OECD Investment Policy Perspectives 2008

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Foreword

Investment Policy Perspectives (IPP) (formerly International Investment Perspectives) is published by the OECD Investment Division of the Directorate for Financial and Enterprise Affairs. This journal focuses on multidisciplinary empirical and analytical research of practical relevance for the global investment policy community. Its mission is to support informed, evidence-based policy dialogue, peer learning, and reforms aimed at improving investment climates worldwide.

The articles published in IPP are based upon research conducted as part of the work programme of the OECD Investment Committee, as well as external contributions. The journal welcomes external contributions from policy makers, the academic community, and other international organisations. Summaries of all IPP articles – including forthcoming articles – can be accessed through the journal's website: www.oecd.org/daf/investment/ipp. *Subscribers and readers at subscribing institutions can order and download articles at* www.sourceoecd.org. *Non-subscribers can purchase the PDF e-book and paper copies via our Online Bookshop at* www.oecdbookshop.org. *Government officials with accounts can go to the "Books" tab on OLIS.*

Inquiries concerning IPP, including submission proposals, should be directed to the editor: Michael Gestrin (Tel.: +33 1 45 24 76 24, Email: michael.gestrin@oecd.org).

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Introduction

This first issue of Investment Policy Perspectives (IPP) reproduces a selection of papers presented during the seventh OECD Global Forum on International Investment (GFI-7) which took place in March 2008 (*www.oecd.org/investment/gfi-7*) as well as two articles based upon original OECD research. The theme of GFI-7 was "Best Practices in promoting investment for development: Pursuing a common agenda". While all of the papers in this issue share this common theme, together they also illustrate the eclectic nature of investment policy and the broad range of policy issues that governments need to consider as they pursue their investment objectives.

The first two articles deal with the interface between foreign direct investment and the local economy, timely contributions as the OECD embarks upon a major project to develop an Innovation Strategy by 2010, as mandated during the 2007 OECD Ministerial. The first article, by **Lesher** and **Miroudot**, represents one of the first empirical studies of technology spillovers in services sectors. One of their key findings is that productivity-enhancing effects of FDI are the strongest in services industries. They also identify the level of competition in the local market as an important factor in determining the extent to which FDI generates spillovers. The second article, by **Kudina** and **Jakubiak**, focuses on the conditions for positive spillovers for FDI in Georgia, Kyrgyzstan, Moldova and Ukraine and the strength of the linkages between MNEs and local firms. The authors find that most MNE affiliates in the CIS operate as "isolated players", developing minimal local linkages. The main reasons identified to explain this include the volatility of the political and economic environment, ambiguity of the legal system and corruption. A common policy conclusion running through both of these empirical studies concerns the importance for governments of establishing the right basic policy frameworks for investment and ensuring that domestic innovative capacity is sufficiently strong to support sustainable linkages between foreign and domestic investors.

The article that follows deals with the social dimension of investment policy. In a legal analysis of regulatory takings, stabilisation clauses and sustainable development, **Cotula** examines the implications of the regulatory taking doctrine and of stabilisation clauses for host state regulation in pursuit of sustainable development goals – specifically, for regulation raising the social and environmental standards applicable to investment projects. His analysis reveals that increasingly broad stabilisation clauses tend to ensure a level of regulatory stability that far exceeds that accorded by general international law under the regulatory taking doctrine. Broad stabilisation clauses respond to the investors' need for stability of the regulatory framework, on which the commercial viability of investment projects depends. But they can also make it more difficult for host countries to improve their social and environmental policy frameworks. In other words, as **Cotula** observes, stabilisation clauses "may as a result 'freeze' a non-optimal balance between social, environmental and economic considerations".

The next two articles look at the financial system, broadly defined, from very different perspectives in terms of the role it plays in the international investment framework. **Gordon** provides a comprehensive overview and stocktaking of investment guarantees and political risk insurance and the role these instruments and institutions play in moderating risks that investors often face but for which market-based alternatives often do not exist. Although not traditionally considered as financial service providers, insurance providers play a specialised financing function, namely by providing financial cover for risk, an important cost of doing business. **Kiyota, Peitsch** and **Stern** examine the financial sector in Ethiopia. Their analysis suggests that the lack of competition in this sector is acting as an important bottleneck and a drag on growth and that liberalisation would bring significant economic benefits. This result complements the results of Lesher and Miroudot on the potential productivity benefits associated with services more generally.

