

Relationship between FDI inflows and Bilateral Investment Treaties / International Investment Treaties in developing economies: An Empirical Analysis

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INTRODUCTION

The first BITs appeared at the end of the 1950s. Some trace their history back to the treaties of friendship, commerce, and navigation (FCN) concluded by the United States over centuries (Salacuse 1990). The FCN treaties had the expansion of international trade and the improvement of US foreign relations as their prime purpose, even though some investment provisions were later added (Guzman 1998). BITs on the other hand are more clearly focused on foreign investment protection. Germany, having lost almost all of her foreign investment during the Second World War, signed the very first BIT with Pakistan in 1959. After that, it took almost two decades before BITs gained momentum. By the end of the 1960s there were 75 treaties, which rose to 167 by the end of the 1970s and to 389 by the end of the 1980s. The number of BITs worldwide began to grow rapidly in the 1990s and by 2002 there would be 2,181 BITs worldwide (UNCTAD 2003a).

In order to explain the popularity of bilateral investment treaties it is necessary to understand how they fit into the larger regime of state-foreign investor relations. Prior to the advent of BITs, the only protection for foreign investors was the customary international legal rule of minimum standard of treatment and the so-called Hull rule. The minimum standard of treatment rule provides only very minimal protection, as the name already suggests, while the Hull rule dealt exclusively with cases of expropriation and therefore provided no general protection against discriminatory treatment. It grew out of a dispute between Mexico and the US in the 1930s over properties expropriated by the government of Mexico. Developing countries challenged its validity as part of their demands for a New International Economic Order with some success: Resolution 1803 of the United Nations General Assembly merely requires 'appropriate compensation' for expropriation (Ginsburg 2004). Guzman (1998, p. 641) suggests that by the mid-1970s 'the Hull Rule had ceased to be a rule of customary international law', if ever it had been one. The fact that there were several spectacular expropriations in the 1960s and 1970s taking place without what investors regarded as adequate compensation supports this view.

The basic provisions of a bilateral investment treaty (BIT) typically guarantee certain standards of treatment for the foreign investor (see Dolzer and Stevens 1995; UNCTAD 1998). By entering into a BIT, signatories agree to grant certain relative standards treatment such as national treatment (foreign investors may not be treated any worse than national investors, but may be treated better and, in fact, often are) and most-favored nation treatment (privileges granted to one foreign investor must be granted to all foreign investors). They also agree to guarantee certain absolute standards of treatment such as fair and equitable treatment for foreign investors in accordance with international standards after the investment has taken

place. BITs typically ban discriminatory treatment against foreign investors and include guarantees of compensation for expropriated property or funds, and free transfer and repatriation of capital and profits. Further, the BIT parties agree to submit to binding dispute settlement should a dispute concerning these provisions arise (UNCTAD 1998). Ostensibly, these provisions should secure some of the basic requirements for credible protection of property and contract rights that foreign investors look for in host countries. They should also protect foreign investors against political and other risks highly prevalent in many developing countries. Far from being neutral, foreign investors are often granted higher security and better treatment than domestic investors (Vandeveldt 1998).

The basic provisions of BITs are all direct answers to the fundamental “hold-up” or “dynamic inconsistency” problem that faces developing nations attempting to attract FDI. The dynamic inconsistency problem arises from the fact that although host countries have an incentive to promise fair and equitable treatment beforehand in order to attract foreign investment, once that investment is established and investors have sunk significant costs the host country’s incentive is to exploit or even expropriate the assets of foreign investors. Even those host countries that are willing to forego taking advantage in these circumstances will find it very difficult to credibly commit to their position. Many developing countries have adopted domestic legal changes over the last decade or so with a view toward encouraging a greater FDI inflow (UNCTAD 2004). However, these domestic legal rules cannot substitute for the commitment device offered by entering into a legally binding bilateral treaty. BITs, and their binding investor-to-state dispute settlement provision in particular, are meant to overcome the dilemma facing host countries who are willing to denounce exploiting foreign investors after the investment has already been undertaken. Interestingly, at the same time as BITs flourished in the 1980s and 1990s, outright expropriations of foreign investors, which were common during the 1960s and 1970s, practically ceased to take place (Minor 1994).

The extent of interference with domestic regulatory sovereignty developing countries succumb to in signing BITs is enormous. In fact, virtually any public policy regulation can potentially be challenged through the dispute settlement mechanism as long as it affects foreign investors. Often, foreign investors need not have exhausted domestic legal remedies and can thus bypass or avoid national legal systems.

Since the early 1990s, transition economies have joined in this trend. Both groups of countries, often hostile or at best distrustful vis-à-vis transnational corporations (TNCs) in the decades that followed the Second World War, began to perceive TNCs no longer as part of the problem but increasingly as part of the solution, bringing not only much needed capital to stimulate growth and development, but also technology, skills and access to foreign markets and creating employment.

