty, the latter would have the right to claim compensation for the damage that this act caused to its own business operations. The damage caused to the parent company would be a normal consequence of the violation by the host country of the investment treaty.

Damage caused to the parent firm via an intermediate parent firm

Figure 4. Damage caused to the parent firm via an intermediate parent firm



One could ask whether the right to claim compensation could be extended to the parent firm in case of an indirect damage. This question is particularly relevant with regard to holding companies. If, for example, a host country prohibits an affiliate located in its territory from transferring profits to the parent firm (via an intermediate firm), the parent firm itself would indirectly suffer damage (figure 4). Another example would be that of a foreign affiliate producing components for an intermediate parent firm in another country, which assembles the final product and sends it to the parent firm for sale; an export prohibition imposed by a host country on the affiliate would ultimately cause damage to the parent firm.

In principle, nothing would impede contracting parties from extending the coverage of an investment treaty to indirect investments. This would protect not only the intermediate parent firm that directly holds shares in the foreign affiliate, but also the parent firm that only maintains indirect links. The foreign affiliate would therefore be regarded as an investment of the parent firm.

So far, a number of investment treaties have included indirect investors in the scope of the agreement,¹⁹ while others have not.²⁰ One may wonder whether claims of an indirect investor would be in conformity with the Barcelona Traction award²¹ in which the tribunal held that only direct shareholders had a right to claim.²² However, this award dealt with a case in which the parent company and the shareholders of that enterprise claimed compensation for damage suffered by the affiliate only. The present situation would be different because the parent firm would claim damages for harm suffered in respect of its own business operations.

Nonetheless, entitling the parent firm to compensation for damage in respect of its own operations could pose other difficulties: What would happen if both the intermediate parent company and the parent firm made a claim vis-à-vis the host country in respect of

¹⁹ For example, the United States Model BIT (Article I para. d).

²⁰ For example, the Model BITs of Germany, Switzerland, and the United Kingdom. Note, however, that these treaties do not explicitly exclude indirect investments from coverage.

²¹ See "Barcelona Traction Case", *ICJ Reports 1979*, p. 3.

²² See also the "ELSI"- Case, *ICJ Reports 1989*, p. 15.

transboundary harm? Both companies could — as direct or indirect shareholders — claim compensation for the damage that the foreign affiliate suffered. How could the host country make sure that it does not have to pay twice? In order to avoid such double claims, it seems advisable that the investment treaty includes an explicit provision in this respect.

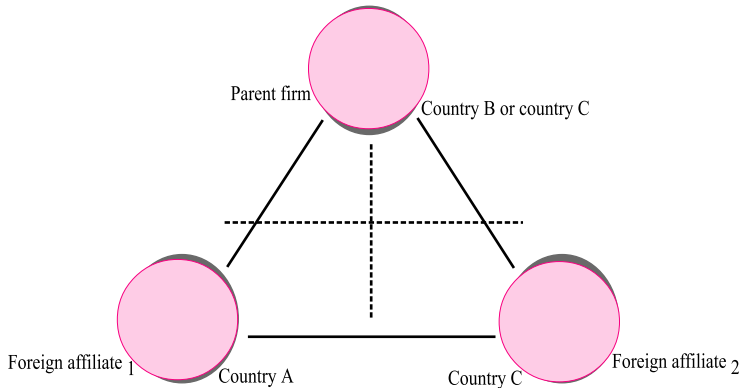
Matters would become even more difficult if the intermediate parent firm and the parent company were located in different countries. In this case, three Governments might become involved, which might increase the risk of a double payment because both the home country of the intermediate parent firm and the home country of the parent company might wish its own enterprise to make the claim to the fullest extent possible. Otherwise, the risk of a double payment would seem negligible because one would assume that the intermediate parent firm and the parent company would coordinate their respective actions against the host country.

There may also be an issue of “free riding” if only the home country of the parent company and the host country of the affiliate want to find a treaty solution. In this case, the parent company might also claim compensation on behalf of the intermediate parent firm which has been directly damaged. The latter’s home country could thus benefit from an agreement to which it was not a party.

Possible solutions include the conclusion of two BITs between the host country of the affiliate on the one hand, and the home countries of the intermediate parent firm and the parent company on the other hand. Alternatively, a plurilateral treaty could be signed involving all three countries at the same time. As one purpose of these treaties would be to delineate each home country’s right to seek compensation, a plurilateral solution would seem to be preferable. The conclusion of two separate BITs could pose more difficulties because whichever country comes late to the negotiations might have to accept the compensation rules already agreed upon in the first agreement as far as damage to the intermediate parent firm is concerned.

Additional damage to other affiliates of the TNC

Figure 5. Additional damage to other affiliates



A vertical link approach may not always adequately reflect the economic realities within a TNC, in particular the various connections that one affiliate may maintain not only with the parent firm — directly or indirectly — but also with other entities of the corporate system on a horizontal level (figure 5). For instance, it may be that the foreign affiliate 1 that initially suffered the damage in country A acts as a direct supplier not to the parent firm, but to other foreign affiliates. If the foreign affiliate 1 in country A is prohibited from supplying its products or services to another foreign affiliate 2 (e.g. in country C) of the TNC, the latter may suffer damage as it may no longer be able to continue its business operations.

For the foreign affiliate 2 of the TNC located in country C to claim compensation, there would need to be an investment agreement between host countries A and C. However, this treaty would not protect against damage caused to foreign affiliate 2 because foreign affiliate 1 is not an investment of the former.

Nonetheless, the parent firm of the foreign affiliate 1 may have a claim, provided that it also owns or controls foreign affiliate 2. In this case, damage caused to foreign affiliate 1 could likewise damage the ownership rights that the parent firm holds in foreign affiliate 2.

This might justify its claim. Moreover, it would be necessary to show that the damage caused to foreign affiliate 2 is a normal or natural consequence of the violation by host country A of the investment treaty that it has concluded with the home country of the parent firm.

Once again, additional difficulties could arise if the parent firm and the foreign affiliate 2 were located in different countries. Although the host country of foreign affiliate 2 would have no legal claim against the host country of the foreign affiliate 1,²³ the home country of the parent firm (country B) would claim compensation with regard to damage that occurred in a *third State* (country C). Country C might therefore wish to participate in the negotiations on compensation. It might also demand that the parent firm transfer the amount of compensation to foreign affiliate 2. Again, a plurilateral solution could be the preferred option.

The fact that a TNC might have affiliates in various countries may make it necessary to limit further the scope of the obligation of the host country to compensate. One possibility could be for a host country to take responsibility only for damage caused to those affiliates of a TNC located within the same region. "Region" here would mean a particular continent such as Europe, Asia, North America or Latin America.

The seriousness of the damage

A further limitation of the host countries' responsibility relates to the seriousness of the damage inflicted upon entities of a TNC outside its home country. It would go too far to hold a host country responsible for any negative effect that its treaty violation may have upon the parent company or the corporate system as a whole, even if it is only of a minor nature. For example, if a host country expatriates a top manager of a foreign affiliate contrary to an investment agreement, the parent company or another entity of the TNC system may be forced to fill the gap by transferring somebody from its own staff to the host country. This might have a negative impact on its own management system. The parent company or the other entity

²³ Because, as has been explained above, foreign affiliate 1 would not be an investment of affiliate 2.

may have to reorganize its management structure, which might at least result in temporary efficiency losses. An obligation to compensate for every inconvenience could make a host country's responsibility almost unlimited and would make it highly unlikely that countries would be willing to accept it. One could therefore restrict a host country's liability to those cases where the transboundary harm is substantial. One could even further narrow down the responsibility to situations where the parent company or an affiliate in a third country is forced to shut down as a consequence of the treaty violation. One could also envisage an upper ceiling for pecuniary compensation for each individual case.

Other issues

Not all issues could be addressed in an investment treaty, and decisions on them would have to be left to the courts. For instance, the question may arise as to what extent a foreign investor would have been able to prevent or minimize the damage, for instance by adapting the corporate system to the new situation once the host country has violated the investment treaty. One could also envisage internal corporate rearrangements that would allow other entities of the TNC to take over the supply function of an affiliate that could no longer fulfil that function. If investors failed to do this, or if they acted only after a considerable delay, they would share the responsibility for the damage and, consequently, the host country could not be held fully liable.

Another difficult issue may be the actual calculation of the damage. Problems may already arise when trying to calculate the initial damage suffered by the affiliate in the host country. If, for example, a treaty violation resulted in the temporary closing of the enterprise it might not be easy to translate the production loss into figures. It might be even more difficult to assess the damage suffered by the parent company or to other entities of the TNC due to the fact that they are no longer supplied with the materials or services needed. However, these practical difficulties —which would also exist in compensation cases which are of an entirely domestic nature — should be no major impediment to considering new international compensation rules in this respect. They may, on the other hand, be a reason for being as specific as possible in an investment agreement

concerning the scope of a host country's responsibility. In particular, one might consider fixing upper ceilings for compensation as outlined above because otherwise the amount of money that might need to be paid out would be unpredictable.

Additional limitation of State responsibility in investment contracts between an individual investor and a host country

It would be possible to seek a tailor-made solution whereby the contracting parties identify those individual entities of a TNC which they want of protect and in respect to which they would be willing to accept responsibility if a treaty violation causes damage to them. This kind of situation could best be achieved in an individual investment contract between the investor and the host State.

In particular, the parties to this contract could specify the production, marketing or distribution channels within a TNC which the host country would protect, and in respect of which it would pay compensation if it violated an investment agreement, thereby disrupting its proper functioning. For instance, an affiliate in the host country may supply specific components to various other entities for the production of a car. The host country could commit itself to compensate these other entities for a loss resulting from the fact that it prohibits the affiliate from exporting its products to these other entities in violation of an investment contract. Compared to an investment treaty between the countries concerned, an individual investment contract would better allow the linkages between the various entities to be identified, and the compensation rule to be fine-tuned accordingly.

Furthermore, one could introduce an obligation in the contract for the investor to keep the host country informed about the corporate structure of the TNC, as well as to provide updated on structural changes. This would allow the host country to better assess the potential effects of its actions, so that it could not argue at a later stage that the actual damage was unpredictable. Major structural changes within a TNC system could be a reason for renegotiating the contract.

Conclusion

As the process of globalization continues, TNCs manage their international investments in an ever more sophisticated manner. They have begun to abandon the traditional investment model based on an exclusive bilateral relationship between parent company and affiliate, and are replacing it with regionally or globally integrated production systems where each corporate entity fulfils a particular function for the enterprise as a whole. Despite these major new developments, the international legal instruments to protect foreign investors have, in principle, remained unchanged. This leaves foreign investors virtually unprotected in cases where the violation by a host country of an investment agreement causes cross-border harm to the parent company or to other entities of the TNC system in third countries.

In order to fill this lacuna, one could consider including into investment treaties or individual investment contracts a provision according to which a host country could be held responsible for a violation of the agreement/contract that causes damage to the foreign affiliate located on its territory, the parent company or to other affiliates of the TNC. In each case, the enterprise that would be legally entitled to a claim could be the parent company or any other entity in the vertical corporate structure. The claim could be justified on grounds that the host country had agreed in the investment agreement to respect and protect the internal corporate network of the TNC, and the various links that might exist therein. In order to have a claim, the parent company would have to show that the damage was a natural and normal consequence of the treaty violation by the host country. Furthermore, limits could be set on State responsibility in the investment agreement, for example with regard to the affiliates covered against damage or the maximum amount of compensation that could be due in a particular case. In cases where the corporate structure of the TNC involved more than two entities exposed to the risk of transboundary harm, a plurilateral agreement could be the preferred solution.

In substance, such a treaty provision could read as follows:

“If a contracting party violates its obligations under this agreement, the foreign investor can claim prompt,

adequate and effective compensation for any resulting damage to its corporate network, provided that it is a normal and natural consequence of the host country's act. Compensation includes damage caused to the investment of the investor located on the territory of this contracting party, to the foreign investor itself and to any other affiliate that is owned or controlled by the foreign investor." ■

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Your place or mine? States, international organizations and the negotiation of investment rules

Elizabeth Smythe*

This article addresses the question of why States choose particular international organizations as their preferred venue for the negotiations of international investment rules. It does this through a study of the decision to negotiate binding rules on the treatment of foreign direct investment at the Organisation for Economic Co-operation and Development (OECD) in May 1995 and the attempts to deal with future investment negotiations at the Singapore ministerial meeting of the World Trade Organization (WTO) in December 1996. It examines the debate over whether the OECD or the WTO should be the venue for negotiations and why various actors had particular preferences for one organization or the other. The article concludes that state and other actors do view international economic organizations in a strategic way and that their perceptions of an organization and their influence within it will shape their decisions about where negotiations should be held.

Introduction

To be effective and beneficial, any eventual investment rules must be truly multilateral. Consequently, the MAI process at the OECD must remain open to non-members, and, more importantly, the MAI's ultimate home should be at the WTO -- Statement by the Canadian Minister of International Trade, Sergio Marchi, at the OECD ministerial meeting, 27 April 1998.

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This was the conclusion of the Canadian trade minister after three frustrating years of negotiations at the Organisation for Economic Co-operation and Development (OECD) on the multilateral agreement on investment (MAI). Two deadlines had passed, domestic opposition, spearheaded in many countries by non-governmental organizations (NGOs), had become strong and no agreement was in sight. Despite a six-month hiatus, negotiators decided in October 1998 not to continue and announced the cessation of formal negotiations on 3 December 1998. About half of the OECD members, including Canada, wished to move the process to the World Trade Organization (WTO). While many observers of the OECD process have commented on the role of NGOs in opposing and possibly stopping the negotiations (Kobrin, 1998), few, if any, have raised the even more obvious question of why negotiations began at the OECD in the first place, rather than at WTO. The Canadian minister's comment brings us back full circle to the wisdom of the original decision to launch negotiations of an MAI at the OECD.

This article examines the May 1995 decision by the member countries of the OECD to launch negotiations on a binding MAI in order to shed some light on the question of why the OECD became the preferred venue. As this article will indicate, when the decision to initiate these negotiations was taken, there was disagreement among states and other actors on both the process and the appropriate organizational venue for such negotiations. Despite these differing views, the question of where to negotiate investment rules has not been the subject of much analysis on the part of academics or policy makers. Yet there is evidence, as this article will argue, that States and other international actors view international organizations in a strategic way in terms of which ones are most likely to best advance their interests (Bayne, 1997). The issue of organizational venue is important since it involves broader questions about the power and influence of various actors, and what interests are represented, legitimated or marginalized in the negotiation process. The ultimate choice of venue itself may reflect various preferences and patterns of power and influence of international actors.

The article focuses on the question of how various actors viewed the OECD and WTO as alternative venues in which to negotiate investment rules and why they had particular organizational

preferences. The introduction discusses the development of international economic regimes and why the choice of organizational venue matters. The second section examines how enhanced capital mobility and globalization have altered State policies and the interests of various actors dealing with foreign investment issues in bilateral, regional and multilateral forums. It briefly outlines the development of international investment rule-making in the 1961-1992 period and the variety of international organizations involved in the process. This sets the stage for the third section of the article, which discusses the launching of negotiations on an MAI in the OECD and the four-year debate that led up to that decision. The fourth part discusses the views of a number of OECD members and why they saw WTO as the main alternative venue for the negotiation of investment rules and the subsequent conflict over investment at the WTO ministerial meeting in Singapore in December 1996. The final section provides some concluding comments about how international actors view the question of organizational venue in the case of international investment rules and what implications this may have for the process of negotiation and the kind of rules which may ultimately emerge.

International regimes and international organizations: does the venue matter?

Investment rules are one set of shared expectations and norms regarding international economic exchanges that have come to characterize the global economy in a number of areas. These sets of norms and expectations are often referred to as “regimes”. While investment rules have a long history of evolution through customary international law and various bilateral agreements relating to trade and commerce, the development of post war international trade and investment regimes has also involved efforts by State actors to create rules through bargaining and negotiating within international economic institutions. These rules, in turn, will shape state behaviour. The key question for States, especially smaller, more vulnerable ones within the international system, is whether such regime development reflects an existing distribution of economic power or whether it can have a transformative effect on power-based relationships. One view would suggest that “dominant states write the rules that conform to their interests and guarantee compliance through the exercise of

power” (Caporaso and Haggard, 1989, p. 109). Thus regimes may serve as a mechanism for legitimizing the hegemonic power of some States through the internalizing of norms. Dominant States may see international organizations as instruments through which they can pursue their specific economic interests. The post-war system of liberal multilateralism in economic exchange is often viewed by critics in this way, reflecting a policy preference of the large capital-exporting States, led by the United States and supported by transnational capital, to build a normative post-war consensus on economic exchange, and, through a “new constitutionalism”, to lock smaller States into a set of rules based on that consensus (Gill, 1995).

In contrast, smaller, less dominant States, may view the negotiation of international regimes as an opportunity for them to achieve their objectives, which may include challenging the prevailing norms and transforming power relations with more powerful, larger States and their economies. This view is at the basis of the belief that multilateralism and a set of binding rules may provide a counterweight from the perspective of smaller countries to the dominance of a large hegemonic actor such as the United States. Smaller State actors may try to use certain organizations to advance rules that would limit or challenge the prevailing economic relationships which may benefit one or a number of hegemonic actors. Such an effort could be seen, for example, in the attempt to create a new international economic order in the 1970s (Krasner, 1984)

These two differing views of regimes and the role of international economic organizations as rule-making venues raise the question, in the case of investment, of whether a particular organization has, on the one hand, afforded an additional tool to those actors seeking to entrench a set of rules which further liberalize State regulation of foreign investment, or, on the other, assisted actors seeking to resist liberalization in some areas or wishing to entrench rights of States to continue to regulate foreign direct investment (FDI). In the past three decades a range of organizations, including the United Nations, the OECD, the General Agreement on Tariffs and Trade (GATT), the World Bank and WTO, have all been involved in the process of negotiating investment rules. Which organization played a role was often, as the following section indicates, a reflection of

both shifting State interests and influence within these organizations, and of the membership, structure and decision-making processes of the organizations themselves.

From interdependence to globalization: the development of international investment rules

The roots of inter-State negotiation on investment rules in the post-war period can be traced back to the attempt to establish the International Trade Organization (ITO). The draft Havana charter of the ITO did address the issue of investor protection, especially the expropriation of investors assets, and, as was to be the case in the 1960s and 1970s, reflected disagreement between developed and developing States. In the case of the ITO, business also saw the draft provisions in the charter as inadequate and when the ITO failed, the issues relating to investment were not taken up in the subsequent creation of the GATT (Kline, 1985, chapter II).

Efforts to address the issues of investor protection and disputes between foreign investors and Governments did continue, however, in a number of other organizations, including the World Bank and the OECD. In the case of the World Bank, discussions on investment disputes ultimately resulted in the establishment of the International Centre on the Settlement of Investment Disputes in 1967. The World Bank also endeavoured to facilitate private capital flows to the developing countries via the establishment of the Multilateral Investment Guarantee Agency in 1988 (Rowat, 1992) and the adoption of a set of non-binding guidelines on the treatment of FDI in 1992 in an effort to articulate and advocate standards of treatment for FDI (Shihata, 1993). This very brief history is indicative of the extent to which investment issues have been addressed by a wide variety of international governmental organizations since 1945.

In the 1970s, investment negotiations centred on the OECD and the United Nations and also reflected the differing interests of home and host economies and North-South divisions on the issues. In the case of the OECD they took place within an organizational context which was dominated by large capital exporters, particularly the United States, and was basically hostile to national controls on

foreign investment, although a number of capital-importing countries did regulate incoming FDI. The OECD membership at that time included European and North American countries as well as Australia, Japan and New Zealand.¹ Although membership expanded in the 1990s to include the Czech Republic, Hungary, Poland, Mexico and the Republic of Korea, all the OECD members in the 1970s, with a few exceptions in southern Europe, were advanced industrial economies, both large and small. From its very inception, the organization reflected the consensus of the liberal-democratic states on which its original membership was based. Its founding goals included “efforts to reduce and abolish obstacles to the exchange of goods and services and current payments and maintain and extend the liberalization of capital movements” (OECD, 1963, p. 3).

The structure of influence is less clear, however. While all members are equally represented at the ministerial level of the OECD Council, which renders the final decisions of the organization, the actual agenda and work programme of the organization are usually based on an informal consensus but have, in practice, been heavily influenced by the largest economic actors in conjunction with the permanent secretariat of the organization (Robinson, 1983). Much of the work of the OECD has involved coordinating the economic policy of member States. Since the late 1960s and early 1970s, when the developing countries began to challenge the prevailing economic order, the organization was used very consciously by some of its largest members to develop a coordinated position on major international economic issues on the part of industrialized countries prior to negotiation in other intergovernmental economic organizations with a broader membership such as the GATT, the World Bank or the United Nations.

In addition to coordinating members’ positions, the OECD endeavoured to create norms and rules governing international

¹ When founded in 1961 the OECD had 20 members. By 1985 total membership stood at 24, as follows: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. By 1996 it had reached 29, with the accession of the Czech Republic, Hungary, Mexico, Poland and the Republic of Korea.

economic exchanges, in line with its founding goals, through both research activities and the development of various codes of conduct. The Code on Capital Movements, for example, was created coincidentally with the establishment of the organization in 1961 and was intended to encourage member States to remove all restrictions on the international movement of capital (Plumtre, 1977, p. 132) over time. While the Code covered capital movements and was binding, it was riddled with individual State reservations and exemptions and did not address the issues of the rights and obligations of foreign investors or the behaviour of governments towards foreign affiliates operating within their economies.

The OECD also attempted to address the issue of investor protection in the 1960s with a multilateral convention on the protection of foreign property (OECD, 1967). However, the draft was never adopted and the effort was abandoned. The impetus to address once again the issue of the treatment of investors in the 1970s came from outside the OECD. The efforts of Third World countries, using their voting majority in the United Nations General Assembly, to restructure the global economic system and limit what they perceived to be the abuses of transnational corporations (TNCs) had led to the appointment of the “Group of Eminent Persons” in 1972 to study the issue of TNCs (United Nations, 1975) and their impact on host countries. This ultimately led to the establishment of the United Nations Commission on Transnational Corporations and the Centre on Transnational Corporations (UNCTC), providing research and technical assistance relating to FDI. With the release of the report by the Group of Eminent Persons in 1973 (United Nations, 1974), it was clear that United Nations action on a code that would address both the behaviour of firms and State regulation of FDI was seen to be imminent. In order to counter the prospect of a code which might not represent the interests of capital exporters, the United States began persuading other OECD member countries to address the issue at the OECD in order to create a more united front and pre-empt action at the United Nations (Robinson, 1983, p. 113).

In May 1973, largely at the insistence of the United States and in reaction to developments at the United Nations, the OECD ministers initiated a work programme for the OECD on the issue, designed,

according to the United States' interpretation, to "put a fence around the use of governmental policies that distort patterns of investment and trade" and to explore the "elaboration of guidelines and consultation procedures with respect to the treatment governments give to foreign investors" (Casey, 1973, p. 1). This ultimately resulted in a non-binding code that included both the Guidelines for Multinational Enterprises and the Declaration on National Treatment, committing member States to national treatment of foreign firms and to further extending the application of national treatment over time. Peer surveillance of members, based on the two codes, was to be undertaken by the Committee on Capital Movements and Invisibles Transactions (CMIT) and the Committee on Investment and Multinational Enterprises (CIME). However, only the Code on Capital Movements was binding and neither code applied to non-OECD countries. National policies that continued to limit FDI or, more commonly, to screen it and impose performance conditions on incoming investors, continued to develop within many non-OECD host countries. Even within the OECD, a number of members lodged reservations or exemptions from national treatment for various national investment policies.

The United Nations, in contrast, provided a very different context for negotiations on investment in the 1970s, since State sovereignty afforded each United Nations member equal voting rights in the General Assembly and thus allowed the Group of 77 developing countries to dominate the agenda and push for the negotiation of a code. Views within the United Nations on various aspects of the draft code of conduct on TNCs, such as national treatment, were much more divided, and large capital exporters were clearly in the minority.