Finally, this volume contains a synthesis of the proceedings of the OECD Global Forum on International Investment, which took place in Paris on 27-28 March 2008. GFI-7 was attended by the Secretaries General of the OECD and UNCTAD, the Prime Minister of Peru, Ministers from Morocco, Uganda, Costa Rica, India, the Chairman of Egypt's General Authority for Investment and Free Zones, and over 400 participants representing 73 economies, the private sector, labour unions, non-governmental organisations, and academia. The next OECD Global Forum on International Investment will take place in December 2009. A conference announcement and call for papers will be posted on the website of the OECD Investment Division (*www.oecd.org/investment*).

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Foreign Direct Investment Spillovers and their Inter-relationships with Trade

by
Molly Lesher and Sébastien Miroudot*

Foreign direct investment (FDI) represents an increasingly important dimension of international economic integration with global FDI flows growing faster than output over the past two decades. FDI is a particular form of investment, as it transfers knowledge as well as finance that may otherwise be unavailable in the domestic economy. This paper uses firm-level data to identify FDI spillovers across countries, sectors and time. The analysis suggests that knowledge-related spillovers from FDI vary considerably across sectors. It is in services industries that the productivity-enhancing effects of FDI are the strongest, in particular through backward linkages. There is no strong evidence of horizontal productivity spillovers at the aggregate level.

The results also indicate a significant and positive correlation between the degree of trade openness and output when measuring the impact of foreign presence in the domestic economy. One of the reasons why spillovers might be higher in more competitive markets is that stronger competition may induce greater knowledge transfer from MNE parent companies to their affiliates in order for the affiliate to compete effectively against its domestic rivals. Moreover, an open trade regime implies that domestic companies tend to export more and that more domestic companies are in sectors in which the host economy has a comparative advantage. Thus, trade liberalisation can be seen as an important component of any reform package designed to help countries maximise the benefits of FDI.

* Molly Lesher is a member of the Development Division of the OECD Trade and Agriculture Directorate. Sébastien Miroudot is a member of the Trade Policy Linkages and Services Division of the OECD Trade and Agriculture Directorate. Correspondence should be addressed to: *sebastien.miroudot@oecd.org*.

Introduction

Foreign direct investment (FDI) represents an increasingly important dimension of international economic integration with global FDI flows growing faster than output over the past two decades. FDI flows remain highly concentrated among OECD countries, and the potential benefits of inward FDI for the host economy are widely recognised (UNCTAD, 2006; OECD, 2002 and 2006). In addition to providing a source of external finance, FDI is associated with job creation and the introduction of new technologies by multinational corporations. FDI also provides a bridge between the host country of a foreign affiliate and the technological resources of foreign multinational corporations.

Importantly for the host economy, theory suggests that the presence of technologically advanced foreign affiliated firms can benefit local producers. Since the ideas embodied in new technologies can only be partially protected from other firms, the introduction of any new technology will often disperse to other firms through informal learning mechanisms commonly referred to as productivity "spillovers". Spillovers can be unintended, such as when a domestic firm imitates a foreign product, or deliberate, such as when a foreign firm offers technical support to a domestic firm to meet certain quality criteria.

A large body of empirical work has sought to identify and quantify the existence of FDI spillovers. A common methodology adopted in these studies is to infer the presence of spillovers by examining whether the presence of foreign affiliated firms increases domestic firm productivity.[1] While the results from many of these studies verify the existence of FDI spillovers, a recurring finding is that they are not automatic. The literature has identified a certain number of "prerequisite" host country characteristics needed for technology to flow from foreign companies to domestic firms, leading to the concept of absorptive capacity.[2]

The debate about FDI spillovers has thus shifted from a discussion of their existence to the policies that encourage them. Early in the literature, trade policy was identified as a catalyst for FDI productivity spillovers in the "Bhagwati hypothesis", which states that productivity spillovers are higher in an open trade regime. At that time, Bhagwati was opposing import-substituting and export-promoting economies, but today most countries have now opted for an open trade regime. There are however still economies more open to trade than others, especially in specific sectors. The Bhagwati hypothesis can thus be reformulated in the following way: Are countries with a relatively more open trade regime benefiting from relatively higher productivity spillovers? And does the magnitude of FDI-related spillovers vary significantly by sector?

This article begins with a short literature review that sets the stage and includes recent empirical work on FDI spillovers. It then presents original quantitative research that draws upon the literature as well as existing OECD resources to test the complementarity between trade openness and FDI spillovers in a sample of OECD economies. Policy implications that draw upon this research are then presented.

1. FDI spillovers: Theory and evidence

1.1. *Theory*

FDI is a particular form of investment. FDI reflects the establishment of a foreign affiliated firm under the management of a parent company. Compared to other types of investment, such as portfolio investment and aid, FDI often transfers knowledge – in the form of production expertise and managerial skills, among others – as well as finance (Balasubramanyam *et al*., 1996). These knowledge effects can be called externalities or spillovers. FDI, therefore, can mean more to a host country than building a new plant or subsidiary.