Consequently, previous restrictive and controlling policies and institutions were replaced by new ones aimed at attracting FDI. Thus, many developing countries and countries in transition have reduced – to various degrees – bans and restrictions on FDI entry, improved the standards of treatment and protection of foreign investors and eased or eliminated restrictions on their operations. Finding themselves in increasing competition with other countries for attracting FDI, they often also implemented incentive schemes for TNCs.

Efforts to promote FDI also included the establishment of investment promotion agencies (IPAs) and export processing zones (EPZs). The process of opening up to FDI and establishing enabling frameworks for FDI vastly accelerated during the 1990s and continues until today,

although more recently there have also been signs of more restrictive FDI policies in several countries.

Generally reluctant to bind their FDI policies in multilateral agreements, developing countries have increasingly submitted some aspects of their investment frameworks, especially those concerning protection and treatment of FDI to international treaties. The result has been an explosive growth of international investment agreements (IIAs). Until the end of 2008, more than 2,670 bilateral investment treaties (BITs) and more than 270 other IIAs –such as free trade agreements (FTAs) or economic integration agreements with investment provisions – had been concluded. All countries are parties to at least one IIA.

In concluding IIAs, developing countries seek to make the regulatory framework for FDI more transparent, stable, predictable and secure – and thereby more attractive for foreign investors (UNCTAD 2003a: 84). However, a recurrent issue in the discussions about IIAs is to what degree IIAs actually fulfill their objective of encouraging more FDI. The debate on the impact of IIAs on FDI, previously perceived as a North–South issue, has recently gained new momentum. As a growing number of developing countries are becoming FDI exporters, they reconsider the role of IIAs as not only a device aimed at stimulating inward FDI from developed countries, but also as a means to encourage and protect their own outward FDI in developed and other developing countries.

Consequently, South–South cooperation in investment rulemaking has increased considerably. In addition, new types of IIAs which also cover trade and other issues have emerged, and many countries have renegotiated their BITs in order to further improve investment conditions. The objective of this paper is to explore the role of IIAs in attracting FDI into developing countries. The Study will review a number of existing econometric studies on the impact of IIAs on FDI inflows into developing countries. The study does not cover agreements on the avoidance of double taxation or so-called “double taxation treaties” (DTTs), as these constitute a special category of IIAs that deal foremost with the elimination of double taxation (although they also serve other purposes such as the provision of non-discrimination rules, the prevention of tax evasion, arbitration and conflict resolution).

While the paper offers a conceptual discussion of the impact which IIAs can have on FDI flows, the objective of this paper is to make the wealth of information included in various studies available to IIA policymakers, negotiators, legal experts and other interested stakeholders.

THE IMPACT OF BITS/IIAS ON FDI: A STUDY OF THE ECONOMIC LITERATURE AND EMPIRICAL ANALYSIS

Among all kinds of IIAs, BITs continue to be the most numerous and most important type of investment treaties. Originally, BITs were concluded between developed and developing countries. For developed, capital-exporting countries, BITs have been part of long-lasting efforts to establish international rules facilitating and protecting foreign investments by their nationals and companies. Developing countries have concluded BITs as part of their desire to improve their policy framework in order to attract more FDI and benefit from it. By engaging increasingly in BITs among themselves, developing countries have begun to consider BITs as a device protecting also investment of their own investors.

METHODOLOGY

Is it sufficient to conclude that BITs have actually promoted FDI into developing countries? The answer is not straightforward because are, in addition to BITs, many determinants of FDI inflows into countries – economic, policy determinants or business facilitation. The objective of an econometric exercise is, based on as large a number of observations concerning bilateral flows of FDI between pairs of countries as possible, to assess the role of *all* key determinants in stimulating FDI and to isolate the role of BITs among these determinants. This is done through constructing a model (representing a mathematical equation), which reflects the relationship between the amount of or fluctuations in FDI –called a dependent variable – and key FDI determinants, including the conclusion or existence of BITs – called explanatory variables. In order to isolate the role of BITs, there is a need to identify other key explanatory variables and to calculate their impact on FDI (i.e. by estimating the numerical parameters of the relationship). Otherwise, all changes in the amount of FDI could be attributed to BITs, which would not be a reasonable proposition. Econometrics also enables one to assess the impact, or the lack of it, of a BIT variable in interaction with key variables of particular interest, such as institutional quality variables. If an econometric exercise finds a strong relationship – that is a strong correlation – between the conclusion of BITs and FDI inflows, its next task is to determine the direction or causation of the impact – do BITs stimulate FDI or does, vice versa, existing FDI results in the conclusion of BITs?

Causality, however, can also be multidimensional and work both ways. The estimation of relational parameters between FDI and its key determinants, including BITs, is not enough to verify an impact. Next comes the checking of the statistical significance of these parameters. There are additional tests available in econometrics permitting, for example, to answer the question whether the relationship represents a correlation or causation. Before drawing final conclusions about the relationship between BITs and FDI, there should be a common sense reflection, based on the knowledge of FDI in general. Dependent FDI variables, bilateral or aggregated, come in econometric studies in different varieties: they may consist of total annual FDI inflows, logged inflows (eliminating annual fluctuations), average inflows over a couple of years, inflows in constant dollars or shares or ratios, e.g. the share of global inflows, of those into developing countries or a ratio of FDI to GDP. Explanatory or independent variables include not only BITs but also other host country determinants of the size of FDI, known from the general FDI literature as key determinants of the location of FDI in host countries.

