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A LEVEL PLAYING FIELD FOR DIRECT INVESTMENT WORLD-WIDE

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Introduction

Investment, environment, competition, social and other issues were identified at the end of the Marrakech Ministerial as possible themes for the WTO. The European Union will very shortly have to develop an overall strategy on these themes. The present paper deals with one subject, because it is not only a potential WTO theme, but also a subject for decision at the OECD Ministerial meeting this May.

1. What is at stake

The surge of global Foreign Direct Investment (FDI) [1] since the beginning of 1980s has transformed the old text-book model of trade, in which manufacturers made all their goods in one country and shipped them abroad. In their modern production strategies, firms ship components from all over the world to their world-wide network of assembly plants. In services, entering a foreign market more often than not comprises commercial presence in the market by setting up a subsidiary abroad.

Accordingly the Commission's White Paper on Growth, Competitiveness and Employment points out that world economic relations are no longer limited to international trade in goods and services. In the world economy, the Community and all major partners are interdependent: Community policies must reflect and build on this reality. [2]

Foreign Direct Investment has become an essential element in today's complex corporate investment and production strategies. The development of global instantaneous communications and data transfer has resulted in the creation of a near global market place. Modern economic operators are involved in a continuous process identifying shifting comparative advantages which today stem from such factors as knowledge base, innovation capacity and the quality of human capital. The world-wide trend towards deregulation and privatisation has given a further boost to this phenomenon.

The creation of a truly global system of markets and production is reflected by 11 per cent compound growth in the last 30 years: stocks world-wide have risen from USD 68 billion in 1960 to 1650 billion in 1993. Annual flows in FDI have grown from USD 60 billion in the mid 1980s to USD 140 billion in 1993. The spectacular raise in FDI has complemented and created trade, not substituted it. Conservative OECD estimates show that at least 40 per cent of world trade is intra firm trade, so exports can be said increasingly to follow investments.

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[1] The OECD definition of FDI comprises investments for the purpose of establishing lasting economic relations with an undertaking, such as, in particular, investments which give the possibility of exercising an effective influence of the management thereof.

[2] European Commission: Growth, Competitiveness, Employment; The Challenges and Ways forward into the 21st Century; White Paper; Parts A and B; Brussels/Luxemburg, 1994; p. 121. (See also for a more detailed analysis of Europe's position in the world economy).

The US, the Community and Japan (in that order) remain the most important sources of FDI with the non-OECD countries playing a minor but increasingly important role, in particular the more dynamic ones (NICs, some countries in Latin America).

However, dramatic changes are taking place as far as the major host countries are concerned. The share of inward investment flows towards the US and the Community, stable during the 1980s at about 60 per cent, has declined markedly to around 30 per cent in 1993 [3]. On the other hand, the vigorous expansion of investment flows towards non-OECD countries is the most notable feature of recent FDI development: in 1993 these countries were attracting USD 80 billion worth of direct investment from abroad or nearly 55 per cent of total inward FDI. We can expect this trend to continue. [4]

Foreign Direct Investment today takes many forms. Besides the traditional green field investments or take-overs, modern operators more and more resort to forms of businesss cooperation, e.g. in joint ventures, strategic alliances or pooling of research and development resources.

These developments underline that the general attitude towards FDI has changed. While in the seventies, the debate was largely dominated by the concern that globally operating MNEs would interfere with the independent development of the states, today it is now almost generally accepted that FDI is a beneficial phenomenon - not only for the host-, but also for the source country and will contribute to securing our energy supplies among other things (the European Union is increasingly dependent on imported energy).

The OECD lists the injection of extra investment capital into the economy, the contribution towards a healthy external balance, increased productivity, additional employment, stimulation of competition and rationalisation of the production as well as significant transfer of technical and managerial know-how as positive effects for the host economy. Recognising this, the developing countries have given up much of their restrictive attitude against the inflow of FDI. They are often willing to allow free transfers without restrictions for balance of payments reasons, have proven to accept global disciplines on trade distorting investment matters in the Uruguay Round and are even generally starting to compete for investment from abroad. Since the dramatic change in East-West relations it has become more evident that foreign investment is a scarce resource which no one can afford penalising.

Outward FDI sometimes is still perceived as associated with the loss of jobs ("delocalisation"). However, empirical studies have not come to uniform conclusions on the impact of outward FDI on employment. The assumption of overall positive employment effects is based on the fact that all investment, including outward FDI, generates secondary flows such as exports of machinery and other capital goods, demand for manufactured production inputs or provision of know-how, which are usually provided by the source country. This creates jobs in secondary sectors, often higher qualified and paid than those that might have been lost. In addition, investment abroad will generate inward flows of profits and dividends which, in turn, increase incomes and hence demand in the source country. Again this has beneficial effects on overall growth and

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[3] Excluding intra-Community FDI flows.

[4] For more statistical information see Annex I.

employment levels. To these can be added the longer term development effect of FDI on the host economy which, in time, expands the local market and creates demand for imports, which will, in part at least, be met by producers in the country from which the investment originated. The discussion on the employment effects of outward FDI should also take into account the motivation to invest abroad: studies show that investments by multinational companies are host-market driven, either to buy into a market or to improve servicing the market. In general, access to "cheap labour" does not play an overriding role to invest abroad.