When we talk about spillovers, what exactly do we mean? Simply put, FDI spillovers are defined as an increase in the productivity of domestic firms as a consequence of the presence of foreign firms in the domestic economy. Spillovers can come in many forms, such as technologies, working methods, and management skills, but they have one thing in common – they boost productivity. While many researchers have studied the channels through which spillovers are possible, we review briefly these channels below (Table 1).

Table 1. **FDI spillover channels**

Skills via labour mobility	Workers gain new skills through explicit and implicit training. In particular, training in foreign firms may be of a higher quality given that only the most productive firms trade. Workers take these skills with them when they re-enter the domestic labour market.
Exports and infrastructure improvements	Because multinationals by definition trade, they lay the groundwork for domestic firms to benefit from distribution networks, logistics services and infrastructure improvements. Domestic firms can also learn about the regulatory frameworks with which exporters must comply.
Imitation	This very obvious form of spillover often takes the form of reverse engineering, whereby a domestic firm creates a similar product based on the design of a good or service that a foreign affiliate produces. Imitation is only successful if the domestic firm has the technical capacity and ability to source the necessary inputs to produce a similar product.
Competition	If the foreign firm is not a monopoly provider and it sells in the domestic economy, then it competes directly with domestic firms in the market. Since multinationals are often more productive – they have to be to trade – this forces domestic providers to become more productive to successfully compete for business.
Vertical Linkages	Backward and forward linkages are another way in which spillovers are transmitted in an economy. As foreign firms set up vertical production networks, they include domestic firms in their production chain. Since these suppliers must meet certain quality standards, they benefit from the experience and knowledge of the foreign firm.

Source: Authors, using Görg and Greenaway, 2003.

Theory not only provides an indication of how spillovers are transmitted, but also of the factors that may affect the ability of firms to effectively use the knowledge generated by multinationals. Indeed, while multinationals bring with them the possibility of productivity spillovers for the domestic economy, positive externalities are not automatic. There are differences in the magnitude of spillovers according to the type of investment and the firm's motives for investing. For instance, differences have been found in the impact of wholly-owned subsidiaries or projects associating foreign and domestic investors. The degree of foreign ownership matters as well as the nationality of the investor (Javorcik and Spatareanu, 2005; Javorcik, 2004). Whether foreign investment is "resource-seeking", "market-seeking" or "efficiency-seeking" is also likely to influence the scope for productivity spillovers as the degree to which firms interact with the domestic economy depends in part on the motivation for investing.

Moreover, not all countries benefit from the presence of more productive foreign firms in their economy. In particular, the "technology gap" between foreign and domestic firms may play a large role because it directly affects a domestic firm's ability to use the knowledge from multinationals (Wang and Blomström, 1992). To the extent that catch up would require licensed technology from abroad, protection of intellectual property rights can play a role.[3] Technology must be internalised and adapted to local conditions, and adaptation requires workers with the skills appropriate to the product or service at hand. One could imagine that if Boeing or Airbus set up a factory in a least-developed country, there would be less scope for productivity spillovers than if it set up production in a country higher up the income ladder.

An associated concern involves the particularities of a given sector, country, and region within a country. For instance, infrastructure – both tangible, such as roads, and intangible, such as regulations – probably influence the degree to which domestic firms can take advantage of the knowledge available in multinationals. And there is some evidence to suggest that knowledge spillovers in certain sectors, such as high-technology sectors, may be more easily transmittable than others.