However, these variables may be included only if they can be presented in a numerical form. This is not possible for all key variables and some measures come in the form of less-than perfect substitutes or proxies.

Key explanatory variables other than BITs typically include the size of the host country's market measured by GDP, population, GDP per capita, economic stability – inflation, exchange rate fluctuations – and other than market size related host country advantages. These include the availability of natural resources – measured by, for example, fuels and ores exports or natural resources intensity – or the attractiveness for efficiency-seeking FDI: that is, openness to trade measured as the ratio of trade to GDP or skill and/or cost gaps between host and home countries. Furthermore, institutional factors are typically included, such as the quality of the legal system, respect for the rule of law, political risk or aggregate measures of institutional quality. The annex summarizes variables used in each of the reviewed studies, as well as the period covered in each study, the host and home countries for which the data on variables had been collected – i.e. the details and the size of the data sample – the econometric method used and key conclusions concerning the impact of BITs.

What follows is an overview of the major econometric studies examining the issue of the impact of BITs on FDI flows into developing countries. In reviewing these studies, the focus would be to assess their conclusions concerning the BITs/FDI relationship. The studies will be discussed in chronological order, as they have been published. A final caveat should be made. In spite of differences in their content, econometric studies treat BITs as homogenous and examine combined possible impacts of channels through which BITs may influence FDI. It is, therefore, not possible to distinguish the impact of *individual* BIT provisions on FDI flows, for example, the impact of investment protection provisions as compared to investment liberalization provisions.

RESULTS / FINDINGS

A first econometric analysis by UNCTAD (1998b) had assumed that BITs should impact on FDI in bilateral flows between BIT contracting parties close to the year of concluding the BIT. However, the analysis of time-series data on bilateral FDI flows – three years prior to and three years after the conclusion of a BIT – in relation to 200 BITs during 1971–1994 did not indicate an impact. The examination of the correlation between the amount of FDI and the number of BITs in 133 countries in 1995, however, showed an impact, although not a strong one. UNCTAD concluded that BITs do have an impact on FDI flows, although the investment amounts involved may be too small to affect significantly the total or bilateral flows of the host countries involved in these analyses.

Further, in another study, Banga (2003) focused on FDI policy as a determinant of FDI, but also estimated the impact of the total number of signed BITs on FDI inflows (based on actual FDI data and on FDI approvals) for 15 developing economies of South Asia, East Asia and South-East Asia for the period 1980 to 2000. Further, the study disaggregated FDI inflows into 10 host countries into FDI from home developed and developing countries, and examined, in the period from 1986 to 1997, the FDI response to government policies and the conclusion of BITs. The study found that the BITs with developed countries had a significant impact on FDI inflows.

On the other hand, BITs with developing countries did not have a significant impact on aggregate FDI inflows. The author gives two possible explanations for this difference. First, developed countries account for more than 60 per cent of aggregate FDI into examined countries during the period under investigation. Therefore, it is possible that the number of BITs with developing countries, accounting for the minority share of FDI inflows into the countries in question, is still too small to show significance. Second, it is possible that determinants of FDI may differ between developed and developing home countries and issues with respect to treatment of foreign companies in the host countries may not be important for FDI from developing countries (Banga 2003, p. 29).

The study also found that BITs act more as a complement to, rather than a substitute for, good institutional quality and local property rights. In host countries with weak domestic institutions, including weak protection of property, BITs have not acted as a substitute for broader domestic reforms. On the other hand, countries that “are reforming and already have reasonably strong domestic institutions, are most likely to gain from ratifying a treaty” (Hallward-Driemeier, 2003: 22–23).

In another study, Tobin and Rose-Ackerman (2003) analyzed, first, the impact of BITs on total FDI inflows – measured as a share of inflows into a host country in world FDI inflows – averaged over five-year periods, from 1975 to 2000 with some data going back to 1959, and

covering 45 plus host developing countries. In the overall analysis, the study concluded that the number of BITs seems to have little impact on a country's ability to attract FDI. However, there appears to be an interaction between the conclusion of BITs, on the one hand, and the level of political risk and property rights protection, on the other hand. Countries that are relatively risky seem to be able to attract somewhat more FDI by signing BITs. For those that are relatively safe for investors, the marginal effect of BITs is small (Tobin and Rose-Ackerman, 2003: 19).