Because of the severe divisions and prolonged procedural debates, no agreement on a code was ever reached at the United Nations, and the effort was ultimately abandoned in the 1980s as attention was increasingly overtaken by other developments such as the debt crisis. While the influence of host countries based on their large numbers was clear in the General Assembly, it was insufficient to produce a code that might effectively bind either TNCs or States. By the 1980s the United States was pushing for the protection of the rights of foreign investors through other means outside the United

Nations process. No agreement on the code of conduct became its preferred outcome in the United Nations as its initiatives on investment issues shifted to bilateral processes and to other international organizations where United States officials perceived they had a higher probability of influencing the outcome. One such organization was the GATT.

Investment and trade: the GATT and investment

In the 1980s the changing pattern of investment flows, the increasing importance of the service sector and the growing relationship between trade and investment became more obvious. The United States was now a major capital importer at the same time that it remained the largest capital exporter. Japan and Europe, along with many of the former smaller capital importers, were exporting more and more capital. The United States and European countries also faced increased competitive pressures within domestic markets as a result of lowering tariff barriers and the growth of the exports of the newly industrialized countries.

At this point the United States began a determined effort to subject aspects of State policies on FDI to the disciplines existing at that point in the GATT. Addressing investment issues within the GATT was attractive to the United States because the GATT, unlike the OECD, provided for the enforcement of rules by sanctioned trade retaliation on the part of members. Such a situation affords large market economies, like those of the United States, Japan and the European Union, major influence because of the attractiveness and large size of their markets relative to other actors. The GATT, at that point, was not necessarily seen by many members as the appropriate institution in which to address investment issues. If the GATT adopted rules on investment measures that reflected the interests of capital-exporting home countries, it would have major implications for host countries. Host countries, especially if highly dependent on access to the markets of large economies, would find the costs of using any prohibited measures to control FDI very high. As such, GATT investment rules would form a major constraint on host States' choices of policy instruments.

On the other hand, GATT membership had expanded throughout the 1970s and 1980s and was more diverse than that of the OECD. This was reflected in the increased attention paid to development issues. Combined with consensus-based decision-making, the evolving membership gave smaller countries, especially if they could combine into a bloc, the capacity to stop initiatives coming from some of the largest developed economies (Hoekman and Kosteci, 1995).

United States concerns about the increased tendency of host countries to use selective controls over incoming investors to extract performance requirements had been growing. By the early 1980s, complaints from firms and a number of surveys of the Department of Commerce in 1977 and 1982 (UNCTC and UNCTAD, 1991) indicated that local content requirements, export commitments, technology transfer requirements and other controls over remittances and foreign exchange were being imposed on United States firms, especially by developing countries. In 1982 the United States International Trade Commission initiated a study on the trade impact of a number of these measures. The subsequent 1983 statement on official investment policy (United States Senate, Finance Committee, 1983) reinforced the linkage of trade and investment issues in United States policy.

The issue of services, another priority for the United States at the GATT, also had an investment dimension. Although the United States enjoyed a trade surplus in services, several large United States-based service industries felt prevented from further expansion abroad because of foreign State regulation of service industries which denied them market access (Feketekuty, 1988). An important aspect of attaining such access was international recognition of the right of establishment for foreign-based firms offering non-tradeable services. This clearly had direct implications for host State rights to control or limit the entry of FDI.

In September 1981, the United States proposed a work programme to the Consultative Group of 18 of the GATT² which

² The Consultative Group of 18 included Australia, Canada, the European Community, Japan and the United States and a number of developing countries such as Argentina, India, Brazil, Nigeria and the Philippines.

included both trade in services and trade-related performance requirements imposed on foreign investors. The intention, according to a senior Treasury official, was to address ultimately a list of investment-related concerns through the GATT, including the right of establishment, national treatment and nationalization. For the United States, the GATT was the preferred venue for the negotiations at that time because, unlike the OECD, its rules could be made binding, the large United States market gave it clout, and membership included developing countries, the chief abusers (in the United States' view) of trade-related performance requirements tied to investment policies. In contrast, for the United States, the United Nations Conference on Trade and Development (UNCTAD) and UNCTC were seen to be less desirable venues because of the dominant role played there by the large number of developing host countries. Even at the GATT, however, a number of developing-country members at the meeting strongly opposed the United States work programme.

United States officials persisted, however. In March 1982 Ambassador W. Brock made it clear to the United States Senate that negotiations on both trade in services and trade-related investment measures were priorities for the November 1982 GATT ministerial meeting (United States Senate, Finance Committee, 1982). Specifically, the United States would seek "a political commitment from ministers to initiate a work program on investment policies with a particular focus on trade-distorting practices such as performance requirements". In the case of services, which were "a top priority", the United States wanted to obtain specific commitments to a work programme that would examine the GATT articles and codes and their applicability to services within a specified time frame. Not all countries agreed with the United States priorities. Canada, for example, argued that any programme of study proposed would be "unbalanced unless it were to address, at the same time, the behaviour of multinational corporations" (Lumley, 1982, p. 5). The opposition of a number of large developing countries was even stronger.

At the November 1982 GATT meeting, Brazil and India led the opposition to any discussion of investment issues. In the case of services there was a fear on the part of developing countries that they would be forced to open key industries, such as banking,

communications and transportation, to foreign companies, in return for access to developed countries' markets for their goods (Grey, 1985).³ A limited compromise on services was finally achieved. The final declaration merely referred to national studies on services to be undertaken by members. There was no mention of investment issues at all in the final declaration. Ambassador Brock's disappointment on the investment issue was clear, and he warned that the United States would "protect its interests" and, if necessary, pursue its "legitimate complaints perhaps in a more unilateral and confrontational manner than would have occurred, if the GATT ministerial had made more progress in this area" (United States Senate, Finance Committee, 1983, p. 2). The United States, thus, continued a policy of both strengthening its pursuit of its services trade and investment objectives on a bilateral basis, while also continuing to work multilaterally, especially in the GATT, to gain acceptance for its agenda.

The United States sought to establish that host countries' efforts to extract enhanced performance from TNCs through increased local sourcing, processing and exports constituted, in effect, a violation of several articles of the GATT. Thus the dispute with Canada over the operation of the Foreign Investment Review Agency (FIRA) provided a useful case with which the United States could test the limits of the GATT rules and pressure Canada to eliminate performance requirements from its investment screening process. In July 1983 the GATT panel found, in the case of undertakings related to sourcing requirements, that FIRA's administration did indeed violate sections of article III (GATT, 1983). In the case of exports, however, the finding went against the United States.

By 1986, several developments had strengthened the prospect for trade in services and investment issues to become an accepted part of future GATT negotiations. The United States had been at least partially successful in its case against FIRA at the GATT. At the same time, some of the opposition from developing countries to any discussion of the investment or services issues had begun to fragment. This was partly because of some divergence of interests

³ For a full history of the origins of the Uruguay Round negotiations and the position of developing countries, see Croome (1995).

among certain newly industrializing countries and other developing countries, increased understanding of the role of services in trade, and also successful United States bilateral trade pressure on a number of countries. Moreover, the United States itself was willing to compromise on its demands to answer developing countries' concerns. Many developing countries had feared the prospect of being pushed by developed countries into trading off services against market access for goods. This concern was addressed when ministers agreed to separate completely the two negotiating processes.

A subset of investment measures was also included as an area to be discussed in a review of GATT articles. The commitment in the ministerial declaration, however, was quite limited, stating that:

“Following an examination of the operation of the GATT articles related to the trade-restrictive and distorting effects of investment measures, negotiations should elaborate, as appropriate, further provisions that may be necessary to avoid such adverse effects upon trade” (GATT, 1986, p. 8).

The key dispute that developed during the Uruguay Round negotiations over trade-related investment measures (TRIMs) centred on how to determine whether various measures had a distorting effect on trade and how broad a range of investment measures would be prohibited on that basis (UNCTC and UNCTAD, 1991; Croome, 1995). The United States had the objective of trying to identify a large number of FDI policy instruments that could be subject to retaliation based on their trade impact. Conversely, a number of host countries, primarily developing countries, totally opposed the inclusion of TRIMs in the GATT, or sought a smaller, definitive list of a priori prohibited measures, confined to those instruments that had a clear, direct impact on trade.

Preliminary proposals were met with strong opposition by a group of developing countries who argued that the proposals were premature, given that neither the trade impact of TRIMs nor the relevance of GATT articles had been clearly established. The focus, they argued, should be on the effects (on a case-by-case basis) and

not the measures per se. The rights of states to regulate investment needed to be affirmed, restrictive business practices of large corporations addressed and exceptions for development purposes recognized. The two sides were far apart. By the mid-term review held by ministers in Montreal, Canada, in December 1988, it was clear that limited progress had been made. Meetings in the spring and summer of 1989 included reviews of the empirical evidence of the impact of TRIMs, provided mainly by the United States, much of which was challenged by developing countries who questioned both the overall impact of TRIMs on trade and how the impact of TRIMs could be separated from that of other factors. Submissions by India and Singapore questioned the whole applicability of GATT articles to TRIMs, since the articles deal with discriminatory trade measure themselves, not their effects. They argued that existing GATT articles could always deal with the nullification or impairment of benefits that may result from TRIMs.

It was left to the chair of the negotiating group to attempt in various drafts to reconcile large differences. As time went on, pressures to have a text ready for the Brussels meeting in December 1990 increased. The gaps between the two sides proved unbridgeable and no text, only a list of areas of disagreement, was put forward. Trade talks were suspended because of major disagreements on key issues, such as agriculture, and were not restarted until February 1991.

By this time the dynamics of the negotiations had changed. The chairs and the GATT secretariat were actively forging compromises in areas such as TRIMs at the negotiators' level to try to clear them off the agenda, while the big battles over agriculture and other issues were being fought at the political level. The draft final act of December 1991 reflected those efforts and included a lowest common denominator TRIMs text, largely the work of the chair. This text, in essence, remained unchanged from that point on and was embodied in the approved Final Act of the Uruguay Round in 1993.

There is little evidence of any attempt by the powerful capital exporters to link TRIMs to other issues or force concessions from weaker opponents. In fact, some observers argue that the United

States saw TRIMs as less of a priority by 1991. This was partly due, they suggest (Low, 1993), to a preoccupation with other issues. In addition, the United States itself was now a net importer of FDI, faced with pressures to develop further restrictions (like the Exxon-Florio amendment of 1988). The lack of pressure was also due to the increased liberalization of FDI regulations in many developing countries, a result of trying to attract new capital, reflected in their eagerness to sign bilateral investment treaties (BITs) with capital exporters, and concessions extracted by the international financial institutions (the International Monetary Fund (IMF) and the World Bank) in the aftermath of the debt crisis of the 1980s. The TRIMs problem was thus receding over time in the view of the United States. However, the larger number of developing countries now involved in trade negotiations and the strong opposition of a number of them to a broader agreement also played a key role in limiting the scope of the TRIMs agreement. Still, the United States did get TRIMs into the GATT and clearly viewed it as only the first step.

The Final Act of the Uruguay Round identified TRIMs as a violation of GATT article III (national treatment), and article XI (limits to quantitative restrictions) required all member States to notify the GATT of non-conforming measures and eliminate them within two years (five years in the case of developing countries) (GATT, 1993). Such measures included all requirements for local sourcing of inputs or domestic content in return for access. In addition, so-called “trade balancing” regulations which force foreign investors to balance imports with exported products and similar restrictions on foreign exchange were also prohibited.

While the experience of the United States at the GATT was one of success in linking trade and FDI, it was one of failure, too, in that only a limited agreement resulted, largely because of the determined opposition of a number of developing countries and the pressures to solve other higher priority items within the Uruguay Round package. Few disciplines were imposed on members as a result of the TRIMs agreement and the United States was forced to recognize that progress within WTO (which replaced the GATT in 1995) on investment issues was likely to be slow. This view was later reinforced by the opposition to liberalizing investment rules

among members of the Asia-Pacific Economic Cooperation forum (APEC). In contrast, the OECD had already embarked on a third revision of the national treatment instrument in 1991 and provided a much more hospitable organizational environment in which to push the investment agenda forward.

The decision to negotiate a multilateral agreement on investment in the OECD or WTO

The roots of the recent negotiations of an MAI at the OECD can be found in the changes that had occurred in the nature of FDI and in national investment policies. By the early 1990s, these developments were reflected in a heightened awareness of the role of foreign investment within a globalized system of production and its relationship to trade. Many economists, business organizations and national policy makers in industrialized countries increasingly saw trade and investment as complementary, requiring more integrated treatment as policy issues. A complete liberalization of controls on access for foreign investors was considered inherently desirable on a global basis. Because so many of the direct and transparent regulations on access and performance requirements had already been removed in the investment liberalization wave of the late 1980s (UNCTAD, 1996a), advocates of further liberalization turned their attention to the remaining sectoral and de facto barriers to FDI, many of which stemmed from differences in national economies.

The proliferation of BITs and investment provisions in regional trade agreements (e.g. the North American Free Trade Agreement (NAFTA)) and sectoral, or issue specific, agreements at the multilateral level, such as the General Agreement on Trade in Services (GATS), the TRIMs Agreement and the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), meant that overlapping and sometimes confusing rules had been developed. All were limited either by geographic region, sector or issue. No comprehensive, consistent, universal and binding rules on international investment existed at a time when certainty and security had become even more important to transnational capital, ever more tightly integrated in globalized systems of production. In the United

States' view, the OECD provided a more hospitable environment for discussion of such rules.⁴

The United States had called on the OECD to initiate discussion on a wider investment instrument, which OECD ministers agreed to study in June 1991. A number of international business organizations that are represented directly through the Business and Industry Advisory Committee (BIAC) of the OECD⁵ expressed the view in 1992 that such an instrument was necessary. The United States wanted a much tighter, more comprehensive agreement than the national treatment instrument, and had been increasingly frustrated by the slow and incremental process to strengthen aspects of it and to make it binding on member States. In December 1991 the United States began the push to launch a full-scale negotiation on a comprehensive, binding investment treaty at the OECD which would have high standards of liberalization, protection of investors and a dispute resolution process (United States, 1991, p. 1).

Despite the strong consensus among OECD members on the need for such a set of rules and the desire for investment liberalization, there was no consensus that the OECD was the preferred venue for such negotiations, or that there was an urgent need to proceed quickly.⁶ Arguments for and against the OECD as the venue for such negotiations put forward by OECD members over the next three years centred on several aspects of the organization, particularly its restricted membership and its strengths and weaknesses. The OECD secretariat was also conscious of the need to find a role for itself in the post-cold war world of global capitalism and embraced the project of an MAI with enthusiasm, pointing to its long experience with the codes. However, the OECD was often compared, sometimes unfavourably, to the newly established WTO, which, as a result of

⁴ Source: interviews with negotiators on the MAI, Paris, April 1997.

⁵ BIAC was established along with a Trade Union Advisory Committee (TUAC) to provide input to the OECD in 1962 and regularly briefs members on its view on key issues prior to committee and ministerial meetings.

⁶ This analysis is based in part on interviews conducted in May 1996 and February 1997 with investment negotiators in the Canadian Departments of Foreign Affairs and International Trade and Industry Canada and documents regarding the OECD negotiations obtained under the Canadian Access to Information Act in February 1997.

the Uruguay Round, was increasingly addressing investment issues. Beyond disagreements over the issue of venue were other disputes at the OECD over the scope of issues to be covered by the agreement itself.

Membership

As indicated above, the OECD had its roots in post-war cooperation among industrialized market economies. The admission after 1991 of the Czech Republic, Hungary, Mexico, Poland and the Republic of Korea did not substantively alter the organization and came only after the adoption by these countries of sufficiently liberal economic policy commitments as part of the negotiated accession process. Clearly for some members, the restricted nature of the membership of the organization was seen to be an advantage in investment negotiations. The United States identified a large degree of consensus on many aspects of the treatment of FDI, making ultimate agreement on a strong treaty with high standards, in its view, quite likely. The advantage of the OECD, from the United States' viewpoint, was that agreement there would both "prevent backsliding within the OECD and promote the adoption of these standards outside the OECD" (United States, 1991, p. 3), reflecting the traditional view of the OECD as a forum for consensus among the largest market economies and as a missionary for liberalization. Unlike WTO, where a coordinated bloc of developing countries might try to stop negotiations or limit the scope of rules, any developing countries acceding to the MAI would do so on a case-by-case basis and would be in a position only to seek exemptions and not to shape the nature of the agreement. Thus the MAI was to be a set of rules agreed upon by a small group of like-minded States which could then serve as a model and ultimately be sold to non-OECD countries as worth adopting if they wished to be seen as attractive to foreign investors.

Other OECD members, however, saw restricted membership differently. Any agreement negotiated by members would exclude the very countries where investors had complained of discrimination or other difficulties. When a number of European countries, as well as Canada, canvassed their own business communities, they found few or no complaints about the treatment of FDI within other OECD countries. In the case of Mexico, Canada and the United States,

a significant proportion of FDI was already covered by fairly strong investment rules embodied in chapter 11 of NAFTA, and much of the growth in new FDI was occurring in non-OECD countries. All OECD members recognized that the ultimate target for new disciplines on the treatment of FDI were countries *outside* the OECD, especially the dynamic Asian economies which were attracting investment, and countries, such as Brazil and India, which had led resistance to investment liberalization at the GATT/WTO. However, there was concern that even if the OECD treaty were ultimately opened up to non-OECD countries, the resentment and sense of exclusion from the negotiation process would make many non-member countries reluctant to accede to the treaty.

Corporate culture

A few States had concerns about the nature of the OECD as an organization, apart from the question of its restricted membership. These concerns focused on what might be broadly called the “corporate culture” of the OECD and its lack of experience with the negotiation of treaties. A number of members expressed concern about the heavy emphasis on consensus and the tendency to opt for “lowest common denominator approaches” designed to satisfy everyone. While members acknowledged the excellent capacity of the secretariat to conduct research, its large research-oriented staff (approximately 1,800 employees, in contrast to 450 at WTO) and bureaucratic procedures were not seen as helpful in the kind of negotiations that a binding treaty on investment would entail. With its limited staff and experience in numerous rounds of trade negotiations, WTO was seen, in contrast, to be “member-driven” (Blackhurst, 1997). For many smaller countries and newer OECD members, however, the OECD’s research strength and its consensus-oriented committee process were seen as advantages, in contrast to the position in WTO, where the largest market economies, such as the United States, Japan and the European Union, often appeared to be forging backroom bilateral deals, marginalizing the smaller countries.

The choice of venue was of particular concern to the European members of the OECD and illustrates how actors view organizations

in terms of advancing their own interests. Each of the 15 member countries of the European Union is a member of the OECD and is individually represented on all OECD committees. The European Commission is also a participant, but in contrast to its status at the WTO, is not an OECD member in its own right. Many issues discussed at the OECD which involve trade are within the competence of the Commission as far as negotiations are concerned. In the case of investment, the competence is, in fact, shared between the Community and member countries. Thus, while the European Union members might endeavour to coordinate their positions on the MAI at the OECD, the Commission would be in no position to oblige them to do so. Some member States, such as the United Kingdom, wished to keep the Commission's role to a minimum in investment negotiations and were therefore concerned that any movement away from the existing OECD committee structure might strengthen the role of the Commission. The Commission itself, and more specifically its Commissioner of external relations responsible for trade, Sir Leon Brittan, was an early and vocal champion, as will be seen later, of negotiating an investment treaty within WTO rather than the OECD, a preference which some observers attributed to the Commission's desire to control more fully the negotiation process. The United States, in contrast, saw the OECD as a venue where the Commission would play less of a coordinating role and European countries would be freer to break ranks, thus fragmenting the influence of their 15 members to the advantage of the United States.

Thus a number of countries, including Canada, Japan and the United States supported a movement away from the CIME/CMIT committee structures and towards the formation of separate and distinct working groups both to conduct the feasibility study and ultimately to negotiate any agreement. This view was shared by the European Commission. In contrast, however, a number of larger members of the European Union, including the United Kingdom and Germany, as well as some smaller countries, sought to bind the whole process of study and negotiation as closely as possible to the existing OECD committees. Ultimately, members agreed to operate with a negotiating group consisting of 29-members, plus the Commission, separate from existing committees and chaired by a Dutch official, with United States and Japanese vice-chairs.

The lack of a consensus on both the parameters of an agreement and where it should be negotiated delayed the completion of an OECD feasibility study on an investment agreement well into 1994. By that time the Uruguay Round negotiations had been successfully concluded, investment issues had been addressed in the TRIMs, TRIPS and GATS agreements, and the creation of the WTO was under way. The successful completion of the WTO process served to raise further questions about the choice of venue for negotiating an MAI. On the one hand, the TRIMs negotiations had illustrated the lack of consensus on investment at the GATT and suggested that negotiating within the now 132-member WTO would be slow and difficult. The exhausting process of the Uruguay Round left few WTO members eager to launch further negotiations until the new agreements had been fully implemented. On the other hand, it suggested to some OECD members that investment was now firmly part of the WTO mandate, and a new WTO, with a strengthened dispute resolution mechanism, would eventually be the logical home for a set of binding and universal rules on investment. The WTO Director-General, Mr. Renato Ruggiero, repeatedly supported that view in speeches he gave in 1995 and 1996.⁷

Despite the basic completion of the OECD feasibility study in the spring of 1994, it did not go forward to the annual meeting of the Council, largely because of a continued disagreement between the United States and the European Union over the issue of binding sub-national Governments in federal States and whether there would be exceptions to the obligations of national and most-favoured-nation treatment for regional economic integration organizations (REIOs), such as the European Union. The question of the pace of negotiations and whether the OECD should be the venue for actual negotiation of the MAI also remained unresolved. Canada argued that the OECD was unquestionably the place to develop a framework and outline key principles for any agreement, but was unwilling to agree that the OECD was the organization where such an agreement should be negotiated. The United States and the United States International Business Council, an influential member of BIAC, came to see the insistence of a number of members that the question of venue be

⁷ See also the *1996 Annual Report of the WTO* on the issue of foreign investment and trade.

addressed as a delaying tactic designed to ultimately sabotage negotiations.

In the fall of 1994 and the winter of 1995, the European Commissioner, Sir Leon Brittan, became the outspoken champion of negotiating a comprehensive set of investment rules in WTO. Brittan used the release of a European Union discussion paper, which called for a comprehensive binding investment agreement, as an opportunity to call for negotiations in WTO. He argued that the WTO was preferable because it could offer an enforceable dispute resolution mechanism, something which a binding agreement required and which the OECD could not provide (Brittan, 1995). Moreover, an agreement negotiated at the OECD would be seen, in his view, as merely a “rich man’s set of rules” (Barber, 1995, p. 8). Brittan made it clear that, in the European Commission’s view, the real need for discipline on State interference in investment matters was among non-OECD countries, virtually all of whom were members of WTO (Brittan, 1995). Further discussions and negotiations resolved the differences between the United States and the European Union in time for the 1995 OECD Council meeting. Brittan and the European Union were willing to live with what has been labelled a “two-track” policy of having negotiations go forward at the OECD, even while the European Union and other actors pursued efforts to put a broader investment agreement on the agenda of WTO. This effort continued, even though a number of developing-country members of WTO had no desire to see it there.

Concerns over the limits of the OECD as a negotiating venue are reflected in the report on the MAI which was finally adopted in May 1995. The communiqué from the 24 May meeting (OECD, 1995) and the appended report on an MAI reflect the compromises and special arrangements required by members in order to gain acceptance of the agreement to launch negotiations at the OECD. The ministers agreed to “the immediate start of negotiations in the OECD aimed at reaching an MAI by the ministerial meeting of May 1997”. The agreement would:

“... provide a broad multilateral framework for international investment with high standards for the liberalisation of investment regimes and investment

protection and with effective dispute settlement procedures; be a freestanding international treaty open to all OECD Members and the European Communities, and to accession by non-OECD Member countries, which will be consulted as the negotiations progress” (OECD, 1995, p. 2).

The communiqué also called for increased cooperation with the WTO on investment issues. WTO observers were present at meetings of the MAI negotiating group.