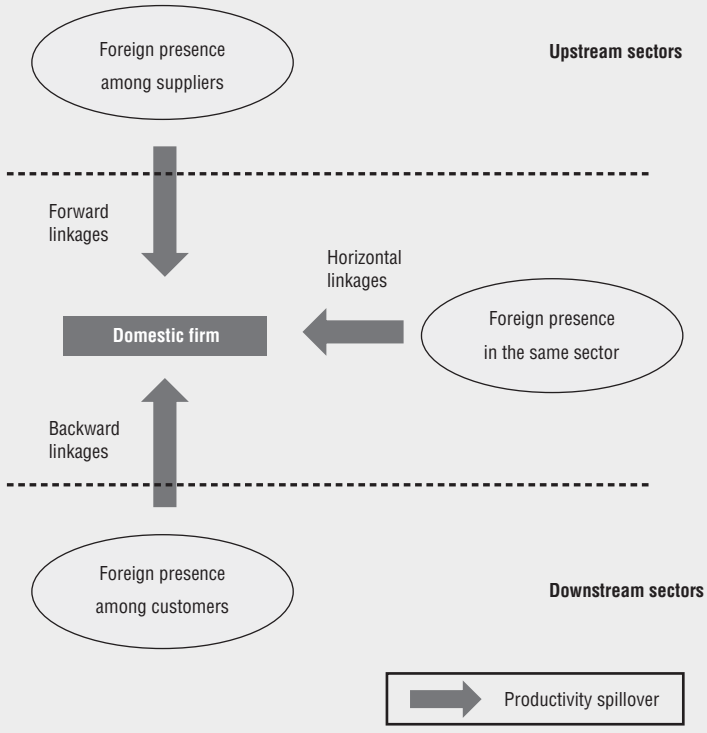
In addition, the characteristics of domestic firms themselves are also likely to affect how spillovers translate in the domestic economy. For instance, some researchers argue that domestic firms that export may not benefit from the presence of foreign firms since they are already productive enough to compete in foreign markets.[4] As a result, some economists hypothesise that spillovers from multinationals will be more pronounced in domestic firms that do not export. Some have also suggested that firm size affects how spillovers are transmitted in the domestic economy. For example, larger firms may have more scope to efficiently internalise knowledge from multinationals.

Theory also suggests that vertical production networks can represent an important channel for spillovers. There are three types of vertical spillovers: the active transfer of knowledge from foreign firms and their parent companies (through a qualification process or training classes, for instance); technology leakages (*i.e.*, unintended transfers of knowledge) and incentives based on more intense competition (*i.e.*, an increase in domestic firm productivity independent of the technology embodied in foreign affiliated firms[5]).

Vertical productivity spillovers can occur through backward and forward linkages (Box 1). Backward linkages involve a transfer of knowledge to a given domestic firm from that firm's customers, while forward linkages imply knowledge transfer to a domestic firm from its suppliers. For example, Blalock (2002) finds evidence of backward linkages in the case of Indonesia, as does Javorcik (2004) in Lithuania.

Multinationals can help domestic firms increase their efficiency through an active transfer of knowledge to suppliers and customers (Görg and Greenaway, 2003; Blalock and Gertler, 2005). Transferring technology to suppliers can make inputs used by the MNE cheaper and of a better or more appropriate quality. Multinationals often require important quality and process improvements (Gage and Lesher, 2006). There are also incentives to transfer technology to the customer firms to improve their efficiency and sales so that in return they buy more inputs from the MNE.

Box 1. **Defining spillovers and linkages**



FDI spillovers: An increase in the productivity of domestic firms as a consequence of the presence of foreign firms in the domestic economy.

FDI spillovers via horizontal linkages: An increase in the productivity of domestic firms resulting from the presence of foreign firms in the same industry.

FDI spillovers via forward linkages: An increase in productivity resulting from the foreign presence among the suppliers of the industry in which the domestic firm operates (*i.e.,* upstream sectors).

FDI spillovers via backward linkages: An increase in productivity resulting from the foreign presence among the customers of the industry in which the domestic firm operates (*i.e.*, downstream sectors).

These spillovers may take place among domestic firms but are more likely to occur with foreign affiliated firms given their linkages with large foreign parent companies. In the case of horizontal spillovers, there are not such incentives and firms would rather protect their intellectual assets rather than risk technology leakage to competitors.

1.2. Evidence

While theory suggests that FDI will tend to generate positive spillovers in the host economy, the evidence from both qualitative and quantitative research has been less clear cut (see Görg and Greenaway, 2003). Most quantitative studies follow the production function approach first used by Caves (1974), which has been refined by subsequent researchers. These studies often use data on goods (sometimes at the sector level) for one

country, and seek to explain changes in productivity using the standard production variables (*i.e.*, capital, output, material inputs and labour).

The results from these types of studies are somewhat ambiguous. For example, some research on FDI spillovers shows that they exist, but only when domestic firms have enough technological capacity to imitate effectively.[6] Other research suggests that regional or country-level characteristics influence the diffusion of FDI spillovers,[7] as does the export orientation and size of domestic firms.[8] Other research has focused on whether the degree of foreign ownership of multinational affiliates affects spillover effects, but again, the evidence is mixed.[9] While the approach used in these studies tests the effect of intra-industry productivity spillovers in a single country framework for goods, it says nothing about inter-industry spillovers,[10] spillovers in services, and cross-country patterns.