Beginning in 2004, there has been a shift in the empirical literature towards a more positive assessment of the BITs' impact on FDI. Studies showing a positive impact of BITs on FDI started to prevail, although those questioning such an impact have not altogether disappeared. Egger and Pfaffermayr (2004) analysed the effect of implementing a new BIT on bilateral outward FDI stocks. In addition, the paper examines the potential anticipation effects after signing and before ratifying a BIT. Using bilateral outward FDI stock data from 19 OECD home countries (old and new) and 57 host countries (including 27 OECD member countries) the paper demonstrated that BITs exert a positive and significant effect on outward FDI of home countries in BIT partner host countries, if the treaties are actually implemented. Moreover, even signing a treaty has a positive –although lower and in most specifications insignificant – effect on FDI. These results are robust to alternative measures of relative factor endowment differences, to the impact of trading blocs such as the European Union (EU) or the North American Free Trade Agreement (NAFTA), and to infrastructure endowments.

The study also addressed the issue of how much more FDI a developing country can expect if it aggressively engages in a programme of concluding BITs with developed countries. The overall effect of concluding BITs sometimes depended on the level of institutional quality. However, it is difficult to say whether the demonstrated benefits of concluding BITs in the form of increased FDI inflows are higher than the substantial costs developing countries may incur in negotiating, signing, concluding, ratifying and complying with the obligations typically contained in such treaties (Neumayer and Spess, 2005: 1583).

OVERALL RESULTS / FINDINGS

The impact of BITs has to be seen in the context of the overall host country FDI determinants. Key among them is the economic attractiveness of host countries concerning the size and growth of the market, and the availability and costs of natural resources, as well as inputs such as skills, infrastructure services, or intermediate goods. Economic determinants interact with policy and institutional determinants of FDI, enhancing or reducing the attractiveness of countries to FDI.

BITs add a number of necessary components to the policy and institutional determinants for FDI, and hence impact FDI inflows into developing countries only indirectly. Although most BITs do not change the key economic determinants of FDI, they improve several policy and institutional determinants, and thereby increase the likelihood that developing countries engaged in BIT programme will receive more FDI.

The potential for BITs to have an impact on FDI inflows is also confirmed by investor surveys. Accordingly, BITs – and other IIAs – are important to TNCs in terms of investment protection and enhancing stability and predictability for FDI projects. For the majority of surveyed TNCs from all sectors, BIT coverage in host developing countries and transition economies plays a role in making a final decision on where to invest. Further evidence that TNCs increasingly make use of BITs is provided by the rapidly increasing number of investment arbitration cases based on these agreements.

As has been seen, developing countries sign bilateral investment treaties (BITs) in order to attract more foreign direct investment (FDI). In recent decades BITs have become 'the most important international legal mechanism for the encouragement and governance' of FDI (Elkins, Guzman and Simmons 2004, p. 0). The preambles of the thousands of existing BITs state that the purpose of BITs is to promote the flow of FDI. Despite the large and increasing number of BITs concluded, there exists very little evidence answering this question. Most existing scholarship, typically written with a legal perspective, simply restricts itself to an analysis of the BIT practice of one country or certain similar provisions in a range of BITs (Vandeveld 1996, p. 545). This omission is strange given that the question is of great importance to developing countries. They invest time and other scarce resources to negotiate, conclude, sign and ratify BITs. Such treaties represent a non-trivial interference with the host countries' sovereignty as they provide protections to foreign investors that are enforceable via binding investor-to-state dispute settlement. While the motivations driving developing countries to incur these costs may be varied (see Guzman 1998; Elkins, Guzman and Simmons 2004; Neumayer 2005), the costs might be justified if the ultimate outcome is an increase in the inward flow of FDI.

As seen, there is scope for pessimism toward the effect of BITs on FDI location. Sornarajah (1986, p. 82), for example, suggests that 'in reality attracting foreign investment depends more on the political and economic climate for its existence rather than on the creation of a legal structure for its protection'. An expert group meeting sponsored by the United Nations Conference on Trade and Development (UNCTAD) in 1997 reportedly held a similar position (Raghavan 1997). Supportive of this view is that some major hosts of FDI like Brazil or Mexico for a long time were reluctant to sign BITs. As UNCTAD (1998, p. 141) has put it in a review of BITs from almost a decade ago: 'There are many examples of countries with large FDI inflows and few, if any, BITs.' And yet, most developing countries have signed a great many BITs by now.

DISCUSSION : THE RIGHTS OF THE FOREIGN INVESTOR TO SUE THE HOST STATE

Inasmuch as foreign investment treaties promote the interests of the foreign investor, it is consistent with the purpose of the treaties that they all depart from a traditional principle of international law in allowing not just the state parties to the treaties, but the investors themselves to directly bring a claim before an international tribunal. Also, a number of treaties are drafted to ensure that contracts concluded by the host state and a foreign investor under the laws of the host state are also subject to the international guarantees provided by the treaty, including the dispute settlement mechanism. For purposes of ICSID proceedings, for example, the states have, as a rule, agreed in advance, on the basis of Art. 25 and 26 of the ICSID Convention, to refrain from requesting that local remedies be pursued. In turn, the investor's home state agrees not to grant diplomatic protection. Because the guarantees contained in the treaty are placed outside of the realm of diplomatic negotiations on the state-to-state level, the laws of the host state are subject to international review at the will of a foreign investor. At the same time, the classical stance of international law as inter-state law is modified in the field of foreign investment by lifting individuals onto the international plane vis-a-vis the host state.