The increasing role of small and medium-sized enterprises (SMEs) in international investment activities is of particular importance for the Community. While the majority of foreign investment continues to originate from large multinational companies, the role of SMEs is growing and the United Nations Centre on Transnational Corporations (UNCTC) has identified more than 3700 SMEs world-wide which have invested abroad, representing about one tenth of international investments. UNCTC concludes in a study that these companies offer greater opportunities for training, transfer more technology and are more likely to reinvest profits and to use local production inputs, than investments by the large ones.

Europe should be able to profit fully from the world-wide trend of liberalising FDI. European firms, including SMEs, have usually widespread familiarity in investing away from home as a result of intra-Community experience where little restrictions on FDI remain. Thus, the European firms are in a good starting position when it comes to making use of investment opportunities. In addition, the Community has at its disposal several instruments that inform about investment opportunities and support the activities of its firms abroad (BC-Net, Euro Info Centres, BRE, PHARE, TACIS, JOPP, MED-Invest, AL-Invest and EC-Investment Partners Programmes).

To make use of their good starting position European companies would greatly profit from a sound world-wide regulatory framework for FDI in which the right to invest and fair treatment of FDI once it has entered the host country are firmly established. However, currently no multilateral level playing field for FDI does exist.

2. The current multilateral rules for FDI

Since no single comprehensive set of rules exists, numerous bilateral and a number of regional and multilateral agreements produce a fragmented, non-transparent picture for FDI. Growing awareness of the present shortcomings have led to attempts to remedy this situation.

In the framework of the Uruguay Round the first small steps have been made to address trade related investment issues, but the motivation was to avoid trade distortion, not liberalising investment flows. The GATS sets standards for the commercial presence of a service provider in another GATS Member State and therefore covers a substantial part of FDI. The results in key service sectors are, however, not yet satisfactory. Here as well, the issue is addressed from a trade perspective and important elements of the promotion and protection of investments are missing.

The OECD Codes of liberalisation and the non-binding OECD National Treatment Instrument relate directly to some investment matters, but the OECD instruments apply to the limited number of OECD Members and lack stringent dispute settlement procedures.

The Energy Charter Treaty provides binding national treatment in the post-investment phase, with stringent dispute settlement procedures. For the present, only non-binding provisions apply to the pre-investment phase.

In the recent past regional and sectoral arrangements, such as the rules on investment in NAFTA as well as the APEC investment code have been concluded. Also in the framework of the intended Free Trade Area of the Americas it is foreseen to eliminate progressively barriers to investment. But this is not the appropriate solution to the problem created by the lack of liberalisation and transparency. Regional arrangements can easily lead to discrimination for European operators, as the example of the preferential treatment for establishing US and Canadian banks in Mexico under the NAFTA shows, and therefore are potentially dangerous for Community interests.

In addition, there are more than 600 bilateral investment treaties, mostly between developed and developing countries. Since these agreements tend to be adapted to the particularities of the bilateral relations and the national interests involved they are without any uniformity between them and add to the risks of discrimination and lack of transparency.

This patchwork of rules [5] is unsatisfactory and is being increasingly seen as a very inefficient and non-transparent way of liberalising investment regimes and protecting investments abroad. Treatment accorded to European investments in different countries varies greatly. A third country may also discriminate between investments from different sources and even among investors from different Member States. As an example, a company established in a Member State with an affiliate established in another Member State may face different treatment for their investments in a third country outside the Community, if only one of the Member States has concluded a bilateral investment treaty with the third country or if both Member States have a bilateral treaty with a different level of protection. US and Japanese companies might again be treated differently, often better than the Europeans.

Nor is the present system able to preserve the liberalisation that has been achieved. There are tendencies, in particular in some OECD countries, to withdraw even from the existing level of liberalisation, as various calls for "conditional" national treatment in US legislation shows.

The present situation is particularly unsatisfactory for SMEs which do not have the means to monitor and adapt to the ever-changing conditions for FDI in the host countries. They are not able to defend themselves against government intervention or other adverse measures. They often will not take the risk to go to arbitration. It is arguable that the SMEs have the most to gain from clear and stringent multilateral investment rules.

Replacing the present system of bilateral investment treaties, regional arrangements and the OECD instruments by a transparent, multilateral agreement would assure that the rules of the game are the same for everyone. As a consequence, in its White Paper on Growth,

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[5] An overview of provisions affecting investment in existing multilateral instruments (WTO Agreements, OECD instruments, NAFTA, APEC, European Energy Charter Treaty, Lomé Convention) is given in Annex II. Details on provisions relating to investments in Europe Agreements and in Partnership and Cooperation Agreements are given in Annex III.

Competitiveness and Employment [6] the Commission considers the elimination of unequal conditions for direct investment an essential part of its strategy for an open world economy.

Therefore, it is the Commission's view that it is of vital interest to the Community and its Member States to actively pursue the establishment of multilateral rules for FDI. Consequently, it should develop a coherent approach to formulate the rules Community operators need and actively work for the implementation of these rules in the international context.