The report on an MAI, which was tabled at the meeting, outlined the need for an agreement that arises from the “dramatic growth and transformation of Foreign Direct Investment which has been spurred by widespread liberalisation and increased competition for investment capital.” Foreign investors, however, according to the report, still encountered “investment barriers, discriminatory treatment and uncertainty.” The MAI would set a high standard for the treatment of investors and provide “clear, consistent rules on liberalisation, dispute settlement and investor protection”. Most importantly, it would create pressure on the non-OECD investment dissidents because:

“The MAI would provide a benchmark against which potential investors would assess the openness and legal security offered by countries as investment locations. This would in turn act as a spur to further liberalisation” (OECD, 1995, p. 3).

Conscious of the restricted membership of the OECD, members started consultations with non-members early in the negotiating process. These took two forms: first, OECD-sponsored workshops were held in various locations such as Hong Kong (now Hong Kong Special Administrative Region of China) and Brazil, where dynamic non-member economies were invited to discuss the MAI along with OECD members and officials of other organizations such as WTO and UNCTAD, and regional organizations such as the Organization of American States (OECD, 1997); the second method of consultation involved the participation of a few non-members who were likely candidates for accession, such as Argentina and Hong

Kong, China, who sat in as observers at the negotiations in 1997 and 1998.

While the substantive negotiations on the MAI are not the focus of this article, it was clear at the outset that although there was a high degree of consensus on principles regarding the treatment of investors, OECD members continued to have differences on specific issues such as extraterritoriality (with regard to the Helms-Burton Act, for example), the European demand for a REIO clause (discussed above) and the demand for an exemption from national treatment for culture, a major issue for France and Canada. The negotiations were slow to reach the key political compromises necessary to forge an agreement, making it impossible to keep to the original May 1997 deadline, or the second deadline of the April 1998 ministerial meeting.

The road to Singapore: WTO and investment

Despite the 1995 OECD ministerial decision to launch negotiations, efforts to push investment as an issue for eventual negotiation in WTO intensified. They continued in the autumn of 1995 and throughout the spring and summer of 1996, with a view towards building momentum for the first full WTO ministerial meeting in December 1996 in Singapore. Moreover, the initial TRIMs agreement had built into it a provision (article 9) for the review of its operation after five years by the Council for Trade in Goods. The Council would also be empowered to “consider whether the Agreement should be complemented with provisions on investment policy and competition policy” (GATT, 1994, p. 4), ensuring that at some point WTO would at least be revisiting trade-related investment issues.

Among those who wanted to see broader investment negotiations in WTO were the European Commission and Canada. Canada hosted a meeting in the fall of 1995 with 16 middle-sized economies including Australia, Hong Kong (China), Indonesia, Singapore and Thailand, where the investment issue was raised.⁸ The

⁸ This account is based on interviews with Canadian officials and WTO staff in Ottawa, Paris and Geneva, February and April 1997.

European Commission began preparing the way through a series of informal discussions in the autumn of 1995 with various WTO representatives in Geneva and Commissioner Brittan's public endorsement of WTO as a venue. The United States remained opposed to any push to put investment on the agenda of WTO because it considered the completion of an MAI at the OECD to be the top priority (Aaron, 1995). Despite opposition by the United States, expressed informally at the Quad trade ministers meetings with Canada, the European Union and Japan and at negotiating sessions at the OECD, Canada and the European Commission persisted in their efforts. These two, along with Brazil, also supported two seminars organized under the auspices of UNCTAD, an organization that enjoyed the trust of developing countries. The seminars, held near Geneva in October 1995 and February 1996, dealt with foreign investment in a globalizing economy and attracted over 40 participants from developing countries (UNCTAD, 1996b). Speakers included officials from a number of international organizations such as WTO and UNCTAD, business organizations and government officials. Shortly thereafter, a review of WTO members' opinions on investment issues revealed a certain amount of opposition from developing countries to initiating negotiations on investment in WTO. Ironically, this put many of these countries on the same side as the United States on this issue, despite their disagreements on other issues such as labour standards and government procurement.

In April 1996, Canada presented a proposal to begin a work programme in WTO on investment, an attempt to move the process forward by proposing detailed analytical work on FDI and the various international rules dealing with investment (Canada, 1996). The effort was portrayed as an educative one that did not presuppose future negotiations even though the goal was clearly to build a consensus on investment negotiations. The caution of the Canadian paper reflected the recognition, however, that any attempt to launch negotiations in the near future would be doomed to failure. While countries such as India and the United Republic of Tanzania were opposed⁹ and questioned the need to undertake research in an organization like WTO, which is largely oriented towards contractual

⁹ The arguments of the Indian representative are presented in an article by the Indian Minister R.B. Ramaiah in *Transnational Corporations* (Ramaiah, 1997).

trade agreements and the negotiations involved in such agreements, other WTO members, such as Brazil and Mexico, were somewhat more supportive. The issue was raised again at a meeting in June 1996 where the opposition of the developing countries was beginning to coalesce, even as Canada was garnering additional sponsorship of its programme from other industrialized countries such as Japan. Eventually the United States also supported the proposal, largely for its educative value, but insisted at a later Quad trade ministers meeting that Canada, the European Union and Japan should reaffirm their support for the negotiation of the MAI at the OECD.¹⁰ From the United States viewpoint, any effort to push investment within WTO would fail and risked building an intransigence to future investment negotiations among a number of countries.

While a number of international business groups, such as the International Chamber of Commerce and the Trans Atlantic Business Dialogue, supported simultaneous efforts in WTO and the OECD to negotiate investment rules, the United States Advisory Committee on Trade Policy and Negotiation (ACTPN, 1996) and the United States Council for International Business were strongly opposed to the efforts in WTO, claiming that the European Union Commission would “use the WTO work program to frustrate our OECD investment objectives”.¹¹ Despite this criticism, the European Union supported the Canadian work programme with a view towards “aiming toward a consensus which might lead in time to the negotiations of a WTO investment instrument”(European Union, 1996, p. 10).

The Director-General of WTO, Renato Ruggiero, and its secretariat also seemed to support the inclusion of investment in a WTO work programme. The secretariat released a 75-page paper on FDI on 9 October 1996 which argued that FDI required a set of global rules that could take the interests of all economies into account and that “only a multilateral negotiation at the WTO, when appropriate, can provide such a global and balanced framework” (WTO, 1996c). The timing of the report’s release was criticized by a few delegates at an October 14 meeting of the General Council who saw it as an attempt to push the investment agenda item prior to the Singapore

¹⁰ *Inside United States Trade*, 28 September 1996.

¹¹ *Inside United States Trade*, 23 August 1996, p. 10.

meeting.¹² In his speeches, Ruggiero repeatedly underlined the linkage of FDI and trade and the need for a set of multilateral rules, given the patchwork of regional and bilateral agreements.

Efforts to forge a consensus among the developing countries to prevent the inclusion of investment and a number of other new issues on the Singapore agenda were spearheaded by India, which hosted a meeting of 14 countries in September 1996. The meeting's communiqué raised the question of the role of UNCTAD, which also had a mandate, as a result of UNCTAD IX, to study the issue of FDI and pointed out that the TRIMs agreement already called for a review in 1999- 2000. The communiqué was critical of the idea of a multilateral investment agreement:

“While countries are trying to promote inward investment autonomously in different degrees and some countries have more liberal inward investment regimes, the efforts to bind all countries into a common framework of disciplines concerning transnational investments does not in the view of many participants appear to be well-considered and equitable.”¹³

No consensus was achieved among WTO delegates on the investment issue prior to the Singapore meeting and a last minute compromise was forged at the meeting itself.

The ministerial declaration that emerged from the Singapore meeting had only a few sentences on investment, greatly reduced from the initial Canadian proposal. Ministers agreed to “establish a working group to examine the relationship between trade and investment” the work of which should not prejudice whether negotiations would be initiated in the future; the process was also to draw upon the work at the UNCTAD and “other appropriate intergovernmental fora” (WTO, 1996b, p. 2). The declaration also referred to the existing built-in agenda in the TRIMs review, due in four years. Clearly little support existed in WTO to launch any

¹² “WTO Secretariat report hints at a need for investment rules”, *Inside United States Trade*, 25 October 1996.

¹³ *Inside United States Trade*, 4 October 1996.

negotiations on a multilateral investment agreement. The WTO press briefing was frank in acknowledging that there was “disagreement over the extent to which the WTO should be involved in setting international rules for foreign investment” (WTO, 1996a, p. 1). Thus the field was left open for negotiations to continue at the OECD, while the study of FDI and trade continued to move forward in WTO and UNCTAD. Within the WTO working group, the Commission continued to push the investment issue (WTO, 1997), hoping for a decision to launch a new round of negotiations that would include investment by the autumn 1999 WTO ministerial meeting.

The OECD in 1998: not so like-minded after all

While the working group on trade and investment proceeded slowly in WTO, the OECD negotiations on the MAI began to unravel in 1997 and 1998. Despite an initial consensus on the broad parameters of an agreement which would have included investor protection, national treatment and a dispute settlement process extended to include disputes between investors and States, disagreements over a small number of key issues were still unresolved by early 1997. In part, this was due to the lack of a pressing impetus on the part of States to compromise. The agreement, on the one hand, involved broad commitments to national treatment of investors across industries, but, at the same time, focused only on investment issues. Unlike the broad agenda of the multilateral trade negotiations, the package, in one sense, did not provide enough trade-offs as an incentive to compromise. In many cases, OECD members had much greater investment concerns with non-OECD countries and thus saw little benefit in making domestically difficult compromises for relatively little gain at the OECD.

Complicating matters even further was the mounting opposition throughout 1997 and 1998 to the MAI as a result of the leak of a draft text in March 1997 and accusations from NGOs that a vast agreement was being negotiated in secret. The slow progress of negotiations afforded these groups additional time to attack what they saw as an unbalanced agreement giving special privileges to TNCs over the rights of citizens and protection of the environment (Barlow and Clarke, 1997) and to organize opposition within a number of member countries. There was pressure to address issues of labour and

environmental standards, further facilitated in several cases by changes of Governments. The growing criticism, lack of progress and a waning enthusiasm on the part of the United States negotiators, themselves divided over the merits of the MAI, ultimately resulted in a breakdown in negotiations in early 1998, a six-month suspension of talks, then a decision by France in October 1998 to withdraw, and the calls, once again, by several OECD members to move the process to WTO and finally the announcement of the cessation of formal negotiations. The failure of the OECD negotiations raises the question once more of the wisdom of embarking on the negotiation of investment rules at the OECD.

Conclusion: whose place is it anyway?

As the history of the development of investment rules and the case of the MAI demonstrates, there has been a pattern of using a variety of international organizations in the last three decades as venues for the negotiation of international investment rules. Countries' preferences for a particular venue were driven by a number of considerations arising from their own particular investment interests, which have themselves evolved over time. Preferences had also been clearly shaped, as this article indicates, by an assessment of organizations based on membership, a country's perceived influence over decisions, either alone or in blocs, and the effectiveness of the organization itself.

In the case of the United States, its position as a major capital exporter and its concerns about the role of capital importers within the General Assembly of the United Nations led it to push for investment rules in the early 1970s at the OECD. In the 1980s, the desire to limit the imposition of performance requirements on United States firms led to an effort to link trade and investment and thus focus on the GATT, where investment measures, if linked to trade rules, could be prohibited via the threat of trade retaliation, providing large markets like the United States with great leverage. At the same time, the United States also continued to use bilateral and regional agreements to secure its investment interests and establish norms regarding the treatment of investors which could later be incorporated into international agreements.

Efforts to build on the trade and investment link at the GATT proved slow and difficult as its membership expanded and an organized bloc of developing countries was able to limit the scope of investment rules. Meanwhile the OECD had continued the process of peer review of investment regulations and efforts to strengthen its codes in the 1980s. Thus it provided a ready alternative venue to further investment liberalization when the United States decided to try to create a binding treaty on investment in the 1990s. The United States had good reason at the outset to expect success. The 29 OECD members were all highly integrated into international systems of production and many, large and small, were now capital exporters. Norms regarding the treatment of investors seemed to be widely shared. Moreover, the European members did not act as a cohesive bloc, as they did in WTO. Even the United States, however, had doubts about how effective the existing OECD structure would be in the negotiations and pushed for a separate negotiating group.

In the case of the European Union there was a clear, unabashed preference for the WTO venue, based partly on the fact that the WTO is the only home for a multilateral agreement where the European Commission's role is not challenged. In the Commission's view, WTO affords Europe a more united front when bargaining with other large actors like the United States. The Commission also shares a desire to forge rules that will bind non-OECD countries, a growing destination for European Union-based FDI. While the Commission was not enthusiastic about talks at the OECD, it could not stop OECD members from initiating the process, but neither did the OECD talks stop it from continuing to push the investment issue in WTO. The negotiations at the OECD also provided the European Commission with an additional forum in which to raise the issue of United States extraterritoriality and the Helms-Burton Act.

For some European Union member States, wary of the role of the Commission and jealously guarding their autonomy, the OECD was a preferred venue, especially given that there was clear opposition in WTO to launching any further negotiations on investment in 1996. In fact, for many OECD members, the OECD and WTO were not seen as mutually exclusive venues. The WTO membership as a whole was not receptive to investment negotiations in 1996, and a model investment treaty at the OECD (which could be extended to non-

members) did seem feasible. Moreover, success at the OECD did not preclude, and might even encourage, the further development of trade-related investment rules in WTO.

For middle-sized countries like Canada, there was less initial interest in an OECD MAI largely because Canada's major investment relationship was already dealt with in NAFTA and increased investment in Latin America and Asia meant that an MAI, if limited to OECD members, would be of little help to Canadian-based TNCs. Moreover, it is WTO, in Canada's view, which has the capacity to create binding global rules on investment with its more global membership and strengthened dispute resolution system. Canadian decision makers have seen such rules as the best protection against unilateral actions on the part of its largest trading partner and a counterweight to the enormous asymmetry of its bilateral economic relationship with the United States (Weekes, 1996).

Was the decision to negotiate an MAI at the OECD a mistake? Few of the participants would admit that it was. Even those who preferred WTO as a venue do not necessarily see the work of the past three years as wasted, since much of the groundwork on the issues has now been done. Perhaps even more importantly, a number of valuable lessons have been learned. From the perspective of those who were critical of the draft MAI there is much to be said for the negotiations taking place in a venue which is much more inclusive in terms of its State membership. Whether it is a more transparent one from the perspective of those who criticized the OECD as secretive remains to be seen. In any event, there is clearly a strong division among WTO members over the negotiation of investment rules. This will limit the progress in the near future of any negotiations in WTO. Should a decision be made to include investment in negotiations at the beginning of the millennium, there is no guarantee that it will somehow result in an agreement that meets the concerns of those who were critical of the MAI process at the OECD. However, the MAI experience has clearly demonstrated the need to create a process that is more inclusive of a broad range of State and non-State actors. Although it may be a much slower process and may result in a more limited agreement, it might be one that is ultimately more balanced, acceptable and effective. ■

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RESEARCH NOTE

World Investment Report 1998: Trends and Determinants *Overview*

United Nations Conference on Trade and Development*

Global trends

Worldwide foreign direct investment (FDI) inflows continued their upward climb in 1997 for the seventh consecutive year. Seemingly unaffected by the Asian financial crisis, they increased by 19 per cent to a new record level of \$400 billion, while outflows reached \$424 billion (table 1). The capital base of international production in 1997, including capital for direct investment purposes drawn from sources other than transnational corporations (TNCs), is estimated to have increased by \$1.6 trillion in 1997.

The upward trend in investment flows supported further the expansion in international production. In 1997, the value of international production, attributed to some 53,000 TNCs and their 450,000 foreign affiliates, was \$3.5 trillion as measured by the accumulated stock of FDI, and \$9.5 trillion as measured by the estimated global sales of foreign affiliates. Other indicators also point in the same direction: global exports by foreign affiliates are now some \$2 trillion, their global assets \$13 trillion, and the global

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Table 1. Selected indicators of FDI and international production, 1986-1997
(Billions of dollars and percentage)

Item	Value at current prices (Billion dollars)		Annual growth rate (Per cent)			
	1986	1987	1986-1990	1991-1995	1996	1997
FDI inflows	338	400	23.6	20.1	1.9	18.6
FDI outflows	333	424	27.1	15.1	-0.5	27.1
FDI inward stock	3 065	3 456	18.2	9.7	12.2	12.7
FDI outward stock	3 115	3 541	21.0	10.3	11.5	13.7
Cross-border M&As ^a	163	236	21.0 ^b	30.2	15.5	45.2
Sales of foreign affiliates	8 851 ^c	9 500 ^c	16.3	13.4	6.0 ^c	7.3 ^c
Gross product of foreign affiliates	1 950 ^c	2 100 ^c	16.6	6.2	7.7 ^c	7.7 ^c
Total assets of foreign affiliates	11 156 ^c	12 606 ^c	18.3	24.4	12.0 ^c	13.0 ^c
Memorandum:						
GDP at factor cost	28 822	30551 ^d	12.1	5.5	0.8	6.0 ^d
Gross fixed capital formation	5 136	5393 ^d	12.5	2.6	-0.1	5.0 ^d
Royalties and fees receipts	53	61 ^d	21.9	12.4	8.2	15.0 ^d
Exports of goods and non-factor services	6 245	6432 ^d	14.6	8.9	2.9	3.0 ^d

Source: World Investment Report 1998: Trends and Determinants, table I.1, p. 2.

^a Majority-held investments only.

^b 1987-1990 only.

^c Projection on the basis of 1995 figures.

^d Estimates.

Note: not included in this table are the values of worldwide sales by foreign affiliates associated with their parent firms through non-equity relationships and the sales of the parent firms themselves. Worldwide sales, gross product and total assets of foreign affiliates are estimated by extrapolating the worldwide data of foreign affiliates of TNCs from France, Germany, Italy, Japan and the United States (for sales), those from the United States (for gross product) and those from Germany and the United States (for assets) on the basis of the shares of those countries in the worldwide inward FDI stock.

value added by them more than \$2 trillion. These figures are also impressive when related to the size of the global economy: the ratio of inward plus outward FDI stocks to global GDP is now 21 per cent; foreign affiliate exports are one-third of world exports; and GDP attributed to foreign affiliates accounts for 7 per cent of global GDP. Sales of foreign affiliates have grown faster than world exports of goods and services, and the ratio of the volume of world inward plus outward FDI stocks to world GDP has grown twice as fast as the ratio of world imports and exports to world GDP, suggesting that the expansion of international production has deepened the interdependence of the world economy beyond that achieved by international trade alone (figure 1).

Figure 1. The degree of internationalization through FDI and through trade, 1980-1996
(Percentage of GDP)



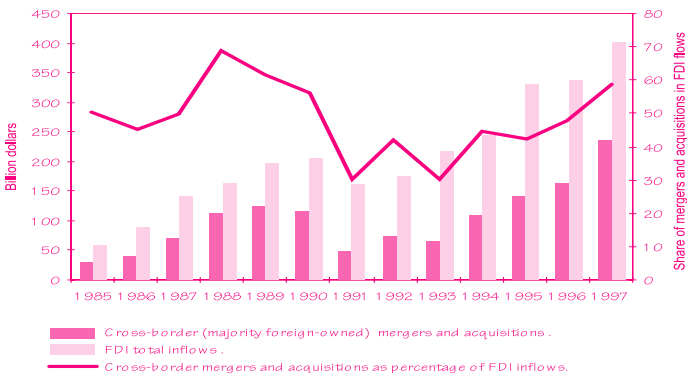
Source: *World Investment Report 1998: Trends and Determinants*, figure I.1, p. 7.

Note: the scales used for the three panels are different.

Mergers and acquisitions

Worldwide cross-border M&As, mostly in banking, insurance, chemicals, pharmaceuticals and telecommunications, were aimed at the global restructuring or strategic positioning of firms in these industries and experienced another surge in 1997. Valued at \$236 billion, majority-owned M&As represented nearly three-fifths of global FDI inflows in 1997, increasing from almost a half in 1996 (figure 2). Many of the 1997 M&A deals have been large and 58 of them were each worth more than \$1 billion. The United States, followed by the United Kingdom, France and Germany, accounted for the biggest share of the large M&A deals. Together, developed countries accounted for about 90 per cent of the worldwide majority-owned M&A purchases. These deals are not only a major driver of FDI flows for developed countries, but also shed light on the prevailing strategies of TNCs: divesting non-core activities and strengthening competitive advantages through acquisitions in core activities. These strategies have been made possible by liberalization (including the WTO's financial services agreement in 1997) and deregulation (e.g. in telecommunications). One outcome is a greater industrial concentration in the hands of a few firms in each industry, usually TNCs.

Figure 2. The relationship between cross-border M&As and FDI flows, 1985-1997



Source: *World Investment Report 1998: Trends and Determinants*, figure 1.9, p. 19.

TNCs are achieving their goals of strategic positioning or restructuring not only through M&As but also through inter-firm agreements. A subset of such agreements involves technology-related activities and is a response to the increased knowledge-intensity of production, the shortening of product cycles and the need to keep up with the constantly advancing technological frontier. Such agreements are particularly important for enhancing the technological competitiveness of firms and their number has increased from an annual average of less than 300 in the early 1980s to over 600 in the mid-1990s. An estimated 8,260 inter-firm agreements in technology-intensive activities have been concluded between 1980 and 1996. Given their emphasis on technology or joint R&D development, it is not surprising that inter-firm agreements are prominent in knowledge-intensive industries, such as the information industry and pharmaceuticals and, more recently, in automobiles.

The largest transnational corporations

The world's 100 largest TNCs (see table 2 for the top 25 of those firms) show a high degree of transnationality as measured by the shares of foreign assets, foreign sales and foreign employment in their total assets, sales and employment. The top 50 TNCs headquartered in developing countries (see table 3 for the top 25 of those firms) are catching up rapidly. The composite index that combines all three shares bears this out: the top 50 TNCs headquartered in developing countries have built up their foreign assets almost seven times faster than the world's top 100 TNCs between 1993 and 1996 in their efforts to transnationalize. The transnationality index of the former was 35 per cent in 1996, while that of the latter was 55 per cent. While the value of the index for the top 100 TNCs is higher, it did not change significantly between 1990 and 1995. In contrast, the value of the index for the top 50 developing country TNCs has been increasing steadily throughout the 1990s. Naturally, there are significant differences by type of industry, with telecommunications, transport, construction and trading being the most transnational in the case of the top 50 developing country TNCs, while food and beverages, chemicals and pharmaceuticals, and electronics and electrical equipment were the most transnational among the world's top 100. The ranking of TNCs by the different transnationality indexes also differs: although General Electric tops the list of the largest 100 TNCs ranked by the

Table 2. The world's top 25 TNCs, ranked by foreign assets, 1996
(Billions of dollars and number of employees)

Ranking by Foreign assets	Transnationality index ^a	Corporation	Country	Industry ^b	Assets		Sales		Employment		Transnationality index ^a (Per cent)
					Foreign	Total	Foreign	Total	Foreign	Total	
1	83	General Electric	United States	Electronics	82.8	272.4	21.1	79.2	84000	239000	30.7
2	32	Shell, Royal Dutch ^c	United Kingdom/ Netherlands	Petroleum expl./ref./dist.	82.1	124.1	71.1	128.3	79000	101000	66.6
3	75	Ford Motor Company	United States	Automotive	79.1	258.0	65.8	147.0	.. ^e	371702	37.7
4	22	Exxon Corporation	United States	Petroleum expl./ ref./dist.	55.6	95.5	102.0	117.0	.. ^e	79000	72.7
5	85	General Motors	United States	Automotive	55.4	222.1	50.0	158.0	221313	647000	30.3
6	52	IBM	United States	Computers	41.4	81.1	46.6	75.9	121655	240615	54.3
7	79	Toyota	Japan	Automotive	39.2	113.4	51.7	109.3	34837	150736	35.0
8	49	Volkswagen Group	Germany	Automotive	.. ^d	60.8	41.0	64.4	123042	260811	55.3
9	71	Mitsubishi Corporation	Japan	Diversified	.. ^d	77.9	50.2	127.4	3819	8794	41.4
10	38	Mobil Corporation	United States	Petroleum expl./ ref./dist.	31.3	46.4	53.1	80.4	22900	43000	62.3
11	3	Nestle SA	Switzerland	Food	30.9	34.0	42.0	42.8	206125	212687	95.3
12	2	Asea Brown Boveri (ABB)	Switzerland/Sweden	Electrical equipment	.. ^d	30.9	32.9	33.8	203541	214894	96.1
13	47	Elf Aquitaine SA	France	Petroleum expl./ ref./dist.	29.3	47.5	26.6	44.8	41600	85400	56.6
14	14	Bayer AG	Germany	Chemicals	29.1	32.0	25.8	31.4	94375	142200	79.9
15	34	Hoechst AG	Germany	Chemicals	28.0	35.5	18.4	33.8	93708	147862	65.6
16	57	Nissan Motor Co., Ltd.	Japan	Automotive	27.0	58.1	29.2	53.8	.. ^e	135331	50.4
17	74	FIAT Spa	Italy	Automotive	26.9	70.6	19.8	51.3	90390	237865	38.2
18	8	Unilever	Netherlands/ United Kingdom	Food	26.4	31.0	45.0	52.2	273000	304000	87.1
19	70	Daimler-Benz AG	Germany	Automotive	26.4	65.7	44.4	70.6	67208	290029	41.9
20	11	Philips Electronics N.V.	Netherlands	Electronics	24.5	31.7	38.9	40.9	216000	262500	84.9
21	9	Roche Holding AG	Switzerland	Pharmaceuticals	24.5	29.5	12.6	12.9	39074	46972	87.0
22	56	Siemens AG	Germany	Electronics	24.4	56.3	38.4	62.6	176000	379000	50.4
23	36	Alcatel Alsthom Cie	France	Electronics	23.5	48.4	24.6	31.6	118820	190600	62.9
24	40	Sony Corporation	Japan	Electronics	23.5	45.8	32.8	45.7	95000	163000	60.5
25	19	Total SA	France	Petroleum expl./ ref./dist.	.. ^d	30.3	25.8	34.0	.. ^e	57555	75.8

Source: World Investment Report 1998: Trends and Determinants, table II.1, p. 36.