In Investment – Treaty arbitration jurisprudence, there are various ways for an individual entity/person to be qualified the right to bring an international claim against the state. The problem lies in the fact that under investment treaties, the particular form of individualization that is adopted is far-reaching. This is strengthened by two essential aspects. First, many investment

treaties limit or remove the duty of the investor the need to exhaust local remedies and allowing them to bring a claim before the host state's courts have had the opportunity to resolve the dispute (Harten, 2007). This was also laid down in the case of *Maffezini (Emilio Agustin) v. Kingdom of Spain* (2000), *CME Czech Republic BV v. Czech Republic* (2003) as well as *Societe Generale de Surveillance v. Pakistan* (2003). Second, these treaties encourage forum-shopping by allowing claims by foreign corporations without imposing restrictions in shareholder nationality or minimum thresholds of foreign ownership and control (Harten, 2007). Thus, this gives a wide latitude to individual investors to bring claims more easily to the detriment of the host state, leading invariably to large number of litigations.

Further, under investment treaties, the host state's general consent and ratification of the bilateral treaty entails a broad waiver of its immunity from suit, not only before an international tribunal but also before a domestic court called upon to enforce an award. In addition, investment treaties authorize the enforcement of awards by investors under the ICSID Convention or the New York Convention. As a result, investors can seek enforcement of an award against assets of the respondent state in any state that is a party to these treaties (Harten, 2007).

Thus, if a state refuses to abide by an award, it may be subject to diplomatic and economic pressure from the home state, from other capital-exporting states, from international financial institutions, and from the international capital market. Further, investment treaties often obligate states in express terms to recognize and enforce an award issued under the treaty, which allows an investor to seek enforcement in the courts of any state party to the treaty itself. Most importantly, where an investment treaty provides for enforcement under the ICSID Convention, the Panama Convention or the New York Convention, an investor can seek enforcement in the domestic courts of any state party to these arbitration treaties (Shreuer, 2008). This last method of enforcement, according to Harten (2007), is exceptionally powerful as most states have ratified at least one of these three treaties: for example, approximately 165 states are party to either the New York Convention or the ICSID Convention.

Based on this structure, investment treaty awards are more widely enforceable than the rulings of any court or tribunal, international or domestic that has the authority to resolve individual claims in regulatory disputes.

By opening the door to parallel claims and forum-shopping under so many treaties, states, specially developing economies, have moved too far to their detriment in international business. It seems they have executed a transformation of international obligations and adjudication without adequate consideration of the consequences.

SUBSTANTIVE GUARANTEES FOR THE FOREIGN INVESTOR: THE COROLLARY OF REDUCED SOVEREIGNTY

The various substantive rules contained in investment treaties bearing upon domestic legal systems of the host countries emanate from different sources of international law. In part, they are based on autonomous treaty law specifically negotiated among the parties to the treaties. Other aspects of the treaties merely restate customary international law that would be applicable even in the absence of a treaty. In all of these treaties, both types of substantive rules are subject to interpretation and application by international tribunals, and thus become part of a more rule-oriented institutionalized system of compliance than exists under classical international law. As

a result, the power to identify, apply, and enforce the rules has been shifted away from the free will of states, because of their voluntary acceptance of these rules.

In practice, three types of clauses typically contained in investment treaties have the most severe impact on domestic legal systems. These are: (a) clauses providing for rules on indirect expropriation; (b) clauses on fair and equitable treatment of foreign investors; and, (c) clauses on the protection of investment agreements concluded between a foreign investor and the host country (“umbrella clauses”). While other provisions—such as those governing admission of an investment or concerning the cross-border transfer of payments by the investor—will also be of practical significance, the everyday life of the investment will mainly be affected by the understanding and the operation of these three rules. Thus, the interpretation and application of the relevant clauses and their variations deserve special examination in attempting to understand the effect of investment treaties on the host country’s ability to determine its own administrative regulatory system.

RISING BACKLASH AGAINST INVESTMENT ARBITRATION- STATE DEFENSES

There has been an increasing discontentment with investment arbitration by most countries, which must be taken in to consideration by the developing nations before the venture in to such treaties with the hope that they would encourage greater capital inflow in to the economy. Rigid interpretation of contracts is of concern primarily to governments, who see it as favouring investors, as bilateral investment treaties (BITs/IAs) usually authorize only investors to bring claims on their contracts in international forums while host governments and nations rarely have parallel rights. Thus, investors do not suffer from the typically rigid attitudes towards contracts (Waibel, 2010).