3. What multilateral rules on FDI

3.1. The principal rules of the game

Investment flows, like trade flows, will bring most benefits to the world economy when they can grow within a transparent and predictable system of accepted rules. The efforts will have to concentrate on three aspects :

- generally free access for investors and investments;
- national treatment for investors and their investment;
- accompanying measures to uphold and enforce commitments made to foreign investors.

a) Access for investors and investments (right of entry and establishment) :

World-wide there remains a host of barriers that prevent foreign investors to enter the host countries freely. Some examples: governments may only allow a foreign investor to set up a subsidiary or take over a local enterprise after a specific authorisation has been given. Foreign investors may only be allowed to start operations in the form of joint ventures together with local companies. Joint ventures sometimes cannot be majority-owned or controlled by foreigners. [7] Foreigners can be excluded from participating in privatisations or barred access to government concessions. Performance requirements, such as export or local purchase requirements, can be made a condition for establishment. Complete sectors of the economy like transport, energy or financial services can be closed for foreign investors.

These barriers clearly are costly - not only to the investor who is prevented from entering freely, but also to the host economy in terms of preventing additional employment, competition, transfer of technical and managerial know-how and a better integration in the rapidly changing world economy. However, completely unrestricted market access for FDI does not seem likely to be achievable in the real world. Just as under the GATT there is no completely free world trade, completely free investment flows will not be possible.

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[6] European Commission: Growth, Competitiveness, Employment; The Challenges and Ways forward into the 21st Century; White Paper; Parts A and B; Brussels/Luxemburg, 1994; p. 13

[7] The restrictions on joint ventures or other forms of business cooperation are especially harmful for SMEs, who more often than not need a local partner for technology, production or distribution in foreign markets.

Even the most liberal OECD countries maintain some restrictions for national security reasons or in traditionally closed or monopolised sectors, such as transport, energy, financial services or telecommunications. The reasoning for this, as long as it is not a cover for protectionist policies, can be sound. For example, a country should have the possibility to control the ownership of a strategically vital defence industry.

There are, however, a number of essential principles that should apply world-wide:

- A general commitment to grant the legal right for foreigners to invest and operate competitively in all sectors of economy.

- Only transparent, narrowly defined and well justified exceptions from the general right of entry for FDI are permissible. National security restrictions or public order considerations might not develop into a pretext for protectionism.

- Most favoured nation treatment (non discrimination). Host governments should not be in a position to accord preferential treatment for investors from certain countries and thus discriminate against others.

- A standstill commitment not to introduce new restrictions. Besides lowering the level of liberalisation and creating uncertainty among investors, the introduction of new restrictions would discriminate against potential new investors (for whom access to a market formerly open is closed) vis-à-vis investors already present.

- A "roll-back" commitment to gradually eliminate measures that run counter to liberalisation and to open up closed sectors.

b) National treatment for established investments :

Once the right of entry and establishment has been assured, the foreign investor might find the operation of his firm hampered by discriminating measures. Typical restrictions include a prohibition to own real estate, limited or no access to government aids and subsidies (the most important example is the participation in R&D programmes), discriminatory tax provisions or an exclusion from bidding for government contracts.

While most of these restrictions discriminate against foreign investors and should be outlawed, not all can be regarded that way. In the important case of access to R&D subsidies, for example, governments have an interest to ensure that they are getting "value for money". Restrictive conditions attached to the access to such funds can therefore be accepted, but the nationality of the investor should not be the decisive criteria. Also, narrowly defined public order and national security exceptions should be possible.

In general, however, the host country should treat the foreign investor and his investment operating in its territory in the same way as a domestic investor or firm. The national treatment principle will have to be complemented by the most favoured nation standard in cases where host countries grant to foreign investors specific favourable conditions that are not available to national investors. This avoids discrimination between investors from different foreign countries.

c) Accompanying measures :

The right of entry and national treatment alone are not enough to create the favourable conditions which FDI needs. One basic requirement is an effective mechanism to settle disputes between source and host country. Another important element is the freedom to make financial transfers. Equally important is that expropriation of a foreign investment is only possible in exceptional, internationally recognised cases and that it is accompanied by prompt, adequate and effective compensation.

Host countries will also have to assure that their domestic regulations are transparent and that international obligations are honoured by sub-federal and local authorities.

The formulation of rules on international investment will also have to consider informal and structural barriers which are not directly linked to FDI, but can have considerable consequences for investment flows. Merger control and anti-trust legislation effectively can prevent the making of an investment. Private practices, such as ownership restrictions in company by-laws could discriminate against foreigners. Exaggerated investment incentives can distort the flow of investments or lead to an unintended "race to the bottom" between countries or regions. A multilateral investment instrument might even address taxation, labour or environment policies, as these can considerably influence the climate and conditions for FDI.

3.2. Defining objectives

Pursuing the establishment and implementation of these rules world-wide would be the cornerstone of a Community FDI approach, guaranteeing a high uniform standard of liberal rules governing FDI combined with its effective protection. Judging from the present level of restrictions, these rules will mainly benefit actual and potential Community investors abroad. Indeed, such rules on FDI represent an essential condition for the implementation of bilateral industrial cooperation agreements, which are increasingly becoming a key basis for international activity by Community firms, particularly SMEs. However, in this context, it should be kept in mind that the Community is also a large gross capital importer, competing for a relatively finite and scarce pool of world-wide available capital. This also means that in order to advance its overall interests, the Community will have to analyse the necessity to preserve measures by which its own and Member States' practice falls short of the principles cited above. Such practices to be examined could include authorisation regimes or capital movement restrictions still applicable in some Member States. Investment limitations on access to certain subsidies or R&D funds, restrictions in the interest of national security or economic need may also fall under this category. Although some existing restrictions could be justified as legitimate exceptions, the Community should be ready to discuss all these issues existing restrictions on inward FDI at the international level with the aim of achieving balanced results.