- ^a The index of transnationality is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment.
^b Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).
^c Foreign sales are outside Europe whereas foreign employment is outside United Kingdom and the Netherlands.
^d Data on foreign assets are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total sales, foreign to total employment or similar ratios.
^e Data on foreign employment are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total sales, foreign to total assets or similar ratios.

Table 3. The top 25 TNCs from developing countries ranked by foreign assets, 1996
(Millions of dollars and numbers of employees)

Ranking by Foreign assets	Transnationality index ^a	Corporation	Country	Industry ^b	Assets		Sales		Employment		Transnationality Index ^a (Per cent)
					Foreign	Total	Foreign	Total	Foreign	Total	
1	9	Daewoo Corporation ^c	Republic of Korea	Diversified/trading	14933.0	32504.0	10238.0	26370.0	37501	47609	54.5
2	15	Petroleos de Venezuela S.A.	Venezuela	Petroleum expl./refin./dist.	8912.0	45402.0	31659.0	33854.5	12756	59318	44.9
3	11	Cemex S.A.	Mexico	Construction	5259.0	9941.0	2027.0	3365.0	9783	20527	53.6
4	4	First Pacific Company	Hong Kong, China	Electronic parts	4645.7	8491.8	6317.5	7025.7	37393	52880	71.8
5	5	Sappi Limited	South Africa ^g	Paper	3760.3	4846.1	2248.6	3438.2	8744	21055	61.5
6	22	Acer Group	Taiwan Province of China	Electronics	...d	16076.0	...e	6100.0	...f	44000	36.1
7	6	Jardine Matheson Holdings & Exp. Corp.	Bermuda	Conglomerate/diversified	3380.2	7788.0	8187.4	11605.0	14000	20000	61.3
8	21	China National Chemicals, Imp.	China	Diversified/trading	3201.6	6166.8	7965.6	17955.0	828	6466	36.4
9	17	China State Construction Engineering Corp.	China	Diversifies/const.	2810.0	5730.0	1590.0	5080.0	...f	2500	40.2
10	7	Compania de Telecomuni- caciones de Chile S.A. (CTC)	Chile	Utilities	2735.6	4406.3	768.8	1274.0	4997	8982	59.4
11	45	Sunkyoung Group	Republic of Korea	Energy/trading/chemicals	2693.0	30793.0	10302.0	42094.0	2500	33299	13.6
12	36	YPF S.A.	Argentina	Petroleum expl./refin./dist.	2650.0	12084.0	864.0	5937.0	2139	9762	19.5
13	50	Petroleo Brasileiro S/A - Petrobras	Brazil	Petroleum expl./refin./dist.	2583.1	33736.3	1508.0	26758.7	22	43468	4.4
14	23	Cathay Pacific Airways	Hong Kong, China	Transportation	2555.0	7968.0	2023.0	4151.0	4038	15757	35.5
15	39	Samsung Electronics	Republic of Korea	Electronics	...d	25837.0	...e	23456.0	...f	59086	16.3
16	20	New World Development	Hong Kong, China	Hotel/construction	2321.2	12413.5	471.6	2162.4	31440	45000	36.8
17	19	Hyundai Engineering & Construction Co.	Republic of Korea	Engineering/construction	2287.0	8404.0	1461.0	5116.0	15950	28000	37.6
18	32	LG Electronics	Republic of Korea	Electronics	2083.2	16662.1	2429.2	14070.0	30889	65284	25.7
19	31	Petroleum Nasional	Malaysia	Petroleum expl./refin./dist.	1876.6	23219.9	6134.1	8901.4	72	13640	25.8
20	13	Citic Pacific Ltd.	Hong Kong, China	Trading/distr./motor veh./supplies	1678.6	6456.3	890.8	1648.9	8100	11750	49.7
21	47	Companhia Vale do Rio Doce	Brazil	Mining	1599.0	17891.0	1342.0	4938.0	86	15483	12.2
22	43	China Shougang Group	China	Diversified/metals	1582.6	6630.0	1032.7	4385.3	1623	221961	16.1
23	18	Singapore Airlines	Singapore	Transportation	1574.0	8584.4	3978.9	5122.4	2818	12966	39.2
24	28	Hulchinson Whampoa	Hong Kong, China	Diversified	...d	8174.0	1400.0	4743.0	10500	27733	28.6
25	2	Panamerican Beverages	Mexico/Panama	Beverages	1436.0	1705.0	1567.0	1993.0	...f	31400	81.4

Source: World Investment Report 1998; Trends and Determinants, table II.9, p. 48.

^a The index of transnationality is calculated as the average of the three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment.

^b Industry classification for companies follows the U.S. Standard Industrial Classification which is used by the United States Securities and Exchange Commission (SEC).

^c Consolidated data are provided.

^d Data on foreign assets are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total sales, foreign to total employment and similar ratios for the transnationality index.

^e Data on foreign sales are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total assets, foreign to total employment and similar ratios for the transnationality index.

^f Data on foreign employment are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total assets, foreign to total employment and similar ratios for the transnationality index.

^g Data on foreign employment are either suppressed to avoid disclosure or they are not available. In case of non-availability, they are estimated on the basis of the ratio of foreign to total sales, foreign to total employment and similar ratios for the transnationality index.

size of foreign assets, Seagram ranks first in the composite index of transnationality. Likewise, Daewoo Corporation topped the list of the 50 largest developing country TNCs by foreign assets, but Orient Overseas International ranked first in the composite index of transnationality. Not surprisingly, firms at the top of the composite transnationality index are from countries with small domestic markets.

Investment policy issues

National policies

During 1997, 151 changes in FDI regulatory regimes were made by 76 countries, 89 per cent of them in the direction of creating a more favourable environment for FDI (table 6). New liberalization measures were particularly evident in industries like telecommunications, broadcasting and energy that used to be closed to foreign investors. New promotional measures included streamlining approval procedures and developing special trade and investment zones (adding to the many such zones already in existence). During 1997 alone, 36 countries introduced new investment incentives, or strengthened existing ones. The network of bilateral investment treaties (BITs) is expanding as well, totalling 1,513 at the end of 1997 (figure 3). In that year one BIT was concluded, on the average, every two-and-a-half days. The number of double taxation treaties also increased, numbering 1,794 at the end of 1997, with 108 concluded in 1997 alone (figure 3). The common thread that runs through the proliferation of both types of

Table 6. National regulatory changes, 1991-1997

Item	1991	1992	1993	1994	1995	1996	1997
Number of countries that introduced changes in their investment regimes	35	43	57	49	64	65	76
Number of regulatory changes	82	79	102	110	112	114	151
Of which:							
More favourable to FDI ^a	80	79	101	108	106	98	135
Less favourable to FDI ^b	2	-	1	2	6	16	16

Source: *World Investment Report 1998: Trends and Determinants*, table III.2, p. 57.

^a Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

^b Including changes aimed at increasing control as well as reducing incentives.

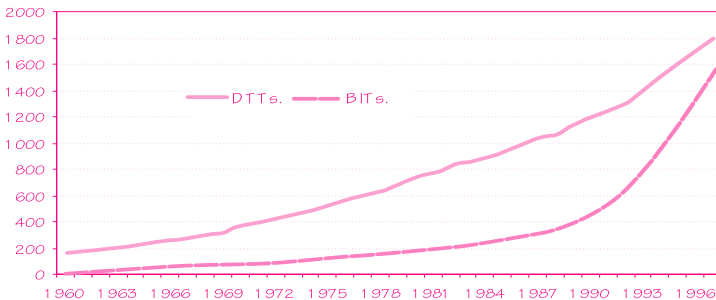
treaties is that they reflect the growing role of FDI in the world economy and the desire of countries to facilitate it.

Discussions of regional initiatives are taking place in most regions in the context of new or existing agreements. On the American continent, negotiations on the Free Trade Agreement of the Americas (FTAA), intended to incorporate a comprehensive framework of rights and obligations with respect to investment, have been launched. If successful, the FTAA will consolidate and integrate the various free trade and investment areas already present in the region. In Asia, the ASEAN Investment Area is scheduled to be established later this year. However, the approach of the ASEAN Investment Area is different from that of other regional initiatives in that it emphasizes policy flexibility, cooperative endeavours and strategic alliances and avoids, at least for now, legally binding commitments. In Africa, there are preliminary discussions on new regional initiatives on investment in the context of the Southern African Development Community (SADC) and the Organization of African States.

Developments at the international level

The ongoing negotiations on a Multilateral Agreement on Investment at the OECD reached a critical point in 1998 after two years of negotiations, when pressures grew to make them more transparent and to initiate a broad-based public debate on FDI issues. Partly reflecting this situation, a pause for reflection until October 1998 was agreed to by the OECD ministers.

Figure 3. Cumulative number of DTTs and BITs, 1960-1997



Source: *World Investment Report 1998: Trends and Determinants*, figure III.3, p. 83.

Wide-ranging discussions at the multilateral level have, meanwhile, been taking place mainly in the WTO and UNCTAD. The work of the WTO Working Group on the Relationship between Trade and Investment is focusing on the economic relationship between trade and investment; the implications of the relationship for development and economic growth; existing international arrangements and initiatives on trade and investment; and issues relevant to assessing the need for possible future initiatives. UNCTAD, on the other hand, is seeking to help developing countries participate effectively in international discussions and negotiations on FDI, be it at the bilateral, regional or multilateral level. In pursuing this objective, UNCTAD is paying special attention to identifying the interests of developing countries and ensuring that the development dimension is understood and adequately addressed in international investment agreements.

Regional trends

The impressive numbers documenting the growth of international production disguise considerable variation across and within regions. There is no doubt that the developed countries, with more than two-thirds of the world inward FDI stock and 90 per cent of the outward stock, dominate the global picture, but their dominance is being eroded (table 4). Developing countries accounted for nearly a third of the global inward FDI stock in 1997, increasing from one-fifth in 1990. It is in flows of inward FDI that developing countries have made the biggest gains over the 1990s, with their values as well as shares of global inflows increasing markedly: from \$34 billion in 1990 (17 per cent of global inflows) to \$149 billion in 1997 (37 per cent of global inflows) (table 5).

Developed countries

Continued strong economic growth in the United States, improved economic performance in many Western European countries, and the mergers-and-acquisitions (M&As) boom are the principal reasons for the acceleration of inflows to developed countries in 1997 (an increase of almost a fifth over 1996, to \$233 billion). The United States received \$91 billion in inflows, accounting for more than one-fifth of global inflows, and invested \$115 billion abroad during the year. Among the countries of the European Union,

Table 4. Regional distribution of inward and outward FDI stock, 1985, 1990, 1995 and 1997
(Percentage)

Region/country	Inward FDI stock				Outward FDI stock			
	1985	1990	1995	1997	1985	1990	1995	1997
Developed countries								
Western Europe	72.3	79.3	70.6	68.0	95.7	95.6	91.5	90.2
European Union	33.6	44.1	39.1	36.9	44.4	50.8	51.1	50.4
Other Western Europe	31.2	41.5	36.3	34.6	40.6	46.3	45.1	45.1
United States	2.3	2.7	2.8	2.3	3.8	4.5	5.9	5.3
Japan	24.4	22.7	20.5	20.9	36.4	25.5	25.6	25.6
	0.6	0.6	1.2	1.0	6.4	11.8	8.5	8.0
Developing countries								
Africa	27.7	20.6	28.1	30.2	4.3	4.4	8.4	9.7
Latin America and the Caribbean	3.1	2.2	2.1	1.9	0.9	0.7	0.5	0.5
Developing Europe	10.1	7.1	10.2	10.9	1.1	0.7	0.9	1.0
Asia	0.1	0.1	0.1	0.1	-	-	-	-
West Asia	14.3	11.1	15.6	17.2	2.3	2.9	6.9	8.2
Central Asia	5.7	2.8	2.1	1.7	0.3	0.4	0.3	0.3
South, East and South-East Asia	0.1	0.2	-	-	-	-
The Pacific	8.6	8.3	13.4	15.3	2.0	2.6	6.4	7.9
	0.2	0.1	0.1	0.1	-	-	-	-
Central and Eastern Europe								
	-	0.1	1.3	1.8	-	-	0.1	0.2
World	100	100	100	100	100	100	100	100

Source: World Investment Report 1998: Trends and Determinants, table I.3, p. 5.

Table 5. Regional distribution of FDI inflows and outflows, 1994-1997
(Percentage)

Region/country	Inflows					Outflows				
	1994	1995	1996	1997	1998	1994	1995	1996	1997	1998
Developed countries										
Western Europe	58.2	63.9	57.9	58.2	58.2	85.0	86.9	85.1	84.8	84.8
European Union	32.3	37.1	29.6	28.7	28.7	47.0	49.4	50.6	46.2	46.2
Other Western Europe	29.5	35.3	27.4	27.0	27.0	42.4	45.2	45.3	42.4	42.4
United States	2.8	1.8	2.2	1.7	1.7	4.6	4.3	5.3	3.7	3.7
Japan	18.6	17.7	22.6	22.7	22.7	25.8	26.1	22.5	27.0	27.0
	0.4	-	0.1	0.8	0.8	6.4	6.4	7.0	6.1	6.1
Developing countries										
Africa	39.3	31.9	38.5	37.2	37.2	15.0	12.9	14.8	14.4	14.4
Latin America and the Caribbean	2.3	1.6	1.4	1.2	1.2	0.2	0.2	0.1	0.3	0.3
Developing Europe	11.8	9.6	13.0	14.0	14.0	1.8	0.7	0.7	2.1	2.1
Asia	0.2	0.1	0.3	0.2	0.2	-	-	-	0.1	0.1
West Asia	25.0	20.3	23.7	21.7	21.7	12.9	12.1	14.0	12.0	12.0
Central Asia	0.6	-0.2	0.1	0.5	0.5	0.4	0.2	-0.3	0.1	0.1
South, East and South-East Asia	0.4	0.5	0.6	0.7	0.7	-	-	-	-	-
The Pacific	24.0	20.1	23.0	20.6	20.6	12.5	11.9	14.2	11.8	11.8
	-	0.2	0.1	0.1	0.1	-	-	-	-	-
Central and Eastern Europe	2.4	4.3	3.7	4.6	4.6	0.1	0.1	0.2	0.8	0.8
World	100	100	100	100	100	100	100	100	100	100

Source: World Investment Report 1998: Trends and Determinants, table I.8, p. 9.

the United Kingdom received \$37 billion (just under a tenth per cent of global inflows) in 1997; in contrast, for the second successive year, Germany registered net FDI withdrawals. Outflows from the European Union were \$180 billion in 1997, and a renewed interest in European integration prompted by the expected advent of the Euro in 1999 led to a spurt in the share of investment directed to member countries. Japan received \$3 billion in 1997, a record figure, though still low compared to other developed economies, and invested \$26 billion abroad.

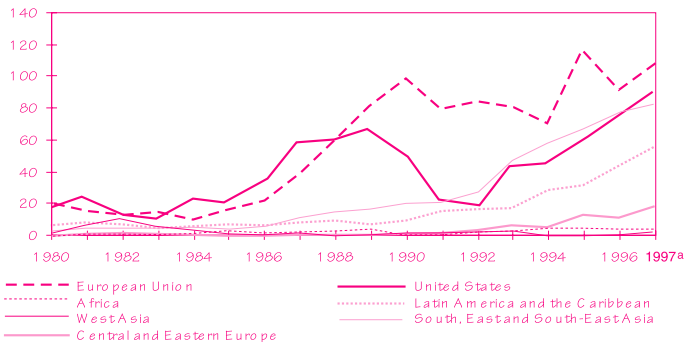
Developing countries

Although smaller than those of developed countries, the increases in 1997 in FDI flows into developing countries are noteworthy because they took place in an environment that presented a complex mix of adverse changes. Unlike other net resource flows such as official development assistance or some other types of private capital, such as portfolio equity investment, FDI inflows increased in 1997, with no developing region experiencing a decline in the level of inflows (figure 4).

Asia and the Pacific

A new record level of \$45 billion in FDI flows received by China contributed to the 9 per cent increase in total FDI flows to Asia and the Pacific in 1997. With \$87 billion in 1997, Asia and the Pacific accounts for nearly three-fifths of the FDI inflows received

Figure 4. FDI inflows, by major region, 1980-1997
(Billions of dollars)



Source: *World Investment Report 1998: Trends and Determinants*, figure I.3, p. 9.

^a Estimates.

by all developing countries, and for over a half of the developing-country FDI stock. East and South-East Asia, the subregion most affected by the financial crisis in Asia during the second half of the year, also saw a small increase of 6 per cent to \$82.4 billion in 1997 but this trend is unlikely to continue in 1998. The five Asian economies most affected by the crisis saw their combined FDI inflows remain at a level almost unchanged from that in 1996. With inflows totalling \$2.6 billion in 1997, largely concentrated in oil-producing Kazakhstan and Azerbaijan, Central Asia has become a more important destination for FDI than West Asia, which received \$1.9 billion in 1997.

China's current FDI boom, now in its sixth consecutive year, is showing signs of coming to an end. The rate of increase of FDI inflows declined to 11 per cent in 1997 from an average of 147 per cent between 1992 and 1993. Furthermore, FDI approvals have fallen from \$111 billion in 1993 to \$52 billion in 1997. The expectation of a decline is based on several aspects of the national and regional economy: a slowdown in economic growth from its exceptional performance of the past few years; excess capacity in several industries due to over-investment or weaker demand conditions; wage increases in the coastal areas that are eroding its locational advantage in low-cost labour-intensive investments; poor infrastructure in the interior provinces that hinders investment in low-wage activities; currency depreciations in other economies that are eroding the price competitiveness of foreign affiliate exports; and adverse economic conditions in its biggest FDI source economies in Asia (Hong Kong, China, Japan, the Republic of Korea, Malaysia and Thailand), which constrict their outward flows to China. While these considerations suggest an impending decline in FDI flows to China, ongoing FDI liberalization, massive infrastructure building, foreign-investor participation in the restructuring of state-owned enterprises and a continued strong growth performance compared with other countries in the region could yet mitigate the expected drop.

FDI outflows from Asia and the Pacific increased by 9 per cent in 1997 to \$50.7 billion. The biggest investor is Hong Kong, China, with an outward stock of \$137.5 billion in 1997. China and Indonesia experienced large increases in outflows, with big projects in natural-resource-seeking investments, while firms from Singapore and Taiwan Province of China were actively involved in acquisitions of firms in crisis-afflicted countries. TNCs from the Republic of Korea, Malaysia

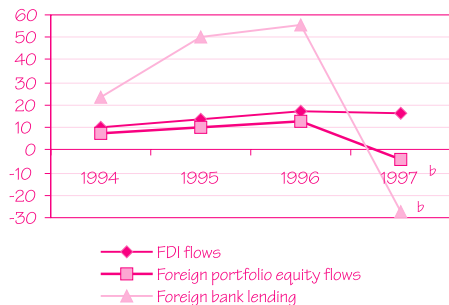
and Thailand had a much lower profile, as a number of their FDI expansion projects were scaled down or put on hold.

The FDI pattern emerging in Asia and the Pacific is characterized by a decline in intra-regional investment, as many of the region's TNCs grapple with mounting debts and other difficulties. On the other hand, European TNCs, having largely neglected Asia until recently, are now taking an active interest in the region. The region's FDI pattern is also characterized by an increasing share of FDI received by the services sector, partly because of liberalization but also in direct response to efforts by some host countries to become regional investment hubs. Finally, M&As are gaining in importance as a mode of investment in Asia and the Pacific, partly in response to corporate restructuring in the countries directly affected by the financial crisis.

The financial crisis in Asia and FDI

For Asia, and especially the five Asian countries — Indonesia, Malaysia, Philippines, Thailand and the Republic of Korea — stricken by the financial crisis in the second half of 1997, the most important question relating to foreign investment is how the crisis and its economic consequences will affect inward FDI in the short and medium term. FDI plays an important role in the region and could thus assist the countries in the process of their economic recovery. FDI flows to the region have been quite resilient in the face of the crisis, remaining positive and continuing to add to the capital stock of the affected countries while other capital flows, including bank lending and portfolio equity investment, fell sharply and even turned negative in 1997 as a whole (figure 5). This is not surprising given that FDI is

Figure 5. FDI flows, foreign portfolio equity flows and foreign bank lending to the Asian countries most affected by the financial crisis,^a 1994-1997
(Billions of dollars)



Source: *World Investment Report 1998: Trends and Determinants*, figure VII.7, p. 208.

^a Indonesia, Republic of Korea, Malaysia, Philippines and Thailand.

^b Estimates.

investment made with a long-term interest in production in host countries, in order to enhance the competitive positions of TNCs. Nevertheless, neither FDI flows nor the activities of foreign affiliates in the region, in particular in the five most affected countries, can remain impervious to the changes that the crisis has set in motion.

Effects on FDI entry and expansion

Indeed, the crisis and its aftermath have changed a number of factors that influence FDI and TNC operations in the affected countries, at least in the short and medium term. Some of the changes are actually conducive to increasing FDI flows to the affected countries. One is the decrease for foreign investors in the costs of acquiring assets whose prices have fallen. In addition, the availability of firms seeking capital and the liberalization of policy with respect to M&As makes the entry of foreign investors through the acquisition of assets easier than before. All this makes it easier for TNCs to enter or expand their operations at the present time, if they can afford to take a long-term view of the market prospects in the region or if they produce for export rather than domestic or regional markets. Firms interested in strategic positioning in Asia and the Pacific or seeking created assets to complement their worldwide portfolio of locational assets might find it attractive to establish or expand operations in these countries at the present time. There is evidence that firms from the United States, Western Europe and less affected economies in the region have taken the opportunity to invest in the crisis-affected countries, especially in Thailand and the Republic of Korea. The increasing importance of M&As as a mode of entry may, however, give rise to concerns over the loss of national control over enterprises; these need to be taken seriously, so as to avoid a backlash.