Governments of host countries in financial crises, specially developing and emerging economies, such as Indonesia in 1997/1998 and Argentina in the early 2000s, can be viewed as being much like the soldier or the devastated house owner. (Wells, 2010). Governments in the past cases facing a collapsing economic house have not generally been relieved of their contractual obligations to foreign direct investors when cases have gone to arbitration.

Case of Indonesia: Perspective of a developing economy in Asia

Following the Asian currency crisis, two US investors in Indonesia were given awards by arbitrators that showed little sympathy for the need for relief (*Karaha Bodas Company v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara*, 2000). With the collapse of the Indonesian currency, the government – and its state-owned power company – had tried to renegotiate contracts for unfinished power plants that that would have produced electricity thought not to be needed in the subsequent deep recession and which required its purchase at prices that were upto six times in local currency what had been originally negotiated. It would have been political suicide for the government to authorize such price increases.

Many investors renegotiated their arrangements. Some, however, refused and turned to arbitration. Arbitrators, with little attention to the collapsing economy in Indonesia, awarded investors not only what they had invested in the projects to date – a sensible base award- but also a substantial portion of the net present value of 30 years of future earnings (Wells, 2003).

Case of Argentina (*CMS v. Argentina*): Perspective of developing economy in South America

More than 30 cases of the cases presently pending before ICSID have been brought against the Republic of Argentina and assert that the Argentine Government's response to the catastrophic financial crisis that hit the country in late 2001 and 2002 impaired investor rights secured under several of Argentina's BITs/IAs. (Waibel and Kaushal, 2010). These cases are of extraordinary importance, not just because of the immense financial liability to which they expose Argentina, but also because, in response, Argentina has invoked a broad set of legal arguments about the rights of states to craft policy responses to extraordinary situations such as a massive financial collapse.

It all started in the last weeks of 2001 when Argentina experienced a financial collapse of magnum proportions (Burke-White, 2010). In one day alone, the peso lost 40% of its value. (The Economist, Mar. 2-8, 2002, p.26). In response to the crisis, which some likened to the Great Depression of the 1930s in the United States, Argentina adopted several measures to stabilize the economy and restore political confidence. Among these efforts was a significant devaluation of the peso through terminating the currency board, which pegged the peso to the US dollar, the pesification of all financial obligations, and the effective freezing of all bank accounts through a series of measures known collectively as the *Corralito*. (Lopez, 2002).

Though these measures offered a long-term prospect of restored economic confidence and stability, they also imposed immediate and painful costs on all participants in the Argentine economy, including foreign investors. While the Argentine citizens had little recourse legally, many foreign investors who were harmed by Argentina's response to the crisis sought legal protection under the regime of bilateral investment treaties (BITs) which Argentina had entered in to the 1980s and 1990s (UNCTAD, 2000). Apart from offering investors guarantees including the internationalization of contractual breached ("umbrella clauses"), national treatment and most favoured nation protections, these treaties often provided investors the possibility of direct investor-state arbitration. (Sornarajah, 2004).

For investors harmed by Argentina's response to the economic crisis, the possibility of direct arbitration against the Argentine government for breaches of BITs offered a potentially promising means to recoup losses suffered during the crisis. Claims framed as a violation of a BIT could be brought directly against Argentina through ICSID. Only limited means are available to challenge ICSID awards and such awards are generally enforceable in national courts. (Burke-White, 2010, p.410).

Not surprisingly, Argentina has become subject to no fewer than 43 ICSID arbitrations brought by investors asserting that Argentina's response to the crisis harmed investments protected by various BITs/IAs (ICSID, 2007). Argentina's potential liability from these cases alone could be greater than US \$ 8 billion, more than the entire financial reserves of the Argentine government in 2002. Some have speculated that the total value of potential claims against Argentina could reach US \$ 80 billion (Burke-White, 2010, p.411).

Argentina asserted two separate arguments that go to the heart of the sovereign prerogative of states to develop policies to address exceptional circumstances. This first is based on treaty law and the second on customary international law. Argentina's treaty law argument invokes the non-precluded measures (NPM) provisions of Argentine BITs/IAs that exempt certain actions taken by states in response to extraordinary circumstances from the substantive protections of the treaties. According to Argentina's customary international law argument, the doctrine of

necessity precludes the wrongfulness of Argentina's actions in response to the crisis. These arbitrations thus test both the limits of state freedom of action and investor protections under the BIT/ IIA regime in exceptional circumstances.

The resulting jurisprudence of the ICSID tribunals in the four cases against Argentina decided as of early 2008 is deeply problematic, due in part to poor legal reasoning and questionable treaty interpretations. In fact, these litigations have cost Argentina very dearly as it has been made responsible for harms to investors notwithstanding the severe financial crisis it faced.

The way which conflicting decisions have arisen from the tribunals in these cases establish no precedent, hence no stability and certainty that could comfort developing and emerging economies that could face catastrophic crisis.