Qualitative studies usually follow a case study format, and often focus on North-South FDI projects. The conclusions drawn from these studies also present a mixed bag. Theodore Moran is perhaps the most prolific producer of case studies on FDI spillovers, and his research generally points to the existence of positive spillovers in the domestic economy (see Moran, 2001). In contrast, other case study research fails to find productivity spillovers from FDI (for example, see Hanson, 2000). And scholars have even come to different conclusions about the same investment project.[11]

A small number of recent empirical studies have examined the impact of various host country factors on FDI spillovers. However, surprisingly few studies have investigated the role of trade policies,[12] and of those that do, the evidence on the role of trade policies appears to be mixed (Kokko *et al*., 2001; Kohpaiboon, 2006). Moreover, existing studies tend to focus on manufacturing sectors, despite the importance of the services sector in all OECD countries and the growth of services FDI. One of the purposes of this study is to explore the relationship between FDI spillovers and trade policy beyond the "Bhagwati Hypothesis" (Box 2).

Box 2. **The Bhagwati Hypothesis**

In the 1970s, Jagdish Bhagwati argued that trade policies could affect the benefits of inward FDI, with trade barriers encouraging investment in less productive import-substituting industries. This so-called "Bhagwati Hypothesis", can be split into two distinct parts. First, that countries with a relatively more open trade regime attract more FDI (the volume effect) and second, that those countries see increases in efficiency (*i.e.* productivity spillovers) resulting directly from FDI (the efficiency effect) (Balasubramanyam *et al*., 1996).

The analysis in this paper focuses on the efficiency effect, that is how trade liberalisation can increase FDI spillovers. The intuition behind the efficiency effect has its roots in comparative advantage theory. Simply put, countries with an unrestrictive trade policy can allocate factors of production more efficiently based on comparative advantage, allowing firms to specialise and achieve economies of scale. In contrast, countries with a restrictive trade regime can expect important distortions in factor and product markets. As a result, one expects more pronounced FDI spillover effects in countries with more open trade regimes.

More recently, authors have focused on learning effects and the diffusion of technology through FDI, where trade can also play a role by encouraging forms of FDI leading to a higher level of technology transfer (efficiency-seeking FDI, vertical FDI).

2. Linkage analysis

Before studying spillovers, this section focuses on linkages. As illustrated in Box 1, these linkages measure how domestic firms are exposed to competition and technologies of foreign companies established in their sector and in upstream and downstream sectors. Their strength is assessed through the share of foreign ownership in these sectors and how they relate one to each other. Spillovers are transfers of knowledge that can take place through these linkages.

Three types of linkages are studied in this section, following the methodology outlined by Javorcik (2004). First, we analyse horizontal linkages, which occur between multinationals and domestic producers within the same sector. Vertical specialisation can generate two other types of relationships; "backward linkages", or connections between domestic firms and their customers, and "forward linkages", or connections between a domestic firm and its suppliers.

Data from input-output tables are used to calculate these linkages, which measure the extent to which firms in a given sector buy inputs from upstream sectors and sell products to downstream sectors. The linkages are calculated following the general methodology set out in Javorcik (2004), although some modifications, indicated below, have been made.

2.1. Horizontal linkages

The horizontal linkages measure the foreign presence in each sector, and they are calculated as the average percentage of foreign ownership in the sector weighted by each firm's contribution to sector output:[13]

$$\text{Horizontal}_{jt} = \sum_{i\ for\ all\ i\ \in j} \text{Foreign Share}_{it}^{*} \frac{Y_{it}}{\sum i\ for\ all\ i\ \in j\ Y_{it}}$$

2.2. Backward and forward linkages

The backward and forward linkages are calculated using data from the 2007 OECD Input-Output Database, which shows the values of inputs and outputs used in the production of goods and services in 42 sectors (see Annex Table A.1.1). Since our dataset covers the period 1993-2006, we use a linear interpolation function to generate values for the years in-between our two data points. Then the value for the earliest data point is applied to all years prior, and the value for the latest data point is applied to all years afterwards.

The backward linkages represent a measure of the potential spillover effects on a producer industry from foreign presence in downstream sectors. The backward linkages are then calculated as:

$$\text{Backward}_{jt} = \sum_{k\ if\ k \neq j}^{n} \alpha_{jk}\ \text{Horizontal}_{kt}$$

Where α_{jk} represents the amount of sector *j*'s domestic output[14] supplied to sector *k*, taken from the 2007 OECD Input-output Database.[15]