A second factor conducive to increasing FDI in the most affected Asian countries is the improvement in their international cost competitiveness due to devaluations. This is especially relevant for export-oriented FDI and there are already signs that investors are responding to the changes in the relative costs of production. FDI in export-oriented industries (such as electrical and electronics manufacturing) has risen in Thailand — as it had in Mexico after the Peso crisis — while production for export by foreign affiliates already well established in both Thailand and Malaysia seems to be increasing. TNCs in the affected Asian economies, which are already

highly export-oriented in certain industries, can take advantage of their corporate systems of integrated international production to strengthen their export orientation substantially, especially in the short and medium term.

The potential positive impact of both lower asset prices and decreased operational costs on inward FDI could be enhanced by the liberalization moves and promotional efforts that are being made by the affected countries. Governments in the countries most affected by the crisis, most of which already have fairly liberal frameworks for FDI, have further liberalized their FDI regimes, opening new areas and relaxing rules, including in the context of IMF adjustment programmes. They have also intensified their efforts to attract FDI both individually and collectively.

On the other hand, some consequences of the crisis will affect FDI adversely in the short and medium term. For firms focused on domestic or regional markets, reduced demand and slower growth can be expected to lead to some cancelling, scaling down or postponement of FDI in the most affected countries. However, the impact on domestically-oriented foreign affiliates varies among industries. Foreign affiliates in the services sector are particularly susceptible to local demand conditions, because of the non-tradability of most services. Affiliates producing goods and services that depend mainly on imported raw materials and intermediate inputs would be more seriously affected than those relying on domestic sources. The automotive industry, in which TNCs figure prominently in the region, is a good example of the impact of the crisis and the range of responses: a number of automotive TNCs have scaled down, postponed or even cancelled investment projects in some of these countries; firms have also adopted various other measures to cope with the crisis, including injecting funds to help their financially distressed affiliates and subcontractors, relocating parts production, boosting exports and increasing domestic sourcing.

Implication for FDI flows into other countries

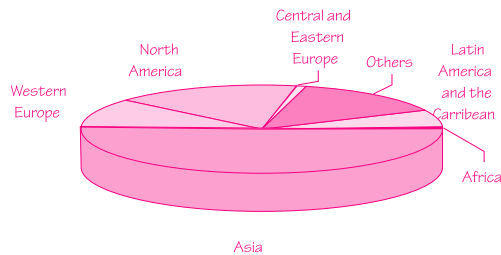
The implications of the financial crisis for inward FDI are also likely to extend to other, less seriously affected, developing countries in Asia. For one thing, some countries, especially those with close economic links to the countries most affected by the crisis, are likely to experience lower economic growth; some countries may also lose

export competitiveness vis-à-vis the countries that have devalued. These factors could reduce their attractiveness as host countries, at least in the short run.

Implications for outward FDI

Furthermore, and most importantly, many Asian developing countries, including China, Viet Nam and the least developed countries of the region, depend heavily on FDI from other developing Asian countries (figure 6) and inward FDI flows to them could decrease because of a decrease in outward FDI from the countries affected by the crisis. In 1997, overall outward FDI from developing Asian economies rose, but flows decreased from all the five crisis-affected countries except Indonesia. The crisis is likely to reduce the financial capacities of Asian TNCs (including TNCs from Japan) to undertake FDI on account of valuation losses, increased debt burdens on foreign-currency denominated loans, and reduced profit-ability of operations due to contraction of demand. The impact of these factors is further compounded for some TNCs by a credit crunch at home and difficulties in raising funds abroad.

Figure 6. Developing Asia's ^a outward FDI stock, by destination, 1995/1996^b



Source: *World Investment Report 1998: Trends and Determinants*, figure VII.11, p. 227.

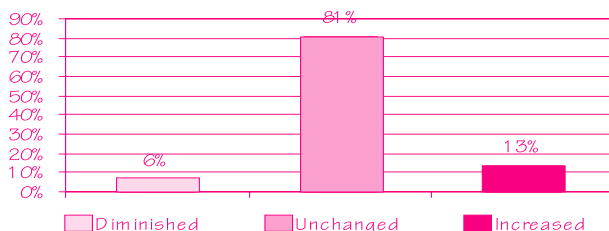
^a China, India, Malaysia, Republic of Korea, Taiwan Province of China, Thailand, Singapore. Data for Hong Kong, China were not available by destination; the greater proportion of its outward FDI is in China.

Overall implications

It is difficult to predict how the various factors set in motion by the crisis will affect, on balance, inward FDI to the crisis-stricken countries and to the region as a whole in the short and medium term. Despite their overall resilience, flows to the affected countries and to the region as a whole may well fall in 1998, but much depends on the extent to which the financial crisis spills over into the real sector. Aside from that, given that the FDI determinants proper — regulatory frameworks, business facilitation and, most importantly, economic

determinants of long-term growth — are attractive, and that the changes resulting from the crisis have positive as well as negative implications for FDI, there is room for cautious optimism. However, the extent to which these various factors translate into actual flows will depend on the assessment by TNCs of the long-term prospects of the region in the context of their own strategies for enhancing competitiveness. If their assessment is negative, TNCs will be reluctant to invest, especially as far as market-seeking FDI is concerned, and cautious in acquiring assets in the region. If they take a positive view and take advantage of the crisis to position themselves strategically in the region, FDI flows to Asia will continue on their upward trend without serious interruption. The rationale for the latter view is that the fundamental features of the region as a destination for FDI remain sound. These same features suggest not only that longer-term FDI prospects for the region remain positive, but that they may even improve as countries strengthen certain aspects of their economies in response to the crisis (figure 7).

Figure 7. Long-term prospects: overall response of companies worldwide



Source: *World Investment Report 1998: Trends and Determinants*, figure VII.24, p. 240.

Latin America and the Caribbean

The turnaround in FDI flows to Latin America and the Caribbean that occurred in the early 1990s was further strengthened in 1997: the region received \$56 billion (figure 4) — an increase of 28 per cent over 1996 — and invested a record \$9 billion abroad. The increase in inflows accounted for two-thirds of the overall increase in inflows to all developing countries. Apart from sustained economic growth and good macroeconomic performance, key factors

in the region's FDI boom were trade liberalization, wide-ranging privatization, deregulation and regionalization. With more than \$16 billion in inflows, Brazil emerged as the region's champion in 1997, surpassing Mexico with \$12 billion and Argentina with \$6 billion. Despite the growing role of Asian and intraregional FDI, the United States is still the largest investor in Latin America and the Caribbean, with its investment in the region reaching \$24 billion in 1997, mostly in automobiles, electronics, apparel and other manufacturing.

MERCOSUR has given a boost to both intraregional and extraregional FDI. Global competition and market expansion are prompting TNCs from Europe, the United States and Asia to invest in the growing MERCOSUR market, particularly in automobiles and chemicals. In contrast, most of the manufacturing FDI in Mexico and the Caribbean Basin has been efficiency-seeking, with the United States market being the final destination of exports. In the services and primary sectors, privatization programmes have provided opportunities for expansion for both market-seeking and resource-seeking TNCs. Government policy has also played a crucial role in generating the conditions under which the current FDI boom in Latin America and the Caribbean has occurred.

Latin America's strong FDI performance has been accompanied by changes in the nature of the investment it receives. First, there are some signs that TNC activities in Latin America have become more export-oriented, as witnessed by the sizeable contributions of TNCs to the region's exports and by increases in the export propensity of United States manufacturing affiliates. Structural reforms, macroeconomic stabilization and adequate macroeconomic management have also contributed to the export performance of foreign affiliates and domestic firms. Primary-sector FDI, still important in a number of countries, is almost exclusively geared to international markets. Services FDI, mostly geared to national markets, has given rise to some exports in certain tradable services and may have increased exports indirectly through services-related activities of manufacturing operations. The lion's share of export creation by foreign affiliates has taken place in manufacturing, in response to the trend towards integrating manufacturing affiliates into global production networks, which can be most clearly observed in Mexico and the Caribbean Basin.

The recent FDI boom in Latin America has also been accompanied by large and rising current-account deficits, reviving concerns over a negative balance-of-payments impact. The immediate effects of trade liberalization on the balance of payments may well be negative because FDI tends to generate higher imports not only of capital and intermediate goods, but also of final consumer goods, if TNCs begin by establishing sales affiliates and distribution networks. In the longer run, however, the strengthened export orientation of foreign affiliates should help to improve current account imbalances, especially as import growth normalizes once the adjustment of foreign investors to the new policy environment is completed, and if complementary policies to strengthen domestic capabilities and linkages are also pursued.

Africa

FDI flows to Africa have stabilized at a significantly higher level than at the beginning of the 1990s: an average of \$5.2 billion during 1994-1996 compared to an average of \$3.2 billion during 1991-1993. In 1997, inflows were \$4.7 billion, almost the same as in 1996 (figure 4). Judging by data for United States and Japanese affiliates in Africa, the continent remains a highly profitable investment location as companies receive rates of return on their investments that by far exceed those in other developing regions. In addition, almost three-fifths of FDI flows from the major home countries of TNCs in Africa — France, Germany, the United Kingdom and the United States — have gone into manufacturing and services since 1989, suggesting that the widely held assumption that Africa receives FDI only on the basis of natural resources is mistaken.

While Africa trails other developing regions in attracting FDI, a group of seven countries — Botswana, Equatorial Guinea, Ghana, Mozambique, Namibia, Tunisia and Uganda — stand out in terms of relative FDI inflows and their growth during 1992-1996, not only in comparison to other African countries but also to developing countries as a whole. While natural resources are an important determinant for FDI flows into most of these countries, they are by no means the only explanation for their relative success in attracting FDI. A number of other factors, including fast-growing national markets, access to large regional markets, significant privatization programmes and — in the case of Tunisia — conditions encouraging the location of export-oriented, efficiency-seeking FDI in the country also play a

role. What all these “frontrunner” countries have in common is significant progress in improving their regulatory FDI frameworks as well as significant progress in strengthening political and macroeconomic stability. Most of them have also stepped up efforts to create an FDI-friendly business climate, particularly through investment promotion activities.

Central and Eastern Europe

Central and Eastern European economies broke their stagnating FDI trend in 1997 — the first year the region as a whole registered a positive GDP growth rate in recent years — by receiving record FDI flows of \$19 billion, 44 per cent more than in 1996 (figure 4). This turnaround took place after a decline of 10 per cent in 1996. The Russian Federation was the leading recipient, mainly in natural resources and infrastructure development. In the other Central and Eastern European economies, most of the FDI growth occurred in manufacturing and services. The FDI pattern, however, remains uneven, reflecting the diverse experiences of countries in the transition to market-based economies, the strengthening of regulatory and institutional frameworks relevant for TNC operations, and privatization efforts. As for outflows, with the Russian Federation as the leading outward investor, outflows from Central and Eastern Europe more than tripled in 1997.

Despite this turnaround, Central and Eastern Europe’s share in world inward FDI stock is still low: 1.8 per cent in 1997 (see table 4). To a large extent, this is explained by the fact that the majority of the countries opened up to inward FDI fairly recently; their accumulated FDI stocks are therefore small. The small stock also reflects the influence of various obstacles such as problems in the legal and regulatory frameworks, a long transition-related recession and a lack of experience in FDI facilitation measures (table 7).

Host country determinants of foreign direct investment

To explain the differences in FDI performance among countries and to ascertain why firms invest where they do, it is necessary to understand how TNCs choose investment locations. In general, FDI takes place when firms combine their ownership-specific advantages with the location-specific advantages of host countries through internalization, i.e. through intra-firm rather than arm’s-length

transactions. Three broad factors determine where TNCs invest: the policies of host countries, the proactive measures countries adopt to promote and facilitate investment, and the characteristics of their economies (table 8). The relative importance of different location-specific FDI determinants depends on the motive and type of investment, the industry in question, and the size and strategy of the investor. Different motives, for example, can translate into different location patterns depending on the investor's strategy.

The national FDI policy

The core enabling framework for FDI consists of rules and regulations governing entry and operations of foreign investors, standards of treatment of foreign affiliates and the functioning of markets. Complementing core FDI policies are other policies that affect foreign investors' locational decisions directly or indirectly, by influencing the effectiveness of FDI policies. These include trade policy and privatization policy. Policies designed to influence the location of FDI constitute the "inner ring" of the policy framework. Policies that affect FDI but have not been designed for that purpose constitute the "outer ring" of the policy framework. The contents of both rings differ from country to country, as well as over time.

Core FDI policies are important because FDI will simply not take place where it is forbidden. However, changes in FDI policies have an asymmetric impact on the location of FDI: changes in the direction of greater openness may allow firms to establish themselves in a particular location, but they do not guarantee this. In contrast, changes in the direction of less openness, especially if radical (e.g. nationalizations), will pretty much ensure a reduction in FDI.

Since the mid-1980s, an overwhelming majority of countries have introduced measures to liberalize FDI frameworks, with positive effects on inward investment. Globalization and FDI liberalization have exerted mutually reinforcing pressures on each other and the momentum for neither has subsided. This has provided TNCs with an ever-increasing choice of locations and has made them more selective and demanding as regards other locational determinants. One outcome is a relative loss in effectiveness of FDI policies in the competition for investment: adequate core FDI policies are now simply taken for granted.

Table 7. Central and Eastern Europe: factors enhancing or constraining inward FDI, 1993-1997

(Number of responses)

Factor	Enhancing factor ^a	Constraining factor ^b
Economic factors		
Labour cost	13	-
Labour skills	12	1
Integration prospects	7	1
Market size	2	8
Market growth	2	3
Natural resources	1	5
Management skills	1	1
Physical infrastructure	1	4
Financial infrastructure	1	3
Access to Russian market	-	1
Niche industries	-	1
Policy factors		
Macro-economic stability	9	1
Currency convertibility	5	-
Favourable privatization strategies	4	3
Readiness of local firms	3	2
Economic reconstruction possibilities	3	3
Progress of privatization	2	2
BITs	1	2
Legal stability	-	5
Enterprise restructuring	-	3
Business facilitation		
Subjective proximity to investors	11	-
Information	3	5
Political environment	3	2
Country image	1	8
Financial incentives	1	8
Market incentives	1	3
Enterprise registration	1	4

Source: *World Investment Report 1998: Trends and Determinants*, table IX.10, p. 286.

^a Number of respondents who identified a particular item as an enhancing factor.

^b Number of respondents who identified a particular factor as an obstacle.

Note: the questionnaire asked the respondents to list the factors (not exceeding six in each case) that, in their view, had most enhanced, or represented the biggest obstacles to realizing their FDI potential.

Table 8. Host country determinants of FDI

Host country determinants	Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
<p>I. Policy framework for FDI</p> <ul style="list-style-type: none"> • economic, political and social stability rules regarding entry and operations • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M&A policies) • international agreements on FDI privatization policy • trade policy (tariffs and NTBs) and coherence of FDI and trade policies • tax policy <p>II. Economic determinants</p> <p>III. Business facilitation</p> <ul style="list-style-type: none"> • investment promotion (including image-building and investment-generating activities and investment-facilitation services) • investment incentives • hassle costs (related to corruption, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc.) • after-investment services 	<p>A. Market-seeking</p> <ul style="list-style-type: none"> • market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets 	
	<p>B. Resource/asset-seeking</p> <ul style="list-style-type: none"> • raw materials • low-cost unskilled labour • skilled labour • technological, innovative and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication) 	
	<p>C. Efficiency-seeking</p> <ul style="list-style-type: none"> • cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conducive to the establishment of regional corporate networks 	

Source: World Investment Report 1998: Trends and Determinants, table IV.1, p. 91.

Another outcome is that countries are increasingly paying more attention to the inner and outer rings of the policy framework for FDI. The key issue for inner-ring policies is policy coherence, especially the joint coherence of FDI and trade policies. This is particularly important for efficiency-seeking FDI as firms integrate their foreign affiliates into international corporate networks. At the same time, the boundary line between inner- and outer-ring policies becomes more difficult to draw as the requirements of international production make higher demands on the efficacy of the policy and organizational framework within which FDI policies are implemented. Thus, macroeconomic policies (which include monetary, fiscal and exchange-rate policies) as well as a variety of macro-organizational policies become increasingly relevant. As the core FDI policies become similar across countries as part of the global trend towards investment liberalization, the inner and outer rings of policies gain more influence. Foreign investors assess a country's investment climate not only in terms of FDI policies per se but also in terms of macroeconomic and macro-organizational policies.

Among the policy measures that can have a direct effect on FDI is membership in regional integration frameworks, as these can change a key economic determinant: market size and perhaps market growth. In fact, because of this effect, such membership can be regarded as an economic determinant in its own right. Regional integration frameworks may cover a wide spectrum of integration measures, ranging from tariff reduction among members to policy harmonization on many fronts. The inner rings for both inward and outward FDI tend to become similar; in the case of developed countries, this may happen even before regional integration becomes a fact. With developing countries, membership in a regional integration scheme usually requires at least some degree of FDI (or capital movement) policy harmonization.

A multilateral framework on investment (MFI) — if it were to be negotiated and if it were to lead to more similar FDI policy frameworks — would underscore the importance of the principal economic determinants and business facilitation measures in influencing location in a globalizing world economy. Even on the policy front, however, the precise impact of a possible MFI would depend on the form it takes, and particularly whether it would merely lock in the FDI liberalization process or further encourage it. Since an MFI is a hypothetical policy determinant, assessments of its

possible impact on the actual quantity, quality and geographical pattern of FDI flows must be tentative and could range from scenarios that see no or very little impact, to a negative or positive impact; it must, moreover, be understood that the implications of the various scenarios would vary from country to country in accordance with specific economic and developmental conditions and specific national stances vis-à-vis FDI. If a possible MFI should lock in unilateral liberalization measures, assure greater protection, transparency, stability and predictability, and create pressures for (or even lead to) further liberalization, it would enhance the FDI enabling policy framework and could lead to more investment — *if* the other FDI determinants were in place. However, it is also conceivable that if an MFI was of a “stand-still” type, it would not create a more liberal policy framework than the one that already exists, and hence, its impact on FDI determinants and flows would be difficult to detect, if there were to be one. Expectations about the impact of a possible MFI — if indeed it were to be negotiated — on FDI flows in comparison to the current regulatory framework and the direction in which it is developing, should therefore not be exaggerated. There are, of course, other issues that would need to be considered in connection with a possible MFI — especially the possible role of such an agreement in providing a framework for intergovernmental cooperation in the area of investment — but these fall outside the scope of the present analysis which is specifically focused on the determinants of FDI.

Business facilitation

It is in the context of a greater similarity of investment policies at all levels that business facilitation measures enter the picture. They include investment promotion, incentives, after-investment services, improvements in amenities and measures that reduce the “hassle costs” of doing business. While these measures are not new, they have proliferated as a means of competing for FDI as FDI policies converge towards greater openness. Furthermore, business facilitation measures have become more sophisticated, increasingly targeting individual investors, even though this involves high human capital and other costs. Among these measures, after-investment services can be singled out because of the importance of reinvested earnings in overall investment flows and because satisfied investors are the best advertisement of a country’s business climate. Financial or fiscal incentives are also used to attract investors even though they typically

only enter location-decision processes when other principal determinants are in place.

Economic determinants

Traditional determinants

Once an enabling FDI policy framework is in place, economic factors assert themselves as locational determinants. They fall into three clusters, corresponding to the principal motives for investing abroad: resource- or asset-seeking, market-seeking and efficiency-seeking.

In the past, it was relatively easy to distinguish the type of FDI corresponding to each of these motives. Historically, the availability of natural resources has been the most important FDI determinant for countries lacking the capital, skills, know-how and infrastructure required for their extraction and sale to the rest of the world. The importance of this determinant per se has not declined but the importance of the primary sector in world output has declined. In addition, large indigenous, often state-owned, enterprises have emerged in developing countries with the capital and skills to extract and trade natural resources. These changes mean that TNC participation in natural resource extraction is taking place more through non-equity arrangements and less through FDI, although the value of FDI in natural resources has far from declined.

National market size, in absolute terms or relative to the size and income of the population, has been another important traditional determinant, leading to market-seeking investment. Large markets can accommodate more firms and allow each of them to reap the benefits of scale and scope economies — one of the principal reasons why regional integration frameworks can lead to more FDI. High market growth rates stimulate investment by foreign as well as domestic investors. Much of the inward FDI of the 1960s and 1970s was drawn by large national markets for manufacturing products, which were sheltered from international competition by tariff barriers and quotas. Large national markets were also important for those services whose non-tradability made FDI the only mode of delivery to consumers. Such investment, however, was initially small because FDI frameworks for services were typically restrictive, excluding foreign investors in many fields such as banking, insurance and most

infrastructural services. Largely immobile low-cost labour was another traditional economic determinant of FDI location, particularly important for efficiency-seeking investment.

The impact of liberalization

The forces driving globalization are also changing the ways in which TNCs pursue their objectives for investing abroad. Technology and innovation have become critical to competitiveness. Openness to trade, FDI and technology flows, combined with deregulation and privatization, have improved firms' access to markets for goods and services and to immobile factors of production and have increased competitive pressures in previously protected home markets, forcing firms to seek new markets and resources overseas. At the same time, technological advances have enhanced the ability of firms to coordinate their expanded international production networks in their quest for increased competitiveness. More and more firms are therefore developing a portfolio of locational assets to complement their own competitive strengths when they engage in FDI, as witnessed by the growing number of firms that are becoming transnational.

All of these factors are changing the relative importance of different economic determinants of FDI location. The traditional determinants have not disappeared; rather, they are becoming relatively less important in FDI location decisions. The traditional motives for FDI have not disappeared either; they are being incorporated into different strategies pursued by firms in their transnationalization process. These have evolved from the traditional stand-alone strategies, based on largely autonomous foreign affiliates, to simple integration strategies, characterized by strong links between foreign affiliates and parent firms, especially for labour-intensive activities, as well as links between TNCs and unrelated firms via non-equity arrangements. Under simple integration strategies, unskilled labour becomes the principal locational determinant. Complementing it are other determinants, such as the reliability of the labour supply and adequate physical infrastructure for the export of final products. Costs feature prominently, but host country markets do not: it is access to international markets, privileged or otherwise, that matters.

Although this type of FDI is not new, it began to prosper under the conditions of globalization. Much of the investment in export

processing zones and labour-intensive industries has been in response to simple integration strategies, driven by cost-price competition and, more importantly, the removal of trade (and FDI) barriers in an increasing number of countries and technological advances that permit quick changes in product specifications in response to changes in demand. However, as labour costs declined in relation to total production costs and as FDI in response to simple integration strategies became more mobile, countries had to offer additional locational advantages over and above the availability of low-cost unskilled labour to attract FDI. Productivity and some level of skill, as well as good infrastructure facilities, gained in importance as locational determinants for this type of investment. Access to international markets also became more important. Losing such access could mean losing this type of investment. This contributed to the efforts of many developing countries seeking to gain permanent access to the markets of developed countries through trade agreements or regional integration arrangements. As services became more tradable, particularly in their labour-intensive intermediate production stages such as data entry, they too began to relocate abroad in response to simple integration strategies. The locational advantages sought by such service TNCs included computer literacy and a reliable telecommunication infrastructure. Again, this contributed to the upgrading of the locational advantages that countries could offer to TNCs pursuing simple integration strategies, in their efforts to attract the more sophisticated activities that TNCs were now locating abroad.

With more and more TNC intermediate products and functions becoming amenable to FDI, TNCs' strategies are evolving from simple to complex integration. Complex integration strategies can involve, where profitable, splitting up the production process into specific activities or functions and carrying out each of them in the most suitable, cost-competitive location. More than ever in the past, complex integration strategies allow TNCs that pursue them to maximize the competitiveness of their corporate systems as a whole on the international portfolio of their location assets. In the process, the dividing line between the three traditional motives of FDI is becoming increasingly blurred.

A new configuration of locational assets

To attract such competitiveness-enhancing FDI, it is no longer sufficient for host countries to possess a single locational determinant.