Inside industrialized and developed countries, companies in crises have options that can excuse them from honoring a wide range of contracts. For instance, a US company that goes through bankruptcy can end up with rescheduled or even discharged debt, renegotiated union contracts and relief from contractual pension obligations. Surely it is not surprising that a backlash occurs when a host country fails to receive similar relief from obligations to direct investors when it faces severe economic problems.

In fact, the regimes that handle sovereign obligations of developing countries generate oddly perverse outcomes. With arbitrators' rigid interpretation on contract, foreign direct investors are likely to come out better in crisis-stricken countries than are holders of sovereign debt. Governments sometimes reduce the value of debt unilaterally – by 70% or so in the Argentine case- or negotiations in the London Club or the Paris Club result in rescheduling or partial discharge – while foreign direct investors stand to be made whole by arbitrators. This creates a topsy-turvy world where foreign direct investors stand ahead of debt holders in the queue for claims in crises. Direct investors hold equity in their projects and contend that they should earn higher returns than lenders, as compensation for the risks associated with equity (Waibel, 2010). Yet, when it comes to dispute settlement for countries in crises, the priorities are the opposite of what a bankruptcy court would establish inside an industrialized country.

Further, States have increasingly relied on customary public international law as a defence to excuse investment treaty breached. Argentina, in particular, has recently invoked the doctrine of necessity to excuse any breaches of its investment treaty obligations in the numerous disputes that arose from the economic crisis of 1999-2002. Such public international law defenses, collectively called state defenses, excuse a state's actions if specific preconditions are met. These include force majeure, necessity, bribery/ international public policy, legitimate exercise of sovereignty, including other several defenses based on customary public international law. Though these defenses can be invoked even in the absence of a specific provision in an investment treaty, they are subject to strict limitations. Only a limited number of investment arbitration tribunals have accepted state defenses (Martinez, 2010). Moreover, it needs to be pointed out that even when these defenses are successful; their effect is often merely to suspend the state's obligation for a short period of time. In practice, that means that the state defense will only reduce the amount of compensation payable and the state will not be fully excused for its behavior. Thus, state defenses are not an easy way for a state to escape its international responsibility. Even the defense of "legitimate use of sovereign power" has not yet been established in the realm of investment arbitration – only three tribunals have relied on this defense to date (Waibel, 2010). However, it has been noted by Martinez that the trend is beginning to look as if the tribunals are now more willing to consider the specific circumstances

faced by states and less perceptive to the plight of investors. This is arguably a symptom of the backlash against investment arbitration (2010).

Further, under almost all BITs/IAs, the state has no authority to go to arbitration to collect damages from an investor that does not carry out its obligations under an investment agreement (Waibel, 2010). Most of the time, it is the investor who is able to initiate the renegotiation of the contract when they face problems. A World Bank study of renegotiation of infrastructure investment agreements in Latin America found that more than half of renegotiations have been initiated by investors, not by the host nation (Sornarajah, 2009).

One good instance of this was in the *Aguas Argentinas* case (*Aguas Argentina S.A. Suez, Sociedad General de Aguas de Barcelona S.A. and Vivendi Universal S.A. v. The Argentina Republic*, ICSID, 2006) involving water for Buenos Aires, which was heard at the ICSID. In the past, Suez and other investors in this project had initiated renegotiations to change the terms to be more favourable to them. The government had no international rights to enforce the terms of its original contract when faced with investor demands. On the other hand, when the Argentine financial crisis struck and the government was under pressure to renegotiate, the lead investor filed for arbitration to enforce the most recent version of its agreement.

More crucially, the terms of many deals struck by foreign investors in developing countries reflect corruption or incompetence, or both, on the part of government officials. This is mostly due to the relative political instability in developing nations and when a new government takes over, agreements and treaties signed by previous government could be subjects of disputes. Even under this head, the host state, specially developing nations are at a disadvantage in front of the tribunal. Only rarely have arbitration panels been willing to conclude that an agreement was unfair to the host country because it was negotiated with corruption or by officials lacking adequate competence. The standard of proof for corruption has been so high that few governments have been able or willing to produce convincing evidence. This has been the case even when publicly available facts indicate that corruption or substantial conflict of interest was present in the original negotiations. As a result, contracts that are unfair to the host government are enforced. Regardless of the fact that terms dramatically out of line with terms elsewhere may have been the result of incompetent officials, poor or no outside counsel, or corruption. Thus, developing countries would be forced to pay up even on what they reasonably view to be “odious agreements” which had been signed by previous corrupt or inefficient governments. This onerous legacy and liability would continue to persist on the countries’ governments.

Moreover, investor-state arbitration has been infamous for attracting calumny regarding arbitrators’ integrity. Arbitrators tend to favour the claimant- investor in order to increase prospects of reappointment. (Harten, 2007). This is especially true when the appointing authority is the International Centre for Settlement of Investment Disputes (ICSID) – a World Bank affiliate. Though these contentions and perceived bias apprehensions have been also offset by the number of decisions of tribunals that have been in favour of the host states.