In any case it is in the Community's interest to retain under any international agreement on investment the right to advance its internal integration without necessarily being forced to extend de jure such mutual liberalisation measures to third countries. Any dilution of this possibility, as actually covered by OECD, GATS and the Energy Charter Treaty rules, should be resisted.

4. How to develop multilateral rules on FDI

The strategic interest of the Community in achieving liberal and predictable multilateral rules on FDI implies that the Community takes the initiative and actively participates in all credible attempts at a multilateral level to elaborate and establish such rules.

At the present stage useful work on FDI has been or is undertaken in the framework of the WTO and OECD. Each forum presents its particular (dis)advantages in relation to this work.

a) The role of the World Trade Organisation (WTO)

The interest of the Community and its Member States is to arrive at a multilateral agreement with the broadest possible participation. This is why, at this stage, the WTO seems to be the most logical and adequate forum for future negotiations on such an agreement.

Chances of a positive outcome of talks in the WTO within a reasonable time-frame are better than ever, since the issue of foreign investment has, in fact, been largely divested of its ideological overtones. A successful multilateral negotiation on the matter seems now a realistic proposition. Indeed, it is more likely to yield the desired ultimate result through the WTO, than through the alternative route which consists in a regional OECD agreement others have to sign up to over time.

It should be recognised that WTO in the context of the GATS and TRIMs already covers issues directly and indirectly related to FDI. Given the very strong and wide-ranging linkages between trade and investment the subject would also be compatible with the Organisation's mandate. The TRIMs agreement calls for a review of its operation not later than 1 January 2000, with a view of a broader discussion on provisions on investment policy.

The fact that WTO will not immediately take up investment issues should not be seen as a major impediment to this approach. The Community and its Member States should actively work for accelerating the timetable laid down in the TRIMs Agreement and push for starting work in the framework of the WTO on multilateral investment rules at an early stage, with a view to securing agreement at the first WTO Ministerial Conference in December 1996 that FDI should be on the agenda for active negotiations. The dramatic rise in FDI-flows to the developing countries will support these efforts.

b) The OECD efforts

OECD is currently studying the feasibility and possible content of a multilateral investment rules. The June 1994 OECD Council of Ministers decided that "OECD will (.....) contribute to strengthening the multilateral system by entering a new phase of work aimed at elaborating a multilateral investment agreement with a report to ministers in 1995". As a consequence, the OECD Secretariat and the OECD Committees working on investment issues intensified work in view of a possible ministerial mandate for actual negotiations to start between OECD members in 1995. The analytical work undertaken by the OECD experts provides valuable insights in the issues that dominate the international FDI discussion. The Commission and the Member States actively take part in the ongoing work.

A considerable number of OECD members have shown inclination for negotiations on a Multilateral Investment Agreement (MIA) open for accession by third countries in the OECD framework. However, one can question whether the OECD is ultimately the best forum for the negotiations on future rules governing world-wide FDI.

The argument in favour of an OECD approach is that most FDI activity occurs within the group of OECD countries and that it will be easier to elaborate an agreement of very high standards, in a reasonable time frame, among "like-minded" countries. Non-OECD members were therefore to be excluded from the negotiation, but could join the instrument once it is established. However, most of the OECD countries already have relatively liberal investment rules, while non-OECD countries and in particular the New Industrialised Countries have considerably less liberal and transparent investment regimes. In addition, the latter group of countries is attracting a growing share of world outward investment (50 per cent of world total in 1992, 55 per cent in 1993) and the most dynamic are themselves emerging as increasingly important sources of FDI. Recently a growing number of non-OECD economies have unilaterally begun to liberalise their investment regimes. Yet foreign investors still stumble against significant difficulties in many of these countries. As business operators in the Community increasingly recognise, it is of critical importance for the EU to ensure a permanent presence through direct investment in the new fast growing markets of Asia, Latin America, Eastern Europe and, in the more distant future, in Africa. Bringing the countries of such fast growing regions into a system of uniformly applied, multilateral rules on investment is the only effective way of assuring that all business enterprises, irrespective of origin, are able to compete on an equal footing.

Limiting a negotiation on multilateral investment rules to OECD members would exclude important actors, such as China, Korea, Brazil and South Africa, and also the countries of ASEAN and Central and Eastern Europe. With respect to the latter, the Community has a specific interest in associating them to the process in the light of the pre-accession strategy and our commitments embodied in the Partnership and Cooperation agreements.

To present these countries with the result of an exclusive OECD negotiation contains certain risks. Not only would it be politically difficult for many countries to accept such a procedure, they might well have sound economic grounds for not doing so if the OECD agreement, negotiated without their participation, did not adequately reflect their concerns. Consequently, an initiative for the elaboration of foreign investment rules should involve the countries of Central and Eastern Europe and the CIS Republics, the New Industrialised Countries and developing countries from the start. A world-wide phenomenon as FDI should be discussed with broad multilateral participation, if broad acceptance is to be achieved.