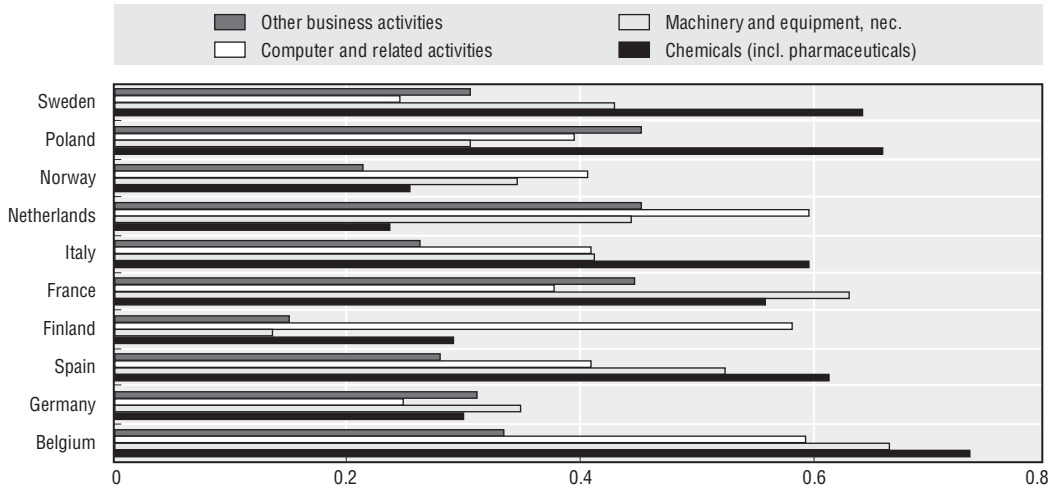
The forward linkages proxy the potential spillover effects from foreign presence in a producer industry's suppliers. The forward linkages are then calculated as:

$$\text{Forward}_{jt} = \sum_{m\ if\ m \neq j}^{n} \sigma_{jm}\ \text{Horizontal}_{mt}$$

Where σ_{jm} represents the amount of sector *j*'s input derived from sector *m* (excluding imported inputs), taken from the 2007 OECD Input-output Database.

The rest of this section presents a brief analysis of the linkages across sectors. To begin, Figure 1 displays horizontal linkages in 10 countries in 2 manufacturing sectors (chemicals and pharmaceuticals and machinery and equipment) and 2 services sectors (other business services and computer and related services) for 2000.[16]

Figure 1. **Horizontal linkages across select countries and sectors**



Source: Author's calculations based on the 2007 OECD Input-Output Database.

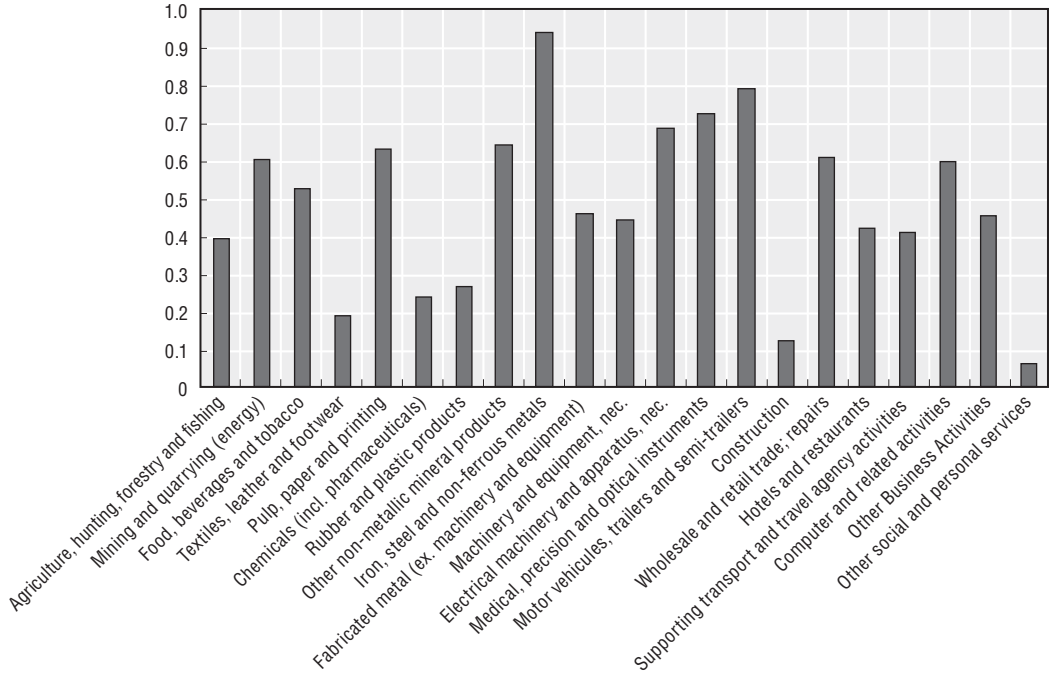
Six of the countries analysed show the strongest horizontal linkages in chemicals and pharmaceuticals, whereas on average, other business services show the smallest horizontal linkages. While variations across countries remain, it appears that the two manufacturing sectors analysed have higher horizontal linkages than the services sectors, thus suggesting that foreign presence is higher in the manufacturing sectors than in the services sectors analysed.