TNCs undertaking such FDI take for granted the presence of state-of-the-art FDI frameworks that provide them with the freedom to operate internationally, that are complemented by the relevant bilateral and international agreements, and that are further enhanced by a range of business facilitation measures. When it comes to the economic determinants, firms that undertake competitiveness-enhancing FDI seek not only cost reduction and bigger market shares, but also access to technology and innovative capacity. These resources, as distinct from natural resources, are people-made; they are “created assets”. Possessing such assets is critical for firms’ competitiveness in a globalizing economy. Consequently, countries that develop such assets become more attractive to TNCs. It is precisely the rise in the importance of created assets that is the single most important shift among the economic determinants of FDI location in a liberalizing and globalizing world economy. In addition, the new configuration also includes agglomeration economies arising from the clustering of economic activity, infrastructure facilities, access to regional markets and, finally, competitive pricing of relevant resources and facilities.

One implication for host countries wishing to attract TNCs undertaking competitiveness-enhancing FDI is that created assets can be developed by host countries and influenced by governments. The challenge is precisely to develop a well-calibrated and preferably unique combination of determinants of FDI location, and to seek to match those determinants with the strategies pursued by competitiveness-enhancing TNCs. It must be remembered too that created assets also enhance the competitiveness of *national* firms. Thus, policies aimed at strengthening innovation systems and encouraging the diffusion of technology are central because they underpin the ability to create assets. Also important are other policies that encourage the strengthening of created assets and the development of clusters based on them as well as policies that stimulate partnering and networking among domestic and foreign firms and allow national firms to upgrade themselves in the interest of national growth and development.

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All in all, the trend towards increased flows of FDI world-wide and the creation of a more hospitable environment for FDI continues. Even the Asian financial crisis does not seem, thus far, to have greatly

affected either FDI inflows to, or the further liberalization of FDI policies in developing countries. Liberalization has proceeded at the international level through the proliferation of bilateral treaties and the creation of new regional markets and investment areas. One of the peculiar consequences of recent developments in the FDI area is that, by becoming commonplace, liberal national policy frameworks have lost some of their traditional power to attract foreign investment. What is more likely to be critical in the years to come is the distinctive combination of locational advantages — including human resources, infrastructure, market access and the created assets of technology and innovative capacity — that a country or region can offer potential investors. ■

VIEW

Mergers and acquisitions as a means of restructuring and repositioning in the global market – business, macroeconomic and political aspects

Helmut O. Maucher*

Mergers and acquisitions (M&As) are an effective and comparatively gentle tool for reshaping an economic structure in response to fundamentally new conditions, such as restructuring the production apparatus or building broader networks for innovations. Global competition is not the primary reason for this process, but it has changed its scope and accelerated its pace. Indeed, there is still much to come in M&A-driven restructuring, particularly in Europe. Today's largest M&As are still far from matching the biggest merger in the United States at the beginning of this century, which represented, in today's figures, a market capitalization of \$600 billion.

M&As are not a threat – all sizes of firm can be managed successfully, though not always with the same structures, and often managers of a special caliber are required. Nor are M&As a one-way street to mega-monopolies. Success is not automatically generated; the timing of an M&A must be right and particular attention needs be paid to the actual integration process. Consolidation runs in waves triggered by external factors such as new technologies or markets). The process includes focusing, spin-offs and outsourcing as a part of the restructuring of firms; it is also followed by the creation of completely new industries and new competitors.

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Today, M&As are usually carried out in a bid to enhance the competitiveness of a company, not to stifle competition. The consumer is the main beneficiary. As with all types of restructuring, steps must be taken to soften the social impact of M&As. Competition policy is also necessary, but it must be based on the right assumptions, a global view, clear objectives and relevant criteria.

Introduction

Over recent years there has been a marked increase in the number and scale of mergers and acquisitions (M&As). This development has fueled growing concern among regulatory authorities and the population at large and at the same time has given rise to new questions relating to business strategy. In this article, I will be looking at the recent wave of M&As from these two perspectives. In doing so, I shall also take a look at the role of emerging markets. I hope that some of the facts and general arguments presented here will contribute to the political debate on M&As and stimulate dialogue with concerned employees and members of the public.

I wish to illustrate, in particular, that:

- If handled properly, M&As today can be an important, and often even indispensable, means of maintaining or increasing a company's competitiveness. They can aid the restructuring and grouping of core competencies beyond existing corporations and help to reposition companies in the value chain in the face of new global challenges. M&As today are inevitably on a much larger scale than those of 20 years ago, but their relative size has not increased given that economies and markets are globalizing.
- M&As, contrary to a widely held view, are a relatively gentle way of bringing the structures of an economy in line with fundamental changes in global markets and new technological challenges. Such an adjustment incorporates Joseph Schumpeter's creative destruction of obsolete ideas and

structures (Schumpeter, 1942) in order to create new combinations of productive capacities. Bankruptcy would be the usual and very costly way of destruction. M&As allow large parts of existing resources, including the employees of companies with their knowledge and expertise to be retained. These resources are regrouped and optimized in this restructuring phase.

- Contrary to often heard allegations, the vast majority of M&As today do not restrict competition, but enhance it, thereby promoting both the spirit of competition and competitive pressures. M&As are thus not one-way streets to mega-monopolies. New industries with new companies are constantly being created. Also, the structures created by M&As are exposed to the full brunt of competition, a force that even a considerable number of tie-ups cannot withstand. In addition, M&As are frequently accompanied by outsourcing and spin-offs, which likewise give rise to new companies.
- Management has a particular responsibility to bear, and must exercise considerable caution, since only M&As backed up by a sound strategy and implemented intelligently will strengthen the long-term competitiveness of a company. Special precautions need to be taken in the form of social safety nets and phased implementation programmes, in order to make the inevitable changes socially compatible. A particular, though sadly often neglected, responsibility of company executives, as well as politicians, is that of communication.

Before proceeding, let me add an unambiguous affirmation of the fundamental importance of competition in all its forms; without it, we as entrepreneurs would be sawing off the branch we are sitting on.

M&As as a means of restructuring production capacities

Global industrial change has accelerated sharply across a broad front over the past 20 years. There has been a whole series of developments, some of which are still ongoing. We are witnessing a fundamental shift in the role of knowledge and information flows

within companies and economic processes as a whole. We are making the transition from an industrial society to an information society. Each day we know more. New technologies and scientific discoveries in every field (from the personal computer to neurobiology), different management methods and new approaches to the organization of cooperation between all functions and levels of industrial activity (from manufacturing, to administration, to marketing and distribution) are becoming the new driving forces of industrial change.

It is not only the quantity and quality of relevant information that has increased, but it is also the speed with which information is disseminated. Open borders and powerful means of communication help information circulate more rapidly. Added to this is the fact that more and more people from all walks of life are receiving education and training, which means that there is a growing number of minds all over the world that can turn knowledge into products, services and, ultimately, profit.

All this gives rise to a third new phenomenon: globalization. Globalization today does not involve merely an increased level of cross-border trading or investment. It is more a case of a global network consolidation (beyond those that are merely technical, i.e. those including an increasing range of different contacts), with a reinforcement and expansion of competition. A wide variety of areas (such as capital costs, the hiring of highly qualified personnel worldwide and corporate image), which have hitherto not been affected at all, or only to a small extent, are today being increasingly exposed to global competition. Increasingly fierce competition is also having an impact on countries, their economic policies and their locational advantages. This adds a new dynamic dimension to a company's choice of where to locate its businesses, and it makes the decision-making process even more sophisticated and demanding.

This is merely a brief sketch of a considerably more complex process of change that began in the 1980s and will continue well into the next century. It is inevitable that these changes will radically alter not only our social and economic environment, but also our companies and structures. Changes make adjustments necessary, but they also open up countless new, unimaginable opportunities. Business leaders are not simply streamlining or reshaping existing firms in reaction to

changing conditions; they are also a driving force behind a constructive restructuring process and new build up geared to the future.

The wave of corporate M&As in recent years is, therefore, an answer to, as well as an engine of, this accelerated change. Companies have to look for new avenues to pursue their goals, including mergers and spin-off cycles. With mergers such as those between Union Bank of Switzerland and Swiss Bank Corporation, and Sandoz and Ciba, ultimately it is not the size of the new company that determines lasting success, but the new structure. In each case, it is a matter of increasing competitiveness in a new environment. In this connection, Gerhard Cromme, Chief Executive Officer of Krupp-Thyssen, has pointed out that in the future Europe's wage cost disadvantages compared to production in low-wage countries could be offset, in part at least, by the optimization of workflows and the deployment of capital.

In the case of the food industry, the aim of acquisitions is not simply to achieve a sort of cumulative growth. As the following sections and in particular the one on the practical experience of the Nestlé Group will show, M&As, always combined with outsourcing and spin-offs, have helped achieve a strategic reorientation of industrial structures and a rebundling of production capacities and competencies. As in other industries, it has been a case of finding the right response to new opportunities and challenges through new technologies – among them genetic engineering – and globalization, with increased competition and network consolidation. Added to this is the challenge from the opening up of closed markets, and the creation of regional markets. Other important factors are social change and the higher demands placed on product quality by consumers, along with evolving structures in the retail trade, the concentration of firms with traditional outlets, and also new forms of distribution (the Internet, shops at petrol stations, etc.). The impact of information technology has been considerable on distribution in terms of supply chain management, but it has certainly not been limited to that area.

The industries of developing countries are also increasingly becoming a part of the process of global restructuring through M&As. Thanks to the advantages offered by their location, these countries emerge mainly as the winners in the reallocation after a local company

is taken over by a foreign group. This has also turned out to be one of the most efficient ways of integrating local industrial structures into the global market. Instead of resisting such takeovers, therefore, developing countries would probably be better off resisting the extraterritorial application of other countries' competition rules.

Mergers are also a way of reducing of surplus capacity and structures in order to create space for new companies from emerging countries or in new sectors of industry. In mature industries, such as the automobile industry, productivity gains have meant that an ever-decreasing number of companies is required to satisfy the global market. At one time, the talk was of a long-term perspective of 10 global suppliers, and in fact the number of auto companies in the traditional industrialized countries has been falling for some time now. At the same time, new competitors from developing economies have been emerging. In future, we will have to get used to the idea that we no longer have 15 auto manufacturers in Europe. Instead of sitting back and waiting for some of these firms to go bankrupt, however, existing assets, resources and activities could be grouped together through M&As and restructured, so that they could continue to be utilized for as long as possible. To take another example: before the crisis in Asia, between 150 and 200 foreign banks had subsidiaries in Singapore. With the growing complexity of international financial markets and the high level of investment required each year for global, state-of-the-art information networks, it appears unlikely that such a high number of financial organizations with global ambition will be sustainable over the long term.

One last point needs to be made in this brief discussion of M&As as a means of restructuring the global production of goods and services: countries that are too slow or tentative in taking advantage of the opportunities brought by the regrouping of productive capacities via M&As, outsourcing and spin-offs are likely to run into problems. Japan might be seen as a case in point. The Japanese economy is extraordinarily efficient in advancing the industrial processes within its existing corporate groups, but any restructuring above and beyond companies through M&As is being hampered solely by a number of rigidities. This may be one reason behind the persistent economic woes dogging this country.

M&As as an answer to far-reaching changes in the corporate environment: a brief look at the past

Up to this point I have outlined the basic technological, economic and economic policy changes that triggered the wave of M&As in the transition to the twenty-first century. A look back shows that for remarkably similar reasons a similar wave of large-scale M&As took place almost exactly 100 years ago.

It pays to examine the past, as it helps put today's events into perspective and it may give an insight into possible scenarios for the future. That past wave of merger activity was followed by a counter movement spanning several decades which was accompanied by a substantial drop in the degree of consolidation – the result of the creation of companies in new industries and competitive forces that eliminated the less successful M&As (see the next section).

The wave of M&As in the United States from 1898 to 1902 followed on the heels of dramatic changes in technology, telecommunications, transport and business organizations to name but a few. It was around this time that the Bessemer process revolutionized the steel industry; in 1881, Thomas Edison installed the first electric lighting system in New York; and George Westinghouse solved the problem of transmitting electricity over long distances in the 1890s, using alternating currents. Electricity replaced steam as the most important energy source as early as the year 1900. The most important change in business organization was the introduction of scientific management by Frederick Taylor, the founder of time-and-motion studies in the 1880s. A modern retail-trade structure started to develop and wholesale trading was pushed into the background. The first brands – many of them still well known today – were created. There were new developments in communications and transport: the telephone was launched, and between 1865 and 1900 the United States rail network grew from 35,000 miles to 242,000 miles of track. By 1897, there were five transcontinental railway lines. Vast improvements in communications meant that the flow of goods was easier to control. There was a substantial reduction in warehousing requirements at all levels and, as a result, in the amount of capital tied up in warehousing (most of these data are from Scott, 1998). The wave of M&As itself came at a

time of an upswing in the economy following a recessionary phase in the 1890s. The parallels with the last third of our own century are undeniable. The only major difference is that, today, changes are happening worldwide.

The scale of M&As between 1898 and 1902 remains unparalleled. The movement peaked with the creation of US Steel, a merger on the scale of a market capitalization amounting to 7 per cent of gross national product (GNP) at that time (Smith and Sylla, 1993). In today's figures, this would be around \$600 billion, that is, far larger than any buyout or merger today. At the end of this historical phase of large-scale mergers, in 1904, 33 per cent of GNP generated by the manufacturing sector of the United States was produced in industries in which the four biggest companies controlled more than 50 per cent of sales (Nutter and Adler Einhorn, 1969).

Selection in the market process and new industries

M&As are not one-way streets leading to mega-monopolies. A turning point was reached in 1904, when a phase of significant fragmentation in company structures caused by, among other factors, a new phase of technological and industrial developments, gave rise to many new companies, divisions, spin-offs and so on. Research carried out among 19 manufacturing industries (Stigler, 1950) shows that, in the period 1904-1937, 14 of these industries witnessed a sharp drop in the level of concentration. Only in the automobile industry did the level increase. In 1935, the proportion of heavily concentrated industries – where “heavily concentrated” means more than 50 per cent of sales being generated by the four biggest companies – amounted to a mere 20 per cent.

The factors behind this counter movement, which was initiated and then successfully steered by markets, are still relevant today. One factor was the constant creation of new industries and the rise of new companies. Since the demise of the medieval guild-based economy with its 15-20 clearly defined and restrictively regulated sectors, the number of industries, first in the manufacturing and then in the services sector, has witnessed a constant increase. And new industries create new companies. With the constant changes in the economy, the list of the 10 biggest companies in the United States at the end of

the First World War painted a very different picture from that in 1890 (table 1).

In order to illustrate this constant change, it is also worth listing those companies that ceased to qualify for the list of the 10 biggest companies, for the top 100 or even for the top 1,000. Among them were American Cotton Oil, Sugar Refineries and Cattle Feeders Trust, all from the first level of transformation of agricultural products, as well as coal companies and the National Lead Trust, which were producing key raw materials of that period.

Table 1. The 10 biggest companies in the United States in 1889 and 1919 (by sales) and 1998 (by market capitalization and sales)

1889	1919	1998 (Market capitalization)	1998 (Sales)
Standard Oil (NJ)	US Steel	General Electric	General Motors
Philadelphia & Reading Coal & Iron	Standard Oil (NJ)	Microsoft	Ford
Sugar Refineries	Armour & Co.	Coca-Cola	Exxon
Pullman Co.	Swift & Co.	Exxon	Wal-Mart Stores
American Cotton Oil	General Motors	Merck	General Electric
Lehigh & Wilkes-Barre Coal	Bethlehem Steel	Pfizer	IBM
Illinois Steel	Ford Motor	Wal-Mart Stores	Chrysler
Distillers & Cattle Feeders Trust	US Rubber	Intel	Mobil
Lehigh Coal & Navigation	Standard Oil (NY)	Procter & Gamble	Philip Morris
National Lead Trust	Midvale Steel and Ordnance	IBM	AT&T

Sources: Bunting, 1986; *Business Week*, 1998.

The industrial changes that gave rise to more and more new companies continued. Shifts within the ranks of the biggest companies have been at least as far-reaching since 1919 as those before. Note that companies for 1998 are listed on the basis of both market capitalization and sales: given structural changes such as outsourcing, comparing sales figures does not produce such a useful comparison as it did in the past. Large groups in the first half of this century, such as integrated steel manufacturers, have been replaced on the list by IBM, Microsoft, Intel and some pharmaceutical companies. Many of the products of the new giants – personal computers, chips, software, franchising – did not even exist as concepts before the Second World War, let alone as products.

Market processes also come to bear in another form. Not all M&As in the 1890s brought about success, as they were meant to, over the long term. Of 156 M&As at that time that were on a scale capable of impacting market structures, almost a third failed within the first 10 years, and, for many, financial results were unsatisfactory (Livermore, 1935). Compare this with the present situation: “Consultants at A.T. Kearney looked at 115 mergers ... between 1993 and 1996, all over the globe, and found that 58% did not add value” (*The Wall Street Journal Europe*, 6 October 1998).

In some cases, one of the reasons for the lack of success was mismanagement. Given that competition has become fiercer still over recent decades – independently of regulatory intervention – the price to be paid for such mismanagement is a high one. Research carried out recently shows that at present a company’s average expected lifespan – based on the top 500 companies worldwide in terms of sales – is only around 40 to 50 years (De Geus, 1998). The author of this research also pointed out that the “natural” lifespan of a well-managed group amounts to three centuries and more.

M&As as a strategic instrument for enhancing competitiveness: prerequisites for success and examples from the Nestlé Group

In this section I take a closer look at the strategies and experiences of the Nestlé Group as regards M&As, and highlight certain practical processes, considerations and basic prerequisites for a successful takeover strategy (Maucher, 1990).

In 1984, the Nestlé Group embarked on one of its most important series of worldwide acquisitions. This section will deal with this series of acquisitions, which has become the basis for today’s focus on organic growth. Nestlé’s acquisition strategy was based on the following three goals:

- (1) Acquisitions provided *access to new business lines and innovations, and strengthened positions in key product groups*. These acquisitions were mainly horizontal in form, and always in Nestlé’s own industry. It was in this perspective that Nestlé acquired, *inter alia*, Buitoni (pasta and other Italian specialty

foods). It was clear at that time that future generations all over the world would not be able to feed themselves on 70 kilograms of meat per capita per year, and that a significant part of their diets (such as pasta) was going to have to come directly from plants. When Nestlé acquired Perrier, it acquired not only a world-renowned spring, but also a whole range of other well-established mineral waters, among them Contrex, as well as a strong franchise in the United States with local springs. Here, too, Nestlé was focusing on long-term strategic goals, in this case to supply high-quality water with a level of safety backed up by a global group. Added to this was the fact that calorie-conscious consumers were moving away from soft drinks in industrialized countries. This was the bedrock of Nestlé's strategy for water. The acquisition of Perrier made the Nestlé Group the leader in the mineral water business. Nestlé has since then reinforced its position and intends to expand it further, for example, by selling water under the Nestlé brand. Holding the premier position in a specific market has become more important today, as the top one or two brands in a product group have a better chance of generating sales, or putting innovations on the shelves, particularly in light of the increasing concentration in retail trade. The decision to strengthen product positions within either the Nestlé Group as a whole, or within certain countries or certain regions, was based on the same objective. This is why Perugina (Italy) was taken over, a firm producing specialty chocolates and confectionery. Other acquisitions with this objective in mind include: Baby Ruth and Butterfinger in the United States; Chambourcy and Hirz for dairy products); and Alpo and Dalgety in ice-cream and pet foods (the pet food business of Carnation was Nestlé's first venture into the sector).

- (2) A further aim was to *strengthen Nestlé's general market presence in important regions and countries with a good long-term potential*. The acquisition of the United States food manufacturer Carnation came at the beginning of Nestlé's series of takeovers in 1984. Carnation had various products ranging from milk to pet foods. At the time, the transaction was at least as spectacular as some of the "mega deals" of today. It made the Nestlé Group a serious contender in the United States, an

excellent platform from which to build over the long term. The Carnation acquisition was followed by takeovers in southern Europe, a region where Nestlé's position had always been weak. There were acquisitions in Italy, Portugal and Greece, partly with a view to the European Single Market, which was starting to take shape at that time, and partly because that region was expected to post above-average growth compared to the rest of Europe, a supposition which was later borne out. The Nestlé Group also used acquisitions to venture into new countries, particularly in Central and Eastern Europe, but also in Egypt, Pakistan, Viet Nam and some parts of China. Recently, Nestlé has been targeting acquisitions to reinforce existing positions in Latin America and Asia, a region which in Nestlé's view has good development potential over the long term.

- (3) In some cases, the aim was to *shorten the time-frame* necessary to secure a leading position in an important market segment and, in doing so, keeping the business risk within manageable limits. For example, Rowntree – a company with its head office in York in the United Kingdom, acquired by the Nestlé Group in 1988 – brought modern product concepts in chocolate and other confectionery, in particular Anglo-Saxon “fun” products, such as KitKat. It would have taken years to build this position without these acquisitions, and it would have been a quite high-risk undertaking in a market that is rapidly changing. With the same goal in mind, that is, to shorten the time needed to build a strong market position, a joint venture for breakfast cereals with General Mills was set up. Tie-ups of this type are in fashion today. As with other “fads”, Nestlé takes a cautious approach. Wherever possible, Nestlé wants to achieve business targets under its own steam. In special situations, however, such as in breakfast cereals, Nestlé does not rule out joint ventures with other companies that have a corporate culture similar to its own.

The Nestlé Group has a rich experience of M&As stretching back to the merger between Nestlé and Anglo-Swiss Condensed Milk in 1905, a merger which took place in the aforementioned phase of comprehensive industrial restructuring worldwide at the turn of the century. Other important mergers followed during the subsequent

decades, the last of them in the wave starting in 1984. From the experiences of the Nestlé Group with M&As on varying scales, one can derive some general prerequisites for success. A few of these are discussed below.

The lasting success of M&As depends to a large extent on how the company is managed; in particular M&A policies need to be geared to clear business goals. Size and growth must never be an end in themselves, or a matter of prestige: the only M&As to take place should be those that take the company forward. Even though Nestlé has an enviable position when it comes to organic growth, innovation and marketing, in each individual situation it is always worth using M&As to underpin the building up of positions, or the preservation or enhancement of competitiveness over the long term. The M&As made by the Nestlé Group are also a reaction to fiercer competition, but the intention is to make the Group more competitive and not to defuse competitive pressures in any way. M&As implemented intelligently and with a clear strategic perspective are an important instrument for a company's general growth and development policy.

Clarity does not mean a one-dimensional way of thinking. This is also illustrated by the three goals of the Nestlé Group's acquisitions set out above. Even with a multi-dimensional approach to thinking and processes, however, the main points of emphasis surrounding core competencies must remain visible. The fashion for many companies during the 1960s was broad-based diversification and the setting up of conglomerates. Nestlé was never a follower of this fashion; I myself was never much impressed by it, and today it has only proven successful in very few cases, such as when an exceptional management personality is involved, as illustrated presently by General Electric (United States). Research shows that it was only the lingering inefficiency of the financial markets in the 1960s, for example, in terms of cost of capital, the possibility of raising outside funds rapidly for large projects and hedging by means of modern instruments readily available today, that allowed conglomerates to function over any length of time. In other words, the reason was that internal financing beyond industry boundaries temporarily papered over the cracks in financial intermediation (Hubbard and Palia, 1998). It is not surprising that with the massive improvement in the efficiency of financial markets, such a situation would not last today.

A further prerequisite for success is securing the right price for an acquisition in relation to the company's overall valuation. When a company is being valued, less attention should be paid generally to straight figures than to strategic factors, such as brands, the value of distribution organizations and potential synergies (e.g., "can we successfully market complementary products via the same distribution channels?"). The cheapest acquisitions on paper often turn out to be the most expensive at the end of the day. On the whole, naturally, long-term return must be good either for the group (via the strategic value of the acquisition or synergies), and/or for the newly acquired business itself. One of the minimum initial criteria is first-year profits, which should at least be sufficient to cover the interest on the additional loans required.

Another important factor is accurate risk assessment. In a market economy, forecasts are often wrong in the long run (due to a change in the competitive environment or consumers' sentiments). Other risks have to be factored in, namely, the different corporate cultures and quality of management of the companies acquired. (Nestlé experienced two extremes: from the very good – Carnation – to the very dubious – Perrier.)