Recognising OECD's expertise and the important work on FDI already undertaken by the Organisation, the Community and its Member States should continue their active support of the analytical work now undertaken in OECD in view of elaborating multilateral rules for FDI and thus contributing to the strengthening of the multilateral system. Consequently, the OECD approach has to properly reflect the possible later participation of non-OECD members in such an agreement. Furthermore it has to be assured that the rules will present no obstacles to subsequent exercises on a broader geographical scale, in particular at WTO. The example of the GATS where OECD input provided the cornerstone of the Agreement is a good example of the positive role OECD can play on the way to international rules with the broadest possible participation.

c) <u>Bilateral agreements</u>

The long-term multilateral objectives of the Community in WTO and OECD could be supported by addressing problems on investment bilaterally through the conclusion of bilateral EC-third country investment treaties, in order to avoid discrimination against European enterprises (for example that which results from some third countries placing increasingly unacceptable conditions on National Treatment) and to secure the promotion and protection of investments of Community enterprises abroad.

d) <u>A focus on developing countries, Central and Eastern Europe and emerging economies</u>

Future discussions and action concerning FDI will need to pay particular attention to the developing countries, the countries of Central and Eastern Europe, the CIS countries and the New Industrialised countries. As pointed out above, the percentage of world-wide FDI destined to non-OECD countries is nearing the 50 per cent mark, as opposed to an average of around 20 per cent in the 1980s. More than one third of total capital flows from OECD to non-OECD countries now are FDI, and FDI has in large parts replaced concessional aid and commercial bank lending as the most important source of capital. Thus, it has become the principal financing mechanism for the modernisation and expansion of the economies in the emerging markets of Asia, Latin America and the Caribbean, and Eastern Europe.

This shows that FDI has an enormous potential for the benefit of international economic development. The dramatic surge in FDI to the developing countries and countries in transition has been helped by the gradual opening of these countries, but investment opportunities in general are still hampered by bureaucracy and ad hoc state interference, balance of payments restrictions, imposition of TRIMs, low protection for intellectual property rights and opaque authorisation and screening procedures. In this connection one should mention the catalytic role investment insurance schemes (such as the Multilateral Investment Guarantee Agency (MIGA), the investment insurance agency affiliated with the World Bank, but also national and private schemes) can play, in order to manage the investment risks associated with currency transfers, expropriation, war and breach of contact.

It is obvious that the elimination of these obstacles and stringent uniform international rules on open access for investment as well as effective national treatment protection could further increase the flow of FDI to the developing countries and Central and Eastern Europe. A major step in that direction was made by the Community in formulating investment principles with regard to the ACP states in the Lomé IV Convention (see Annex II).

- <u>Central and Eastern Europe</u>

  In the case of Central and Eastern Europe the benefits of FDI are of particular importance. It is generally accepted that the restructuring of these economies vitally depends on the attractiveness of these countries for foreign investment. The transfer of capital, technical and managerial know-how is a key element in making markets function. Multilateral rules on investment that are accepted by the Eastern partners

of the Community will greatly increase the confidence of Western investors and contribute to the implementation of the Community's pre-accession strategy for Eastern Europe and the Partnership Agreements.

- Developing countries

  Particular attention should be given also to the concerns of developing countries. These countries have a special interest that FDI contributes to human resource development and that MNE accept a social responsibility when acting in the host country. They in particular want to avoid that FDI inflows are motivated by low environmental or social standards, or that these standards are even lowered further to attract FDI. The Community therefore should accept discussing complementary safeguards, such as codes of conducts for good corporate citizenship for MNEs, to meet these concerns as an accompanying element to the general principles assuring the free flow and the protection of investments.

  Liberalisation of international direct investment flows can imply the liberalisation of other forms of capital movements. It has to be noted that other forms of capital flows to these countries, in particular portfolio investment, have grown in the past few years even faster: FDI to developing countries has quadrupeld between 1986 and 1992, whereas portfolio investment grew 50 times in the same period having already reached almost the same level as FDI. The Community has unilaterally liberalised its capital movement regime with third countries. Thus, in the medium-term, rules on world-wide investment and investment protection should be extended to all sorts of capital movements. In the future, IMF could also become active in this area.

The Community is aware that some of its partners, mainly in the developing world and Eastern Europe, are interested in assuring that in a first stage only capital movements in the form of FDI will be covered by an international consensus to liberalise for reasons related to money laundering, destabilising currency speculation and capital flight. Although the Community's capital movement regime is almost completely liberalised, it could be envisaged that the international rules for FDI ensure that the FDI link of capital movements covered are obvious.

5. Organising the Community approach

The implementation of the approach outlined in §§ 3 and 4 calls for further study on the effects of international direct investment and other forms of capital movement in a changing world economy. In this context, the Commission has recently published a discussion paper on trade and investment. [8]

There is a substantial change in Community law with regard to capital movement operations including investments from the regime which existed up to 1 January 1994 which basically only contained a "best endeavours" liberalisation requirement: the third-country regime of Member States on capital movements and with it the issue of market access for investments (pre-investment) has - with the beginning of the second stage of the

[8] European Commission, Directorate-General for External Economic Relations, Trade and Investment Discussion Paper, Brussels/Luxemburg 1995.