In fact, all these factors have led to several countries, especially in Latin America such as Bolivia and Ecuador, to pull out of the entire system, either partially or wholly. Disenchantment with the entire investment arbitration system has led to a number of reactions by developing and emerging economies, including the termination of treaties providing for arbitration (Schreuer, 2010). In fact, Bolivia denounced its adhesion to the ICSID Convention while Ecuador’s new constitution generally prohibits treaties or other international instruments that require arbitration in commercial disputes with private parties (Montanes, 2007).

TOWARDS A MULTILATERAL SYSTEM OF INVESTMENT PROTECTION

In the current negotiating round of the World Trade Organization (WTO), which began in Doha in Qatar in 2001, an effort was made by developed states to reach an agreement on a multilateral investment treaty. This attempt failed, but the same initiative may be taken again in the future. What is of interest for the present discussion is that developing states such as Brazil, India, Malaysia, and even China spoke out against the proposal. These countries argued that they had reason to fear that such a multilateral treaty would significantly curtail their control over their domestic regulatory space and that future studies would be necessary to examine the impact on their national legal order.

It is not clear at the moment whether and under what circumstances the effort to create a multilateral investment system will be revived inside or outside the WTO framework. It is clear that a certain ambivalent attitude prevails when, on the one hand, more and more developing states are willing to negotiate bilateral investment treaties among themselves, such as the recent agreement between China and India, but when, on the other hand, the same countries nevertheless object to a corresponding multilateral treaty because of an allegedly undesirable reduction of regulatory space and other potential effects of such treaties.

TOWARDS A TRANSNATIONAL REGIME FOR FOREIGN INVESTMENTS

On one level, states have accepted that the willingness to conclude investment treaties is recognized today as the passport to the global competition for foreign investments. While this recognition is accompanied by a partial loss of national sovereignty, reformers in developing countries nevertheless see these investment treaties as powerful tools for the modernization of the domestic administrative legal system, providing effective external checks and discipline on deficiencies and shortcomings which may be difficult to agree upon and to implement at the domestic level. The growing subjection of states to mechanisms of international dispute settlement is based on the acceptance by these states of the notion that international economic relations require internationally agreed rules and that these rules need to be enforceable.

CONCLUSION

Foreign Direct Investment is one of, if not the, most important force driving economic globalization. It can be especially helpful for emerging and developing economies, to which more than one-third of all investment flows.

As a part of this force, the proliferation of bilateral investment treaties (BITs/IAs) is an expression of the wider trend of treaties being used as basic international “legislative” instruments and represents a further movement toward economic globalization as well as more crucially, the juridification of key relationships in the global economy. They also contribute to a fundamental change in international law – the individual or legal person in private law is assigned individual rights through a treaty in international law and thus, upgraded to the status of a partial subject of international law. Further, in international investment law, globalization has caused the states to transform their role as the guarantors of legal certainty: states no longer establish law and order on their own but rather provide for and guarantee the establishment of law and order through the provision of investor-state dispute settlement procedures. It has been seen by a number of empirical studies that there is no significant correlation between signing of

BITs and FDI inflows in to the country. There are many other important factors and determinants.

The preceding remarks have shown that the treaty-based rules for foreign investment can be seen from a variety of different perspectives. Concerning the host state's sovereign rights (as traditionally understood), these rules will operate as significant barriers that may turn out to be costly to disregard, as some states have found in the past decade. This has been further bolstered by the lack of symmetry in the current dispute settlement regime, with protection accorded to investors but not for host governments is patently unfair to host nations and puts them at a disadvantageous position right from the outset -it is, of course, in the view of the author, a product of the unequal bargaining power when rich countries negotiate treaties with poor countries.

For foreign investors, it is precisely this reduction of sovereign regulatory space that is indispensable for their investments to benefit from long-term legal stability and predictability, thus providing for a fair return that is consistent with their legitimate expectations. Obviously, under certain circumstances, the focus on state sovereignty will collide with the expectation of the foreign investor and with the notion of good governance. Although no single set of guidelines exists to direct each state as it seeks to strike a balance in these matters, the international trend, especially of developing countries, is certainly to place higher emphasis on an investment-friendly climate leading to economic growth rather than on legal and political concepts of national sovereignty. This practice must, in the view of the author, be cautiously exercised given the multitude of litigations and costly disputes that could cost the economies of the developing host nations dearly in the future.

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Summary:

Bilateral Investment Treaties (BITs) / International Investment Agreements (IIAs) are signed between two countries under which a country binds itself to offer treaty-based protection to investments and investors of another country. This paper would see if there is a positive correlation between signing BITs/ IIAs and foreign investment inflows in developing countries. It would be seen whether it is prudent to sign BITs/ IIAs given the restriction on policy space to host nations as BITs/ IIAs are structured purely for foreign investors, granting them extensive rights without recognizing the right of sovereign states to regulate in the national interest.

Key words: Arbitration; Foreign Direct Investment (FDI); state sovereignty; tribunal.

JEL classification: G18