How successfully a company can control these risks and implement an acquisition is often a result of the action and decisions taken after the acquisition itself. A report by A. T. Kearney on acquisitions in the years between 1993 and 1996 confirms this: "Most of the top executives interviewed said that in hindsight they wished they had paid more attention to the mechanics of merging the companies and less to finding the target and negotiating terms" (*The Wall Street Journal Europe*, 6 October 1998). Nestlé pays particular attention to the issues of motivation and equal opportunities for executives from the acquired company, as well as to ensuring that promises are kept and that the integration as a whole takes place quickly, a psychologically important factor. Many executives from companies taken over by Nestlé have been given important functions in the Group.

A crucial factor is the combination of the right timing based on a clear corporate vision. It is vital that restructuring, particularly acquisition-related restructuring, be carried out in good time. The

steps Nestlé has taken since 1984 were initiated with a view to the major changes ahead in global markets: the continued concentration and partial internationalization of retail trade; new social structures and thus consumer requirements; differentiation of demand in globalization; increased purchasing power in new geographical regions; new opportunities for cross-border cooperation via the opening up of markets and new technologies; and intensifying competition. What was predicted, or often just guessed, has since then become reality. Costs and acquisition prices are generally lower with a forward-looking strategy, and there is more time for preparation for the overall integration. In the initial stages of the takeover of Carnation, for instance, Nestlé decided not to merge the existing and acquired organizations right away, concentrating instead on optimizing the individual businesses in a step-by-step development of collaboration in the various divisions. Only several years later, Nestlé implemented a single management structure with a holding company and a uniform organizational structure, in order to make full use of all synergies, both internally and as regards clients, and to establish firmly the image of Nestlé as the corporate identity. The example of Carnation also shows that the dividing line between an acquisition and a merger is often very thin; legal issues are only *one* aspect. Although it was clear that Nestlé was taking over Carnation, elements of a merger were incorporated, because as much as possible of the knowledge and expertise of Carnation (and of other companies acquired) was supposed to be merged with those of the Nestlé Group.

A further prerequisite for success is accompanying the acquisition with a series of concomitant measures. This includes divestment of peripheral activities in order to concentrate on the core capabilities and strengths of the group, or selling loss-making businesses where losses cannot be rectified even over the long term. In Nestlé's case, divestments from this first category – some of them quite sizeable – included Eurest, Libby's preserves, hotel chains, the manufacturing of packaging materials and various other activities that were not in line, or had ceased to be in line with Nestlé's business strategy. Nestlé does not want to be tackling several fronts at the same time. Other aspects of this policy are lean production, flat organizations, streamlined product ranges and rigorous reductions in fixed costs and overheads. Nestlé outsources and then mobilizes suppliers "marketing reverse" in a focused partnership. Outsourcing

also helps transform costs from fixed to variable, and ensures that services are provided in a manner that is in line with the market as much as possible.

Alleviating the social impact of mergers and balanced communication

M&As and restructuring measures affect people – many have to get used to different structures at their place of work, many have to relocate to a new town, some take early retirement and often people are laid off. Even if it all serves to secure jobs over the long term, the fate of individuals must be kept in mind. It is in the clear interests of the company to ensure an effective programme of social measures geared at softening the impact of restructuring measures. In my view, such a programme is a basic prerequisite for the success of an M&A policy over the long term. I see investing in such a programme as an investment in credibility, motivation and image, all of which are just as important as the money spent on marketing or research. Nestlé's long-term success is based on trust. Consequently, if this trust is not to be lost, Nestlé has to provide sufficient help for the workforce to either adjust to the new situation at the workplace, or find a new employer. This has always been a pillar of Nestlé's approach.

One of the problems today is the often one-sided and at times one-dimensional point of view put across by company executives when M&As are announced. Communication on mergers should be seen as part of the steadily increasing demands made on communication and transparency, especially where big companies are concerned. One of the issues is that of the short term versus the long term. Announcements of mergers often attach too much importance to a positive reaction in the stock markets over the short term. I can think of a few official press releases that linked additional profits running into the billions directly with a reduction of the headcount after M&As. Probably, it would have been better to present such mergers as an important strategic step for the company that will secure the most jobs over the long term and enhance earnings at the same time. One could also mention outsourcing, because in reality, many short-term job cuts are jobs simply shifted to smaller companies. Big M&As are not only carried out in the interests of shareholders; communication must be balanced and geared to all groups involved.

What might be said, for instance, is that although a merger is painful, it is necessary for survival in the long term, that part of the increase in earnings will be used to help cushion the social implications of an M&A and for investment in the further development of the firm (the payout ratio in Swiss and other European firms is typically very low).

As mentioned previously, the goal of an M&A must be optimization over the long term and not the short term. Ultimately, what also counts on the financial markets is not a “flash in the pan”, but the long-term consequences of a decision.

General criticisms regarding the size of companies – new opportunities for SMEs

M&As prompt a reaction in the form of a wave of general criticism based mainly on a few spectacular cases, and unfortunately often without any understanding of the real reasons behind the changes or trends in global markets. Speaking as one of the first companies to use, from the mid-1980s onward, acquisitions on a large scale as a strategic means of strengthening the organization, and as the biggest company in the food industry worldwide, Nestlé was and still is confronted frequently with critical questions relating to its size. Various questions are asked, such as: are sales of around 50 billion Swiss francs, SwF100 billion or even as much as SwF200 billion manageable, or will efficiency inevitably suffer as a result?

Over the past few years, criticisms have become broader-based and more obfuscated, and are levelled at the supposedly excessive market clout of merging companies (a deduction based entirely on sales figures and percentages), alleged abuse of market muscle and at the suspected reasons behind and impact of mergers. In some cases, the criticism directed at the companies is that they suffer from megalomania (the “big is beautiful” syndrome); it verges on a return to the Marxist caricature of companies believed by some to be above the law and social order (the “metanationals”). What is happening here is that the alleged economic might of companies is being confused with political might. Many see M&As solely as the addition of sales and factories and so on, and the end product thereof as sum totals, without taking the aspects of momentum and relevant reference criteria into account.

Being big is not in itself dangerous to a market economy or to society. The bigger and more successful a company is, however, the bigger the threat that it will develop a complacent attitude and the bigger the threat that a situation will arise where questions cease to be asked. Like other companies, Nestlé is confronted today with competition that is fiercer than ever before. Mistakes, arrogance or reacting too slowly are rapidly and mercilessly punished by the markets. Competition has become global, which does not only mean that company size is being measured against a larger market; it also increases the number of competitors. And in addition, many relationships and flows previously internalized are increasingly exposed to competitive pressures, which in turn promotes outsourcing.

Being big is not a weakness, but nor is it a panacea for all problems. Being big becomes a danger, including for a company, when monopolistic situations are created. I will discuss this in more detail in the section on competition policy. In certain cases, size can lead to problems if it cannot be handled properly internally. With the right structures and the right personalities in management positions (management mentality and structure, organizational structure, an appropriate form of decentralization), a company can cope with any size. Today, additional help is available from new technologies, particularly information technology. Further proof that it is not size in itself but the structure involved that plays the most decisive role can be found in the research on downsizing carried out by Bain management consultants. That research shows that only 30 per cent of all downsizing programmes carried out in the 1990s actually led to increases in productivity (Gadiesh, 1998). It also shows once again that “how” things are done is more important than the question of “how big – or, for that matter, how small – are we?”

When the issue of size is being discussed, one aspect often brought into the discussion is the promotion of small and medium-sized enterprises (SMEs). Such discussions at times become somewhat one-sided. An efficient economy needs a mixture of large and small companies, each with their own particular strengths. This is an important aspect for the future of an economy. There are functions that can only be performed efficiently by very big companies. At the same time, there are activities and factors that make smaller firms more competitive and open up a large number of new opportunities

for them. First, big companies are resorting increasingly to outsourcing and, as a result, are creating new opportunities for other firms. It is not only simple activities such as cleaning services that are outsourced. Today, the leading chemical and pharmaceutical firms in Basel outsourced a third of their research budgets in order to expand their horizons and cover efficiently specialized areas in research and development (R&D). Another striking example of outsourcing is provided by Coca Cola: most of the independent local bottlers who prepare the soft drink use concentrates, and then bottle and supply the drink. Second, increasing differentiation in consumption patterns is opening up new niche opportunities. Third, we are moving more in the direction of a service-based economy, a natural terrain for SMEs. Fourth, globalization, open borders and new technologies (such as the personal computer and the Internet) are chipping away at the bureaucratic and organizational barriers that have kept SMEs out of certain markets. In summary, with industrial change, the market itself is continually ensuring a balance between large and small companies.

National and global competition policies

Efficient competition needs rules. A well-constructed competition policy is necessary; like it or not, it must combat all elements that pose a genuine threat to competition over the long term. This does not mean, however, that the types of rules used and the way in which they are applied should not be discussed by those concerned.

International companies are confronted with the following issues.

- Allocative efficiency – through competitive intensity and market access – has never been the sole goal of competition policy. Competition policy has to have coherent and transparent goals, particularly when the level of internationalization is increasing. However, the more vociferous the debate about M&As becomes in public, the more diverse and contradictory the things expected of competition policy become. “First, as to goals, certain antitrust rules are clearly not based on allocative efficiency” (Fox and Pitofsky, 1997, p. 237). According to the same authors, the situation today is not much

different from the one in the past: “The 1914 merger law ... was supposed ... to protect the opportunities of small business... The events of World War II gave rise to the next important amendment of the antitrust laws. Americans observed how the concentration of industries in Germany had played into the hands of fascism. This led, in 1950, to a further strengthening of the merger law... aimed to preserve a society of small, independent, decentralized businesses in order to keep economic power dispersed and thereby keep political power diffused” (Fox and Pitofsky, 1997, p. 237). Christian Watrin (Hasse, Molsberger and Watrin, 1994) notes that the “taming of capitalism” is also a declared goal of some advocates of tighter competition policy. Another current issue is the potential abuse of anti-dumping procedures in trade policy to keep out successful competitors from emerging markets. There is an urgent need to reflect again on the main goals of competition policy – competitive intensity and market access (the key words here are “contestable markets”) – if there is to be efficiency, prosperity and substantial advantage for consumers.

- Competition policy can only achieve its goals when the right assumptions are in place. “US antitrust jurisprudence of the 1990s shows no signs of adopting into law an assumption that markets work well and virtually always pressure firms to operate efficiently – or the motto that one should trust markets, not governments” (Fox and Pitofsky, 1997, p. 237). In some cases today, certain mindsets are more important than reality; for instance, as regards the understanding of corporate goals. The initial assumption is still that mergers take place in order to restrict competition, when the general aim is rather to use merger restructuring to increase competitiveness. This normally increases competitive pressures in the overall markets. One of the more specific questions here is the one of oligopoly/duopoly: the often-mooted theory that oligopolies and duopolies almost inexorably lead to restrictive practices and the like is not borne out by reality. These assertions are based on models of a static economy without technical innovation, changing consumer preferences and so on, and therefore lead to the wrong conclusions. According to empirical evidence and Nestlé’s own experience, oligopolistic companies compete much more

fiercely than organizations operating in the atomistic competitive environment so preferred by competition theorists; competition is fiercer still in a duopolistic situation (see, for example, Pepsi and Coca Cola). In conclusion, the analysis of a merger case and competition policy should be based on the general assumption that “markets work well, that business acts efficiently, and that government intervention [may be] clumsy” (Fox and Pitofsky, 1997, p. 237).

- Efficient competition policy needs effective and transparent criteria. According to research, however, it can be difficult to find dependable tools for assessing M&As and their dynamics. “Predicting a merger’s competitive effects can be quite speculative” (Rosenthal and Blumenthal, 1993). In the absence of reliable criteria, the discussion often remains hung up on issues such as the critical market share (25 per cent, or more, or less?) and on whether or not to use more sophisticated indicators, such as the Herfindahl/Hirschmann indicator. Distinctions have to be made from the outset. Effective competition is not about percentages; it is much more a case of whether you can gain access to a market in spite of a well-established competitor, supplier or buyer. The concept of contestability is often proposed here; it not only deals with the issue of entry barriers but also covers exit barriers, that is, it also includes the freedom to leave the country, to sell a company or to stop production and supplies. A further issue is how to define the relevant market; once it was a village; today, it is the global market in many instances (bear in mind the case of Perrier, where the European Union antitrust authorities investigated the French market first and foremost). As the largest company in the food sector, Nestlé holds a share of between 1.5 per cent and 2 per cent of the global food industry. (The exact figure varies depending on the criteria involved, and is naturally much higher for some individual companies and product sub-groups, such as instant coffee.)
- One should also mention the risks when the legal experts who work for the regulatory authorities get involved in the micro-management of firms. This, too, was an issue with which Nestlé was confronted during the acquisition of Perrier. In the process,

whole divisions were hived off, and conditionality was imposed on how certain contracts and parts thereof should be formulated.

- A further point I wish to make is that the regulatory authorities should be setting priorities more in line with actual problems. Competition policy should, for instance, come to grips with the consequences of the concentration and vertical integration of the retail trade. When authorities are assessing the competitive position of manufacturers, more attention should be paid to retailers' own-label brands as privileged competitors. Another, even more important example is the countless market barriers and other restrictive practices that have State support (despite the fact that State monopolies are being dismantled in several places). Restraints on competition in the grey zone between company and State include direct and indirect aid given to prestigious or "strategic" companies; the aggressive export promotion of a few large industrial economies that use militaristic vocabulary and virtually all means available (see for instance the description of United States practices in Garten, 1995; the usual excuse is that others, such as the French, are doing it as well, and the main losers are smaller emerging economies with less political clout); special relationships in State procurement; and the promotion of research or social labels backed up by government subsidies. In my experience, those and many other types of impediments in this grey zone still account for the lion's share of market barriers worldwide. In the grey zone, one can also find certain types of discrimination, in the form of political and so-called "strategic" factors, in actual competition policies. In some cases, competition authorities are called upon to help inefficient companies, or companies that have let investment opportunities pass them by, either because their policy was too focused on the short term or because they lacked the courage to take the risk (see, for example, the demands of United States companies in Latin America). Drucker (1998) summed this situation up as follows: "I am not afraid of monopoly. In 1906, a German economist named Liebman published a book that is still the book on cartels, in which he showed that every monopoly in history, unless it was a government monopoly, never lasted more than ten or fifteen years". Most regulatory authorities do not

feel responsible for what goes on in the grey zone between company and State, the sole exception being the European Union.

- With outsourcing, a necessary complement to M&A policies, companies build up more focused relationships with suppliers and clients (an efficient flow of information, increasingly required by a modern economy, plays an important role here). In this connection, for example, the United States attacks against the measures put in place by the Japanese auto industry is a critical development for a growing number of industries.
- A typical problem for international firms and M&As is the proliferation of national and regional competition bodies that are, or believe themselves to be, responsible in cases of global M&As. Some 60 countries have at least mandatory M&A notification. One problem here is proliferation in the resultant “paper war”.

At the national level, it will probably no longer be possible to cope with many of the practical issues and concrete approaches set out above as they should be coped with. One should therefore consider the extent to which a globally oriented competition policy, but not necessarily a global competition authority, could produce better results in terms of the goals of market access and intensity of competition for efficiency and competitiveness. One of the prerequisites for better results is that this newly oriented policy should focus more on pressing and truly fundamental problems rather than on newspaper headlines and legal constructs, thereby placing more emphasis on the notion of competition worldwide. The European Union initiative to this end is heading, at least in part, in the right direction. It is to be hoped that here, too, the large trading partners cease resisting a truly global solution. Outdated theoretical assumptions need to be replaced by an understanding of real corporate motives (e.g., the desire to be competitive through M&As and not to stifle competition). The understanding of what the market itself can put right should be deepened.

What is needed is an objective analysis in light of increasing global competition. A too small-minded local competition policy risks

preventing the very dimensions necessary to face the global challenge. An international and independent body should, in particular, be able to tackle effectively the competitive barriers in the grey zone between private sector and government described above. We also need a design for a global competition policy that will allow international M&As to be dealt with using rules of subsidiarity and the “one-stop” shop principle, thereby defining better the relevant market for global products, instead of the plethora of national bodies competing against and even contradicting each other. Furthermore, the problem of decisions imposed unilaterally and implemented extraterritorially – often as a result of national interests – should be recognized and an unequivocal legal solution should be found.

The World Trade Organization can play a role in many of these issues, paying attention to trade policies and their significance for developing countries. One of the demands is for global standardization at the level of the most restrictive competition policy, in order to create a “level playing field” for companies from the countries with the most restrictive policies. The underlying argument seems to be that a restrictive competition policy hampers competitiveness, while I would argue that an efficient competition policy helps to improve competitiveness by means of fiercer competition, and therefore, competition policy itself is exposed to competition. “Because the underlying economics of competition policy are murky, some argue that it is better to allow for policy competition, under which different ideas would compete in different regions” (Graham and Richardson, 1997). We have already made the point that the proliferation of too many authorities and approaches should be avoided, but it is noted that competition watchdogs seem decidedly less keen on competition when it is a matter of themselves and their own policies.

Outlook

We have probably not yet seen the end of the current wave of comprehensive corporate restructuring across major industries. Various processes are in full swing, among them technological change, the globalization of competition, and the emergence of new competitors with global ambitions. A century ago the United States witnessed M&As on scales that today would translate into an overall capitalization of up to \$600 billion. Up to now, we have seen tie-ups

nowhere near this scale. We should not be surprised to see M&As on the global market producing even higher stock market capitalizations.

In addition to all the factors mentioned above, the process is likely to be accelerated further still in Europe by the introduction of the Euro and the eastwards expansion of European integration. There will also be a very large number of corporate tie-ups and restructuring programmes that, as mid-scale mergers, will not hit the headlines. With regard to the starting situation in Europe, one example is the industrial structure in the manufacturing of industrial batteries: there are still 47 companies in that industry in Europe, compared to only five in the United States. Other examples include agricultural machinery, with 124 companies in Europe versus only 14 in the United States; domestic appliances, with 297 companies in Europe contrasting with a mere 19 across the Atlantic (Griffith, 1998). This is, however, merely an intermediate phase. In the future, even the European approach will be a “local” approach in many industries.

Restructuring will continue to fuel not only spin-offs, but also the identification of unsuccessful M&As. In the future, we will no doubt witness the emergence of companies with products and services that are unknown today, and their subsequent rise through the ranks of top organizations. Others at the top today will slide further and further down the list. Another important factor is the globalization and liberalization of the markets that open up development opportunities for the new technologies of small companies, which are much better off than ever before. As always used to be the case, the primary requirement for this is not competition experts, but the commitment by individuals to build up a company.

An increasing number of new companies with global market positions will come from those emerging economies whose mindsets (motivation, the willingness to fight and learn, etc.) give them competitive advantages. For example, in the case of the food industry, President Food (Taiwan Province of China) announced a few years ago that its aim was to become the largest company in the food industry. The current crisis in Asia does not mean that this challenge should not be taken seriously.

Conclusions

The following general conclusions can be drawn from the ideas and observations set out above:

- If implemented properly, M&As are an important and efficient strategic instrument for enhancing the competitiveness of a company. They help establish critical mass, as well as the framework for improved work organization and more efficient utilization of capital; they accelerate the establishment of new market positions; and they provide access to innovations. Provided an M&A is implemented properly, the company is ultimately more efficient, and consumers benefit as well. The acquisitions of the Nestlé Group over the past 15 years are a living proof of this; they laid the basis for its current success, as well as for its prosperity and growth into the twenty-first century.
- M&As do not automatically generate success. Management should give its undivided attention to aspects of the actual integration process itself during the period when all contractual and financial aspects have been taken care of. These aspects include, *inter alia*, motivating the new employees, ensuring equal opportunity for all, and achieving a two-way transfer of knowledge – all aspects that are much more difficult to deal with than, for example, handling a property transfer. Another aspect is timing: M&As should be bold steps taken at the right time, and not a means of manoeuvring oneself out of a difficult situation. In this respect, the German industrialist Carl H. Hahn made a very apposite remark: “He who restructures first flourishes; he who restructures too late threatens or destroys jobs.”
- M&As are an effective and comparatively gentle tool for the necessary reshaping of the industrial structure of an economy, such as the restructuring of the production apparatus, a more rapid processing of innovation, and the transformation of duplicated efforts into synergies. They allow a constructive adaptation to fundamentally new conditions. They allow companies, such as those in emerging economies, to be

incorporated by a process of network consolidation into the global market that is shaped by more intensive and more broadly-based competition. The entire debate surrounding M&As, size, power and market positions therefore needs to be carried out on a non-emotional basis.

- One of the most important points in this process is the understanding of the relationships between competition, M&As and competitiveness. Today, M&As and restructuring programmes are almost always carried out in a bid to strengthen competitiveness, not to stifle competition. As the competitiveness of individual companies increases, competitive pressures within a market as a whole also increase. This ensures consumers benefit fully from the results of the restructuring.
- Size in itself is not an advantage, but it is far from being a threat, either for society or companies. If success leads to increased size, this is no reason to reconsider, let alone retrench. All sizes can be managed, though not always with the same structures, and often managers of a different caliber are required. Indeed, the M&A-fuelled restructuring process under way today has not yet run its course. There is still much to come, particularly in Europe. Companies perceived as gigantic today may be small fry in merely a decade.
- M&As are not one-way streets to mega-monopolies. History shows that corporate consolidation runs in waves, followed by protracted phases of increased fragmentation. Strong market positions and size are controlled effectively in the market by the mechanisms described earlier: the creation of completely new industries and new competitors; and focusing, spin-offs and outsourcing as a part of the reconditioning of the company after an M&A against the backdrop of rising competition in the global market.
- As with all types of restructuring programmes, steps must be taken to soften the social impact of M&As. When M&As take place, a sadly oft-neglected responsibility is that of communication. One-sided announcements designed to please financial markets in the short term have caused a lot of damage recently.

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- Competition policy is necessary, but its actual implementation is still dogged by biased assumptions, mixed objectives, provincial attitudes and insufficient criteria. Allocative efficiency – said to be the major issue – has never been the sole goal of competition policy in industrialized countries. These themes must be debated less by legal pundits and more by those directly concerned. More attention should be paid to global factors – the World Trade Organization will have to tackle this issue in the long run – such as a globally designed, though not necessarily globally standardized, competition policy. Dialogue and more conceptual clarity are particularly important where emerging economies are weighing the implementation or revision of instruments of competition policy, and where they are often under pressure from industrialized economies with their own ill-defined conceptions and not entirely selfless goals. ■

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BOOK REVIEWS

World Investment Report 1998: Trends and Determinants

United Nations Conference on Trade and Development

(New York and Geneva: UNCTAD, 1998), xxxi and 428 pages.

The annual publications of the important agencies of the United Nations almost invariably achieve a high standard of analysis and provide an excellent source of data on their own focus: both the analysis and the data are made available to non-professionals. The focus of the *World Investment Report* is foreign direct investment (FDI), transnational corporations (TNCs) and the policy setting in which TNCs conduct FDI. The *World Investment Report 1998* maintains the standards which we have come to expect. It provides detailed information on the current flows and stocks of FDI and addresses both the activities of TNCs in the different regions of the world and the policy concerns. While it will offer little in terms of theoretical insights to most international business scholars such as the members of the Academy of International Business, it will provide, for other economists and non-economists, an overview of the contributions of this type of organization and its impact on world welfare, as well as of the international organizational problems which arise from FDI. Essentially, this involves the conversion of the “rules of the game” from a narrow focus on international trade to the much more intricate arena of trade and investment (international economic involvement). In the course of this, the *Report* makes a great deal of data available.

This review will focus mainly on chapters II, III and VII, and will address a definitional issue which arises from chapter V.