EMU - come under the Treaty (Article 73b to 73h). Existing restrictions on the movement of capital between Member States and third countries in some forms, including direct investment, may continue to be applied under the grandfather clause of Art. 73c (1) subject to their elimination or modification under the powers given by Art. 73c (2) to the Community.

In the operational field, the implementation of this approach implies a strengthening of the efforts of coordination between the Community and its Member States. Given the shared competence that exists for a very broad range of issues arising in the field of FDI, neither the Community nor the Member States can act on their own in a comprehensive negotiation on FDI issues. The essential objective will be to ensure full and effective Community participation in the discussions ahead. Close coordination will be necessary to ensure that the Community and its Member States speak with one voice.

The Community should also take up the dialogue with the European business community and trade unions with a view of identifying their preferences and concerns. The Commission is preparing initiatives in this direction.

6. Conclusions

The Commission requests the Council to take note of this Communication and suggests the Council to conclude along the following lines:

- to recognise the vital interest for the Community and its Member States to actively pursue the establishment of transparent, coherent and liberal multilateral rules on Foreign Direct Investment (FDI), while preserving its capacity for further internal Community integration. This will ensure the presence of Community operators in important and emerging markets and will provide the necessary confidence to its investors to take the investment decisions which will consolidate Europe's competitive position in the world economy. Multilateral rules on investment will prevent discrimination which may derive from the establishment of regional investment regimes and will discipline countries which still apply a number of TRIMs. Such rules will also enhance the attractiveness of the Community as a host for FDI for its partners, thus creating directly and indirectly employment and boosting growth and competitiveness;

- to recognise the important role of FDI for the restructuring of the economies in Central and Eastern Europe and for the economic progress in the developing world;

- to endorse the objective that these international rules on FDI should guarantee generally free entry and establishment for foreign investors, full national treatment for established investments and high standards of investment protection;

- to call for negotiations on international rules on FDI with the broadest possible participation the result of which should be incorporated into the WTO system;

- to request OECD, as a contribution to strengthening the multilateral system, to pursue its work aimed at elaborating a multilateral investment agreement;

- to urge an early start of discussions in the WTO in order to prepare formal negotiations which should begin as soon as possible;

- to invite the Commission to analyse further current problems related to inward and outward investment and to come forward with proposals where necessary;

- to encourage the European business community to contribute to the discussion on FDI;

- to agree to intensify work within the Community on defining common positions on FDI with a view to the implementation of these conclusions;

- to ensure, with the Commission, that the positions of the Community and its Member States on FDI be closely coordinated, in order to produce the necessary unity of action in OECD and WTO discussions.

Statistical Background on Foreign Direct Investment

The creation of a truly global system of markets and production is reflected by statistical evidence: FDI stocks world-wide have risen from USD 68 billion in 1960 to 1650 billion [1] in 1993 (i.e. 11 per cent average annual growth). According to UN and Eurostat figures, FDI world-wide has grown faster than GDP and trade by a factor of four and three respectively. The number of Multinational Enterprises (MNEs) has increased from around 7000 in the late 1960s to 37000 in the early 1990s. As a result of these developments, the sales of foreign affiliates have surpassed exports as the principal vehicle to deliver goods and services abroad. Firms' sales through foreign affiliates totalled USD 4800 billion in 1991, USD 300 billion more than the world-wide value of trade in goods and services [2]. Some estimates even put the value of goods and services sold by foreign affiliates even as almost twice as high as that of world exports. This alone makes FDI one of the most important mechanisms of international economic integration. UNCTAD estimates that as much as one third of world output is under common governance of MNEs - even if the estimation is too high, there can be little doubt that MNEs form the productive core of the globalised world economy.

The spectacular raise in FDI has probably complemented and created trade, not substituted it. Conservative OECD estimates show that at least 40 per cent of world trade is intra firm trade thus establishing a link between trade and investment according to the formula 'exports follow investments'. If compared to trade, FDI flows are still only a fraction of international trade flows (around 5 per cent). This comparison is, however, misleading insofar as an investment typically involves a larger and long-term commitment. Its economic and integrative effects surpass the comparatively limited effects of trading transactions.

The Community is by far the most attractive destination for foreign direct investors. Of the total FDI stocks of USD 1650 billion in 1992 about 30 per cent (USD 460 billion) is hosted by the Community [3]. The US host USD 420 billion, slightly more than the amount of all non-OECD countries aggregated (USD 370 billion). Japan remains notoriously behind with an FDI stock of below USD 40 billion. The other OECD countries (USD 350 billion) host the rest.

The Community is also one of the most important sources of FDI representing about 30 per cent of world-wide outward FDI (USD 470 billion). The US is the biggest source country with an outward FDI of USD 490 billion, while Japan with USD 250 billion is an important player. The non-OECD countries play a minor but increasingly important role with USD 65 billion.

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1 Source: UN World Investment Report 1994 excluding intra-EU stock (estimated).
2 Source: UNCTAD World Investment Report 1994.
3 Community of twelve Member States.

From these figures it emerges that the Community, the US and the other OECD countries have a more or less balanced situation in relation to inward and outward FDI stocks, while Japan is an important source country and the non-OECD countries are still mainly host countries.