A more detailed look at sectoral data within countries shows that the intensity of horizontal linkages differs considerably across sectors. Data from the Netherlands in 2000 is presented as an example (Figure 2).

In some sectors like construction or textiles, leather and footwear, foreign presence is quite low and hence horizontal linkages are limited. It is also the case, albeit to a lesser extent, for chemicals and rubber and plastic products. On the other hand, data for sectors like iron and steel and motor vehicles indicate significant foreign participation, and therefore more scope for horizontal spillovers exists in these sectors. The intensity of horizontal linkages across countries varies because it depends on the degree to which large foreign firms are present in the domestic economy, which is in turn partly explained by a variety of FDI determinants and partly explained by certain means of protection (such as trade barriers).

Turning to backward and forward linkages, we present data for select countries and sectors (Figure 3). On average, the values calculated are lower than the horizontal linkage measure, in part because upstream and downstream sectors are weighted according to their contribution to sectoral output, and on average, sectors with relatively lower foreign participation weigh more in the calculation. There are, however, important variations in the backward and forward linkages illustrated in Figure 3.

Figure 2. **Netherlands: Horizontal linkages**

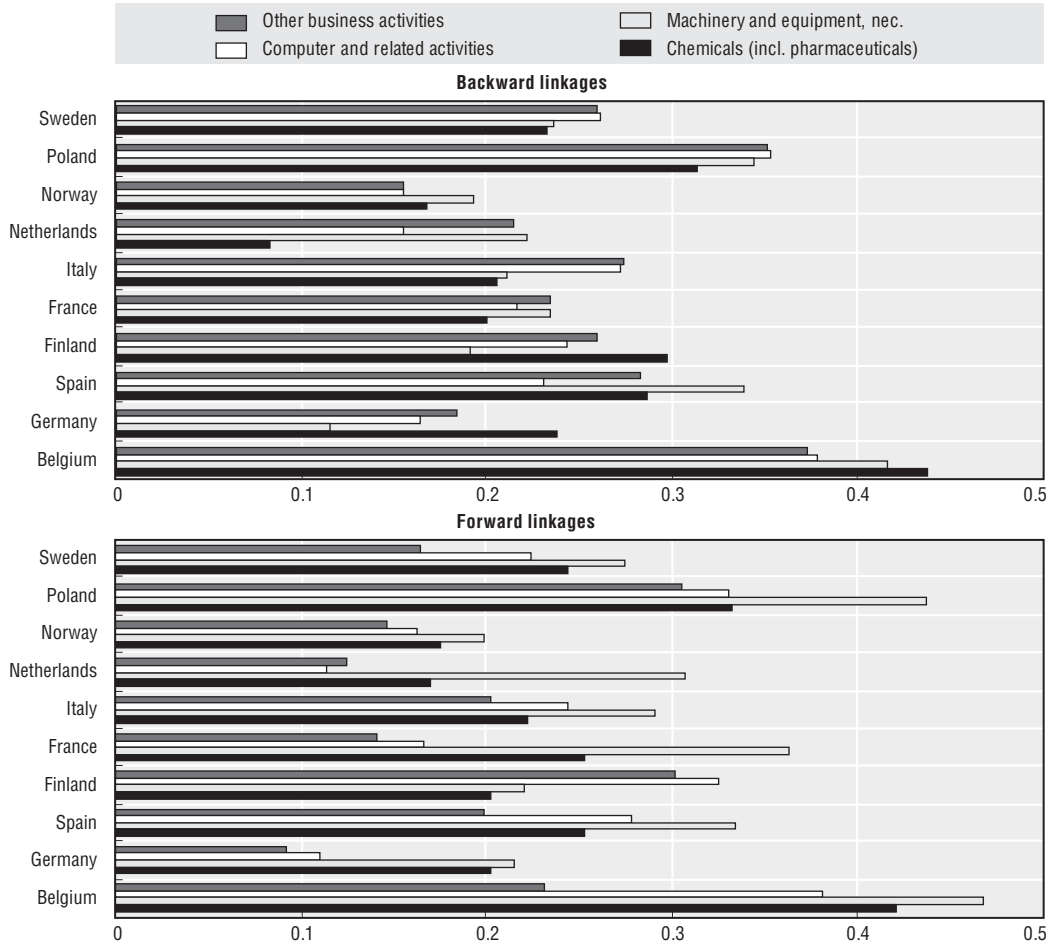


Source: Author's calculations based on the 2007 OECD Input-Output Database.