Chapter II identifies the largest 100 TNCs, their parent country and their industry (pp. 36-38). Ten of the largest 40 TNCs are automotive firms, though recent mergers will reduce that proportion in future reports. The chapter also computes a measure of the firms’ “transnationality”. This transnationality index measures the degree

to which the major TNCs divide their activities between their home country and the various host countries in which they have affiliates. The index is a simple arithmetic average of the ratio of foreign-to-total assets, sales and employment. Obviously, this depends greatly on the size of the home country. Not surprisingly, two Swiss corporations, Asea Brown Boveri and Nestlé, are ranked second and third. The most “transnational” corporation is Seagram Company (a firm in the “beverages” industry, according to the list) from Canada, with an index of 97.3 per cent. Seventy-five firms had indexes in excess of 35 per cent and the median value is approximately 57 per cent. A detailed study of transnationality and its measurement by Grazia Ietto-Gillies (1998) has been published in *Transnational Corporations* and forms the basis of a box which tries to reconcile the concept of transnationality, as defined above, and the number of foreign countries in which the TNC has a presence.

The transnationality index raises an interesting problem: the ratio of foreign-to-total assets is based on balance sheet concepts and, therefore, largely on the book value of physical assets. One can surmise that intellectual property is becoming an increasing source of quasi-rents and that expenditures on research and development (R&D) are, for technology-intensive industries, a much higher proportion of revenues or profits than in the past. For these industries, balance sheet asset figures will understate the value of assets “located” in the home country although, if the intellectual property is transferred to a foreign affiliate, its existence may be partially captured in the ratio of foreign-to-total sales.¹ Joint ventures which are R&D-oriented, form the basis of many of the more interesting examples of alliance capitalism.

Chapter II also addresses the existence and characteristics of TNCs based in developing countries. As expected, these TNCs come from the richer developing countries which can best be described as “industrializing/developing”, and which can be clearly distinguished from the lower echelon of developing countries.² The *Report* provides

¹ Sales are, of course, an inferior measure, as compared to value added.

² See UNDP (1996), p. 2. It reports on the dichotomization of developing countries into those which are achieving acceptable and apparently sustainable rates of economic growth and those which are near stagnation. The *Human Development Report* identifies a number of countries accounting for 25 per cent of the world’s population, as suffering from “failed growth”.

data on the largest 50 TNCs from developing countries. These TNCs are less transnational (the median value of the index is about 35 per cent) but the data probably offer a degree of confirmation of Ozawa's flying-geese theory.

Chapter III reports on investment policy issues at both the national and supranational level. There exist special regimes at the national level in 143 countries: these regimes include both incentives for TNCs and constraints on their operations. Of the 76 countries enacting changes in 1997, 67 were favourable to inward FDI and TNCs operating in those countries. Many of these changes derived from international commitments such as the WTO Agreement on Trade-related Aspects of Intellectual Property (TRIPs) and the Agreement on Trade-related Investment Measures (TRIMs).

In addition, there exist important ongoing negotiations within the Organisation for Economic Co-operation and Development (OECD) and within the western hemisphere. There was an agreement at the Second Summit of the Americas, held in Santiago, Chile, in April 1998, to launch negotiations on a free trade agreement of the Americas and within that framework the Working Group on Investment has been meeting since 1993. Perhaps the crucial measure of interest here is the idea of a hemispheric system of perfectly free international economic relations including trade, investment and national treatment, and the creation of a climate which encourages international investment. There is no hint that regional blocs will or could impede the creation of a free global system (Kobrin, 1995). The report of the Working Group sketches out the multiplicity of dimensions on which some prearranged agreement must be established. The free trade agreement is expected to be concluded by 2005: given the difficulties in reaching agreement in the different dimensions, this must be considered an optimistic timetable.

In addition to negotiations in the western hemisphere, the OECD attempted to develop a multilateral agreement on investment, to create a standard for the international investment environment on a par with the environment in the industrialized countries. All these attempts to create multilateral agreements and sets of standards for investments must recognize the need to allow some time for less developed

countries to build up the institutions and the expertise needed for a country to be able to meet the conditions of such agreements.³

Chapter III also provides information on, and analyses, double taxation treaties, which are bilateral agreements on how TNCs will be subjected to tax by the host and home Governments. It is important that the same revenues and/or profits should not be taxed by both. Clearly, the taxation of value added or profits is a matter of serious concern for any TNC and the issue becomes more complex because taxation incentives can be, and often are, used by a potential host Government as a means of attracting inward FDI. The chapter provides a thorough introduction to the complexities of this issue.

Chapter V examines the developments in FDI among the countries of the industrialized world. The question is raised of what constitutes “international” investment in the modern context, when the European Union is on the verge of renouncing national currencies and generating virtually uniform regulatory environments. Should members of the European Union which have adopted the euro be considered as separate countries? There is a logical argument for regarding such countries as a single nation. The *Report* (pp. 154–156) goes some way towards recognizing this problem by identifying the amount of FDI in the industrialized world that is conducted among the members of the European Union. However, the tax systems are far from harmonized and there are reasons for not adopting identical tax systems among a group with wide disparities in income (Kiel Institute of World Economics, 1998). In this reviewer’s judgement, those members of the European Union which are fully committed to the euro should be considered as a single nation from 2002 onwards when assessing patterns of trade and FDI.

Chapters VI to IX examine developments in FDI in three developing regions, Africa, Asia and the Pacific and Latin America and the Caribbean, as well as in Central and Eastern Europe. The latter is, in effect, a study of economies in transition. Given the financial crisis in Asia in 1997, the impact of the crisis on Asia and

³ Stanley Fischer (1998) recognizes that any proposal for complete freedom from restraints on international capital movements must be qualified for countries that lack the necessary socioeconomic infrastructure.

the Pacific is of the greatest analytical interest. Clearly, economists and non-economists interested in other regions will do well to read the chapter dealing with their particular region. It is an interesting question as to whether subsequent crises in the Russian Federation and Brazil will be subject to the same analysis.

Data show that the inflow of FDI into the five most affected Asian industrializing/developing countries (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand) continued to be positive in 1997 even though portfolio equity investment and bank lending turned sharply negative. Clearly, export-oriented affiliates located in countries whose currency has been sharply devalued can be expected to be invaluable sources of economic strength and of foreign exchange and may be expected to expand.⁴ The determinants of inward FDI will change in the short term, at least, following a financial crisis – provided always that the industrialized world and developing countries not affected by the crisis are able to keep their markets open to imports from the crisis-affected countries. But the stresses are likely to promote protectionist fervour in many industrialized countries and the more widespread the crisis or crises, the greater the likelihood that imports from crisis countries will be restrained in response to political protests in the importing countries.

At the same time, there is a possibility that distressed home country firms will be merged with or acquired outright by foreign TNCs, at the expense of the host country's nationhood. This may prove to be a very high price to pay for earlier policy mistakes.⁵

Chapter VII provides four extremely interesting case studies (Seagate Technology in Malaysia and Thailand, Toyota in Thailand, Honda in Thailand, and Motorola in Malaysia and the Republic of Korea) and reports on two surveys in Thailand (a general survey) and Malaysia (on the electrical and electronics industries). The *Report* also generates its own analysis of the effect of the crisis on Japanese FDI in the five most affected countries. All these studies suggest that

⁴ Maxwell J. Fry (1966) provides data on the benefits to the current account of Asian developing countries from inward FDI.

⁵ Zubaidur Rahman (1999) reports on a very high ratio of financial leverage common to many firms in East Asia. This high ratio makes firms vulnerable to collapse in crisis. In fact, many did: those that survive can be taken over by foreign TNCs relatively cheaply.

TNCs are a beneficial force in the aftermath of a financial crisis, as straightforward economic theory would suggest, although the effects are not evenly spread among the five countries.

The *World Investment Report 1998* is a valuable document. It warrants being read by all students of international business as well as by economists interested in the complex issues of international negotiations and in the aftermath of the Asian financial crisis. ■

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The Andean Community and the United States: Trade and Investment Relations in the 1990s

Miguel Rodríguez Mendoza, Patricia Correa and
Barbara Kotschwar (eds.)

(Bogotá, Andean Development Corporation, and
Washington, DC, Organization of American States and
Inter-American Dialogue, 1998), 408 pages

The Latin American economic physiognomy underwent a deep transformations in the 1990s. One of the main features to have emerged from the region's new economic openness to trade and foreign investment is the revitalization of many integration schemes among the countries of the region. The current Andean Community that came into force in 1997 is the result of the reshuffling of the Andean Pact established in 1969. This integration scheme encompasses five medium-sized countries of South America (Bolivia, Colombia, Ecuador, Peru and Venezuela). Like the Southern Common Market (MERCOSUR) – the other integration project in the region – the Andean Community is inspired by the successful example of the European Union that is, the example of a gradual and deepening process, starting with intra-zone free trade, leading to the enhancement of the economic integration, and culminating in a political union.

The cornerstone of Andean external policy is to foster and support member States' development strategies, and the liberalization and diversification of trade and investment flows among members as well as with the rest of the world. The United States is a key economic partner of the Andean countries, in terms of trade as well as foreign investment trends. The tensions that dominated the United States–Andean economic relationships until the 1980s were relieved at the beginning of this decade, thanks to the new Andean liberalization policies. In addition to that, the current negotiating process for a free trade area of the Americas, launched in 1994, is a new driving force in the dialogue between the United States and the Andean countries.

The editors of *The Andean Community and the United States: Trade and Investment Relations in the 1990s* provide a comprehensive picture of United States–Andean economic relations through a compilation of studies prepared by well-known experts and officials. The topics of the studies include the reforms and progress in the Andean countries, private capital flows and market access, competition policies and dispute settlement procedures, to mention but a few of the issues that are relevant for government officials, firms and trade analysts. All these papers were presented in a conference sponsored by the Organization of American States, the Inter-American Dialogue and the Andean Development Corporation in October 1997. The last section of the book includes a summary of a two-day seminar on future policy issues held at the Brookings Institution in Washington, DC, with the participation of experts, business leaders, trade ministers and government officials.

The first part of the compilation deals with the Andean integration process as such, assessing its domestic reforms. The second and third parts analyze the integration scheme from the United States and the Andean perspectives. Specific topics such as telecommunications policies after privatization and regulatory reforms, anti-dumping policies and intellectual property rules are examined in part four.

As far as trade liberalization is concerned, the accomplishments of the new Andean Community are quite impressive: since 1990, trade among its members was increased by an average of 29 per cent per year. Trade flows with the rest of the Latin American region are stimulated by a network of bilateral agreements concluded between individual Andean countries and non-members such as Chile, Mexico and the Caribbean countries, and between Bolivia and MERCOSUR. However, the journey to a real free trade area is still incomplete, and many critical decisions still need to be taken to enhance the second-generation reforms after the first wave of market-oriented changes and macroeconomic shock therapies. A certain scepticism is characteristic of some of the authors. Sebastian Edwards, for instance, states that "...the so-called 'consolidation phase' has turned out to be more of a 'standstill'" (p. 400). Poor productivity growth, institutional weaknesses and poverty rates are identified as the obstacles to the

success of the Andean integration scheme and the development of its members.

From the perspective of foreign investors, the book provides a useful insight into the new subregional regulatory framework, which replaced the more restrictive Andean Decision 24 of 1973. The current regime for foreign direct investment (FDI) eliminated previous restrictions on foreign participation, as well as restrictions on profit repatriation. In this favourable context, FDI flows increased fourfold between 1990 and 1994, reversing the negative flows of the previous decade. Privatization is identified as one of the catalysts of this increase.

The comparison between the United States' and the Andean countries' perspectives highlights an imbalance between the critical importance of the United States for Andean economies and trade and the relative unimportance of Andean countries for the United States. The Andean Community is losing ground as a trading partner of the United States, being gradually replaced by Chile, Mexico and the MERCOSUR countries.

Although it would be erroneous to talk about a specific United States policy *vis-à-vis* the Andean Community, some of the studies included in the book refer to recurrent topics that can be considered as determinants in the United States–Andean relationship, such as intellectual property rights and the fight against drugs. As Patricia Correa, a Colombian author says, those topics dominated the economic agenda and led to a “carrot” initiatives such as the Andean Trade Preferences Act (ATPA) together with “stick” measures such as the decertification of Colombian exports. Rather than talk of politicization, some of the authors talk of the “narcotization” of the trade agenda, where the use of trade sanctions by the United States in its anti-drug policy is a worrisome trend that may affect the normal evolution of relationships.

From the Andean countries' point of view, their relationships with the United States are characterized by diversity. Venezuela's trade dependency on the United States has increased in the 1990s, while that of Bolivia, Colombia and Ecuador has diminished.

Diversity also characterizes the FDI trends of Andean countries: Peru is more dependent on European capital than Colombia, where United States FDI represents almost half of total inflows. Venezuela is a totally different case because of its large gasoline distribution investments in the United States. Finally, as pointed out in studies by Ana Julia Jatar and Luis Tineo, Andean competition policies are also characterized by diversity, since each country has its own unique legal and institutional mechanisms. Restrictive and monopolistic practices are still common in Andean countries, and the improvement of competition policies through supranational rules will be an important task in the near future. For the time being, Andean Decision 285 is the only common rule on competition, but it has only a limited scope when compared with individual countries' legislation.

A similar weakness is found in the anti-dumping rules, where there is room for improving Andean Decision 283, especially as regards its compatibility with the rules of the World Trade Organization (WTO), as noted by Gary Horlick and Eleanor C. Shea. Moreover, it is worth noting that the authors do not consider anti-dumping actions as a major controversial issue in United States-Andean trade. In the same context, Craig Van Grastek correctly stresses that dispute settlement mechanisms for trade will probably receive greater attention in the United States-Andean agenda, particularly as the negotiations progress on a free trade area of the Americas.

The differences between the Andean domestic legal frameworks do not modify a common trait of all Andean countries' trade with the United States: Andean exports are dominated by raw materials and primary products, while a widening range of manufactures is imported from the United States. Therefore, as stressed by Gary Hufbauer and Barbara Kotschwar, the United States-Andean relationship is a perfect illustration of the theory of comparative advantage, although some specific examples seem to indicate that the picture is changing. For instance, Colombian and Bolivian exports to the United States are increasingly diversified and are taking advantage of preferential instruments such as the ATPA to penetrate the United States market. However, as in the case of the Generalized System of Preferences, the exclusion of sensitive exports that are particularly important for

potential Andean exporters (footwear, textiles and apparel, sugar, canned tuna and petroleum) reduces the potential benefits of the ATPA. The limited domestic capacity of Andean countries to diversify exports is another point stressed by one of the authors.

The free trade area of the Americas will provide a setting to review (and probably eliminate) trade preferences for Andean exports to the United States, introducing reciprocity and common goals into economic relations. Nevertheless, as correctly mentioned by Miguel Rodríguez Mendoza, the setting up of such a free trade area will not diminish the importance of WTO mechanisms and rules for Andean countries as a multilateral framework for trade and trade disputes.

This important compilation of studies sets the stage for the examination of United States–Andean relations in the medium term. In the medium term, we will certainly see more changes in Andean attitudes *vis-à-vis* the United States than vice versa. It also provides a basis for understanding many of the key issues in the negotiations on a free trade area and the challenges the Andean integration process faces. As the Andean Community steps up its efforts to implement a common external policy, businessmen, investors and trade officials from the United States and the rest of the world will begin to look at this group of countries with different eyes. ■

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Les banques à l'ère de la mondialisation

Zuhayr Mikdashi

(Paris, *Economica*, 1998), 365 pages

In the dynamic environment of a globalizing world economy (i.e. one characterized by the increasing integration and interdependence of national economies) uncertainties and economic turbulence pervade. The main objective of Zuhayr Mikdashi's book is to examine the different strategic choices available to banks and other financial groups, as well as to evaluate the principal regulatory systems. The recent history of some financial groups is rich in lessons. First and foremost is the lesson that the quality of management and visionary leadership are fundamental to the success of enterprises.

Professor Mikdashi, from the University of Lausanne, Switzerland, analyses the role of financial innovations (e.g. in derivatives), technological progress (e.g. in telecomputing) and the liberalization of financial and banking transactions in promoting the expansion of trading volumes, heightened competition and cost reductions. These developments have also contributed to the negotiability of financial assets and in raising the liquidity level in financial markets. As long as economic agents from different countries have access to international savings without geographical impediments and these savings are channelled to projects judged on their merits, the globalization of financial markets has the distinct advantage of leading to a more efficient allocation of capital.

When appropriately used as coverage instruments, derivatives allow economic agents, including banks, to neutralize or at least moderate the risk of exposure in their positions, but some institutions use them as instruments for speculation. Derivatives may multiply the effects of the reward (or loss) through debt financing (leverage factor), but it should be remembered that the market may sanction the institution if the latter behaves unreasonably.

The analysis of Professor Mikdashi of these issues covers four main subjects: (1) the strategic choices of managers of financial

groups, and corporate governance; (2) the nexus of risks in the financial sector; (3) the criteria for measuring the solidity of financial institutions; and (4) regulation of the competition, prudential measures and insurance mechanisms. Professor Mikdashi's findings are particularly timely, and deserve to be summarized here.

Business strategies in the global economy

Globalization has permitted for certain financial institutions to expand and better diversify their portfolios and increase their economic power – frequently by means of joint-venture strategies, mergers and acquisitions. Indeed, with the liberalization of financial markets, many managers of banks are concerned with the profitable development of their activities. Their strategy is based on several factors, such as: risk diversification, economies of scale, the rational utilization of skills and other resources, maximization of opportunities, and the quality of customer services. According to Professor Mikdashi's analysis, leaders of financial institutions may choose between (i) the “niche” strategy, whereby they limit their function to one central activity or a very small number of particular products, or (ii) the strategy of “multidimensional” expansion, more appropriate for a mega-financial institutions. The optimal choice will depend on the relative capacity of management to produce added value in each approach in a dynamic environment of competition and uncertainty.

Risks of contagion

Globalization has led to a higher level of uncertainty, deriving from the enormous amount of destabilizing speculation and the volatility in the prices of assets and other financial instruments. The opening of markets has also contributed to an increase in risk transmission across institutions and across markets, as well as to the illicit exploitation of the imperfections or loopholes in prevention systems. The contagion of problems from one institution to another is a dreaded phenomenon, known as systemic risk, as shown by the way in which the recent financial crisis in Asia spilled over to the Russian Federation and Latin America.

As pointed out in the book, the use of deposit insurance, in coordination with the central bank in its capacity as lender of last

resort, will protect any sound bank against a liquidity crisis that could lead to the selling of its assets at fire-sale prices in order to face up to massive transfers or cash withdrawals by depositors. A forced liquidation of assets could pull down the banks in trouble into insolvency and then into default. Such default could also happen to debtors whose credit lines are cut. The risk of such a cascade-like breakdown could become systemic, with chain reactions of financing problems affecting many economic agents, and difficulties in savings and credit distribution channels.

Measuring performance

The higher the uncertainty concerning the flow of funds to and from a bank, the higher the level of liquidity required by the bank. Similarly, a more risky profile will prompt depositors and shareholders to demand a proportionally higher remuneration. A bank may reduce uncertainty through a reasonable diversification of its activities and through risk control. Quantitative analysis offers considerable help in the evaluation of the solidity of a bank, but it is only a first diagnosis and needs to be completed by a balanced judgement on the bank's innovativeness and competitiveness and on the quality of its personnel.

According to Professor Mikdashi, the evaluation of the performance of a bank cannot be restricted to the sole criterion of financial reward. A comprehensive evaluation must include three principal groups of factors, namely:

- The financial solidity of the bank, measured by its earning capacity, its capital and its prudence;
- The social and ethical conduct of the bank's business; and
- The bank's respect of the environment in its own activities and in those of its clients.

Regulation and control

The opening-up of markets should, normally, motivate the authorities to cooperate more closely. Regulation, like national and international controls cannot be preventive. The key to sustainable performance and development of a bank is professional competence, good judgement, and efficient control by managers. In the absence

of a supra-national global regulatory body which is unrealistic in current conditions, it becomes imperative for various parties in the international financial community to enhance their cooperation in order to avoid systemic risk. According to Professor Mikdashi, to do this will require:

- (1) Uniform principles for healthy risk management;
- (2) Common accounting standards allowing for the transparency of real economic conditions;
- (3) The audit of all the activities of an enterprise; and
- (4) The selection of an accredited agency capable of assuming the role of principal coordinator for all national agencies concerned with the worldwide supervision of diversified financial groups.

Professor Mikdashi synthesizes his long experience as an analyst of the banking and financial services industry, and examines the challenges facing financial leaders at the turn of the century. His book offers a clear review of the principal issues in bank management, with references to some of the most recent events on the subject. It is a reference book that provides an introduction for beginners or students to the multiple problems and questions facing the banking profession. For practitioners, it will serve as a framework for their thoughts and actions.

Aimed to appeal to both the general public and professionals, the book is written in a non-mathematical style, and should stimulate their thinking and their decision making. ■

Antoine Basile

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Bilateral Investment Treaties in the Mid-1990s

(Sales No. E.98. II.D.8) (\$ 46)

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ProInvest, vol. 10, nos. 3 and 4

ProInvest, which replaces *Transnationals*, is a quarterly newsletter drawing on the results of research and technical cooperation activities undertaken by the UNCTAD Division on Investment, Technology and Enterprise Development. It is available free of charge upon request (see address on p. 213).

WAIPA Annual Report 1997–1998

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Scope and Definition

(Sales No. E.99.II.D.9)

This paper analyses the scope and definition of investment agreements. Investment agreements must specify not only their geographical and temporal coverage, but, most importantly, their subject-matter coverage. This is done primarily through the provisions on definition, especially the definitions of the terms “investment” and “investor”. The study considers the different economic and developmental implications of the definitions of these terms in investment agreements and how these definitional provisions interact with key operative provisions of investment agreements.

Foreign Direct Investment and Development

(Sales No. E.98.II.D.15)

This paper considers the direct and indirect effects of foreign direct investment (FDI), along with the broader role of transnational

corporations in the process. It also considers policy issues for national Governments inherent in the linkages between FDI, trade and development. The trade effects of FDI depend on whether it is undertaken to gain access to national resources or to consumer markets, or whether FDI is aimed at exploiting locational comparative advantage.

Transfer Pricing

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Transfer pricing issues raise important policy questions for host and home Governments, as well as for transnational corporations, as transfer pricing methods directly affect the amount of profit reported in host countries by corporations, which in turn affects the tax revenues of both host and home countries. This paper considers the issue of effective transfer pricing regulation and to what extent international investment agreements can address this and ensure that developing countries derive full benefits from foreign direct investment without exposure to a potentially harmful diversion of revenues through transfer pricing practices.

Admission and Establishment

(Sales No. E.99.II.D.10)

This paper analyses the legal and policy options surrounding the admission and establishment of FDI by transnational corporations into host countries. The topic raises questions that are central to international investment agreements in general. In particular, the degree of control or openness that a host country might adopt in relation to the admission of FDI is a central issue. The paper describes and assesses the types of policy options that have emerged from the process of FDI growth and host country responses thereto in national laws and, more importantly, in bilateral, regional, plurilateral and multilateral investment agreements.

Most-Favoured-Nation Treatment

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The most-favoured-nation (MFN) treatment standard is a core element of international investment agreements. It means that a host country treats investors from one foreign country no less favourably than investors from any other foreign country. The paper examines the implications of the MFN standard, its application to both pre- and post-establishment phases and the effect on host countries of existing exceptions to the standard. The use of exceptions to MFN treatment introduces an element of flexibility that allows development objectives to be taken into account. The MFN standard gives investors a guarantee against certain forms of discrimination by host countries, and it is crucial for the establishment of equality of competitive opportunities between investors from different foreign countries.

Investment-Related Trade Measures

(Sales No. E.99.II.D.12)

Investment-related trade measures (IRTMs) are a diverse array of trade policy instruments that influence the volume, sectoral composition and geographic distribution of FDI. For developing countries, it is important to assess accurately the interactive link between trade and FDI in order to understand the effects of changes in national policy regimes as well as the potential consequences of international investment agreements. This paper looks at IRTMs and provides a way to understand some of these effects so that they can be assessed and, if appropriate, addressed in international discussions on trade and FDI policies.

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Dunning, John H. (1979). “Explaining changing patterns of international production: in defence of the eclectic theory”, *Oxford Bulletin of Economics and Statistics*, 41 (November), pp. 269–295.

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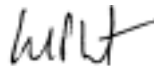
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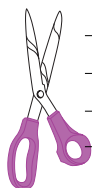
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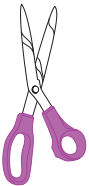


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