The Group of Industrialised Countries (OECD) remains responsible for the bulk (95%) of outward FDI flows, but their share of inward investment flows has declined markedly in the last few years from more than 80 per cent in the 80s to 42 per cent in 1993. The vigorous expansion of investment flows toward non-OECD countries is the most notable feature of recent FDI development. In 1993 these countries were attracting USD 80 billion worth of direct investment, or nearly 55 per cent of total inward FDI, compared to an annual average of 21 per cent in the period 1980-90. More than two thirds of this figure was concentrated on 10-15 host countries, mainly in South East Asia and Latin America. This trend is expected to continue.

At the same time, the more dynamic economies of South East Asia and Latin America have themselves begun to invest abroad, predominantly but not exclusively in other countries of their region, with total FDI outflows of around USD 9 billion in 1992 and USD 14 billion in 1993. Four of the ten largest investors in China are East or South East Asian countries, and China has emerged as the main recipient of foreign non-OECD investments, as well as becoming, itself, an increasingly significant source of outward investment. FDI from these countries is also directed toward the mature industrial economies of Europe and North America. For example, recent investment and proposed investment plans toward the EU were proclaimed by PGI (Singapore) and the Korean conglomerates DAEWOO and SAMSUNG with the latter announcing a USD 700 million investment in a new electronics plant in the UK.

ANNEX II

Provisions in existing multilateral instruments with significant impact on FDI

1) World Trade Organisation (WTO) Instruments

General Agreement on Trade in Services (GATS)
The GATS covers investments in the form of "commercial presence" for the purpose of supplying a service. The benefits of the GATS are granted, i.a., to "service suppliers" of another Member. Investment as such is protected to the extent that the service supplier is more than 50 per cent owned or controlled by a natural or legal person of another Member. The GATS is the only agreement containing substantial obligations on FDI with potential world-wide coverage (over 100 signatories up to now). It covers all service sectors and its obligations extend to establishment and subsequent operations of the service suppliers of other Members. However, negotiations on important service sectors (financial services, basic telecommunications, maritime transport) are still continuing. Monopolies, government procurement and subsidies are also covered, but specific disciplines still need to be negotiated.

The central obligations of the GATS are to accord most favoured nation treatment for market access (exceptions possible) and national treatment (subject to limitations set out in each member's schedule of commitments).

The GATS extends obligations to sub-national measures, although exceptions regarding state or provincial measures can be inscribed in the schedule. The GATS requires members to make transparent the measures relating to trade in services. The Agreement provides for compensation in case a liberalisation commitment is withdrawn.

One of the most important features of the GATS is the access to the strong state-to-state dispute settlement procedures, including retaliation, agreed upon in the Uruguay Round.

Agreement on Trade-Related Investment Measures (TRIMs)
The TRIMs Agreement addresses a number of investment matters from a trade angle, i.e. TRIMs are subject to disciplines because their application distorts trade flows.

The TRIMs Agreement outlaws such TRIMs which are violating Art. III and XI of the General Agreement on Tariffs and Trade 1994. The illustrative list attached to the Agreement includes local content and purchase obligations as well as trade balancing requirements. Such illegal measures can on condition of proper notification be phased out, within two years for developed countries and within up to seven years for least developed countries.

Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs)
The TRIPs Agreement does not address directly FDI issues, but the improved protection of intellectual property rights brought about by this Agreement will improve the investment climate in the countries concerned.

2) Organisation for Economic Cooperation and Development (OECD) Instruments

In 1961, OECD Members have adopted a Code of Liberalisation of Capital Movements and a Code of Liberalisation of Current Invisible Transactions, the so-called Codes of Liberalisation, and in 1976 a National Treatment Instrument.

The Codes of Liberalisation cover inward direct investment by non-residents from other Member States, including establishment in services. The National Treatment Instrument comes into play once the foreign direct investment is made and obliges Members, on a non-binding basis, to accord foreign investors and investments national treatment. The OECD members also have adopted non-binding Guidelines for Multinational Enterprises which establish the standards of corporate citizenship for Multinational Enterprises abroad.

The sectoral coverage of the Codes of Liberalisation, while comprehensive, is not complete. Countries can maintain individual lists of reservations, be it across the board or in specific sectors. Important issues, such as government procurement, key personnel, subsidies or monopolies are not covered. To certain commitments a standstill applies and there is a general obligation to reduce restrictions.

The OECD holds regular "country examinations" which amount to a close scrutiny by OECD Committees of the remaining restrictions on FDI maintained by the country concerned. These examinations are to create "peer pressure" aiming at the reduction or withdrawal of restrictions affecting FDI. Besides peer pressure, sanctions for alleged violation of Codes of Liberalisation obligations can only be obtained by referring the issue to the OECD Ministers which could take up the issue in a Council decision in the form of a recommendation. This is no real dispute settlement mechanism, and therefore it is often said that the OECD instruments lack teeth.

3) North American Free Trade Agreement (NAFTA)

The NAFTA contains extensive chapters relating to investment. As a general rule, investors and investments from other Parties are granted the best of most favoured nations treatment and national treatment for their establishment and operation. NAFTA Parties are prohibited from applying performance requirements or nationality requirements for key personnel.

It is important to note that these far-reaching basic principles are subject to liberalisation commitments and substantial reservations which appear in the Parties' schedules. Each country must also specify non-conforming sub-national measures within a certain time

after the entry into force. Government procurement and subsidies are excluded from the general rule; monopolies and state enterprises remain permissible. Financial services are dealt with in a separate chapter. Major exceptions pertain to national security and to Canada's cultural industries.

The NAFTA investment chapter contains a detailed mechanism for the resolution of disputes involving the breach of the NAFTA investment rules by a host country. It provides for investor-to-state dispute settlement.

4) Asia-Pacific Economic Cooperation (APEC)

The APEC annual meeting held in November 1994 agreed on a set of non-binding principles on investment. These "best effort" commitments provide i.a. for transparency of laws and regulations pertaining to investments; non-discrimination for establishment and operation of investments from any other economy as well as national treatment, minimisation of performance requirements distorting trade and investment; investment protection with regard to expropriation, transfers and settlement of disputes. An interesting point is that the APEC principles forbid member economics to relax health, safety and environmental regulations as an incentive to encourage FDI.

The rather general APEC principles are only a first step and work within APEC on more binding investment rules continues.

5) Energy Charter Treaty (ECT)

Signed at Lisbon on 17 December 1994 by almost all European countries as well as some non European industrialised countries, this most recent multilateral treaty covering i.a. investment is mainly aimed at Eastern Europe and the CIS. The ECT is a sectoral agreement covering only activities in the energy sector. Its main goal is to facilitate energy related investments in Central and Eastern Europe and to help the restructuring of the sector there. It contains comprehensive rules on investment protection and notably state of the art provisions on trade-related investment measures, key personnel, transfer of funds, sub-national compliance and an exception clause from the most favoured nations obligations for regional integration agreements. It has a refined mechanism for dispute settlement. On pre-investment (market access, right of establishment) only a best-effort commitment for national treatment/most favoured national treatment was agreed, but a second phase of negotiations addressing this issue has already started.

6) ACP-EEC Convention of Lomé (Lomé IV)

Lomé IV contains a separate extensive chapter on investments with different sections dealing with notably promotion, protection, financing, capital flows and payments, as well as establishment. Lomé IV thus notably contains a MFN provision for establishment (unilateral derogations possible) and framework rules for the individual Member States and ACP-countries bilateral investment protection treaties. In addition, the Community in 1992 has elaborated a "Community position on investment protection principles in the ACP states." This detailed document sets out the salient principles which should govern the protection of foreign direct investment in ACP states.

7) United Nations Organisation sponsored Agreements

World Intellectual Property Organisation (WIPO)

As pointed out above for WTO/TRIPs the numerous conventions in the area of the protection of intellectual property concluded under the auspices of WIPO do indirectly foster the investment climate in the countries member to these conventions.

International Labour Organisation (ILO)

The ILO rules on labour standards and labour relations can also be of some importance for international direct investment flows.

ANNEX III

Provisions relating to investments in Europe Agreements and in Partnership and co-operation Agreements

Provisions	***Europe Agreements (EA)***	***Partnership and co-operation Agreements***	
		with Russia	other
1. Establishment of enterprises and professionals	NT reciprocal but to be introduced asymmetrically	MFN for companies only. For financial services, national treatment (NT) with exceptions.	EC offers MFN. NIS offer best of MFN/NT, with some exceptions (Bel, Mol, Ukr,) some of which are transitional.
2. Operations of enterprises and professionals	NT reciprocal but to be introduced asymmetrically	EC offers NT (Russia best of MFN/NT) for subsidiaries with some exceptions. MFN for branches.	EC offers NT for companies and MFN for branches, with some exceptions. NIS offer best of MFN/NT.
3. Capital transfers in respect of investments	to be liberated including transfer of dividends and possible repatriation of capital	Liberalisation of inward investment in Russia, including transfer abroad of investment and profit. Russia may maintain during a transitional period restrictions on outward investment.	Liberalisation of capital movements for FDI including repatriation of assets and profits.
4. Protection of intellectual, industrial and commercial property	CEC to provide same level of protection + subscribe to international agreements	similar to EA	similar to EA

Provisions	Europe Agreements (EA)	Partnership and co-operation Agreements	
		with Russia	other
5. Competition rules, including state aids	similar to Rome Treaty rules	disciplines inspired from EEC rules, but less strict than EA rules	Ukr, Bel, Mold: right to consult and obtain information; non-discrimination re. marketing and procurement rules within 4 years. Kaz, Kyr: right to consult where trade affected.
6. Law in all areas having impact on agreements	approximate	gradual approximation	gradual approximation
7. Industrial standards and certification	co-operation (i.a. PHARE)	co-operation	co-operation
8. Investment promotion - improve legal framework - conclude investment protection agreements	co-operation (i.a. PHARE)	co-operation	co-operation
9. Access to market	free trade in industrial goods	MFN for goods and for a list of services	MFN for trade in goods (and Bel: for a list of services)

Europe Agreements : Poland, Hungary, Czech Republic, Slovakia, Romania, Bulgaria, negotiations with Baltics started and are expected with Slovenia.
Partnership and co-operation agreements signed with Russia, Ukraine and Moldova; signature expected shortly with Kazakhstan, Kyrgyzstan and Belarus
CEC = Central European countries
MFN= Most Favoured Nation treatment
NT=National Treatment

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