Forward linkages (from suppliers to the domestic firm) show more variation across countries and sectors. With the exception of Finland, all countries analysed show the strongest forward linkage in the machinery and equipment sector. In contrast, the other business services sector has the lowest forward linkage across all of the countries presented. These results simply indicate that in the machinery and equipment sector, countries tend to source inputs from sectors where foreign presence is high; firms in the other business services sector tend to source inputs from sectors with relatively low foreign presence. Backward linkages (from customers to the domestic firm of interest) are more similar across sectors within countries (that is, the linkages tend to cluster together), and the pattern across countries is less clear.

The linkages presented in this section assess foreign presence across sectors and how exposed firms in a given sector are to foreign competition and foreign technology in their own sector and in upstream and downstream sectors. The analysis suggests that there is large potential for knowledge transfer via these linkages, but this potential varies across sectors and countries. We extend the analysis in the next section, where we use these measures in a production function to assess how they translate into productivity gains.

Figure 3. **Backward and forward linkages across select countries and sectors**



Source: Author's calculations based on the 2007 OECD Input-Output Database.

3. Quantitative analysis of spillovers: methodology

The empirical analysis that follows tests the hypothesis that spillovers are higher in an open trade regime. It features three novelties. First, it analyses spillovers in services sectors, which traditionally have not been included in studies of spillovers, despite the increasing shift towards services FDI (UNCTAD, 2004). Second, trade indicators that have not been tested in previous papers are incorporated into the quantitative analysis. Third, the study utilises cross-country firm-level data.

It is important to bear in mind that the concept of productivity spillovers is abstract and cannot be directly measured. So a production function approach is used to model the effects of FDI spillovers and their relationship with trade policies. In this framework, domestic output[17] is regressed on the standard variables explaining the production of a firm (capital, labour and material inputs). Because we analyse the determinants of output controlling for inputs, the other variables introduced in the empirical model deal specifically with productivity. We include the foreign share of each firm (to test the effects of productivity spillovers only on domestic firms), three variables measuring horizontal, backward and forward linkages, as well as trade variables to test the Bhagwati hypothesis (*i.e.*, that a more open trade regime leads to higher productivity spillovers).

In addition to the sectoral data presented in Section 2, the quantitative analysis relies on a sample of firm-level panel data from the AMADEUS dataset[18] (see Annex 2) covering 208 796 companies from 17 OECD countries. AMADEUS includes an ownership database that lists the main shareholders for each company and indicates the global ultimate owner. The Authors calculate the foreign share variable based on this ownership information. The AMADEUS dataset does not include developing countries and, as such, they could not be incorporated into this analysis.

Using firm-level data abstracts from the biases[19] associated with cross-section sectoral data (Görg and Greenaway, 2003), and lessens the probability of a selection effect bias. As some of the first studies on FDI spillovers were conducted at the sector level for a given year, some researchers have contested the existence of FDI spillovers when sector productivity and foreign presence positively correlate. The argument goes that the positive result obtained for the FDI spillover variable results from a selection effect in which investors pick the most productive sectors and where the overall productivity of the sector is influenced by foreign firms without spillovers to domestic firms. The use of firm-level data with a panel dimension makes this selection effect less likely because the productivity change is captured for each firm over a number of years controlling for its own foreign share.

It should also be emphasised that this dataset primarily includes data on European firms. One might expect to see stronger evidence for productivity spillovers in this sample because developed countries make up the dataset and they have a high level of absorptive capacity. As developing countries generally have a lower stock of human capital than developed countries, they often are less able to make use of the knowledge spillovers embodied in FDI (for instance, in high technology sectors). But in developed countries, it may be precisely in these sectors in which the most significant knowledge spillovers exist.

Alternatively, one could argue that firms in developed countries are already very close to the global technology/productivity frontier, in which case they may be expected to benefit less than a firm in a developing country. However, as highlighted by Blonigen and Wang (2004), it might be inappropriate to pool wealthy and poor countries in empirical FDI studies as determinants of FDI are often very different in the two group of countries. Flows of FDI to developing countries also tend to be concentrated in a few emerging economies (UNCTAD, 2006). For poor countries, the question may not be how to benefit from FDI, but rather how to attract FDI in the first place, a question that certainly merits further research.

The firm-level production function is expressed mathematically as:

$$\ln oprev_{ikt} = \alpha + \beta_1 \ln cap_{ikt} + \beta_2 \ln labour_{ikt} + \beta_3 \ln mat_{ikt} + \beta_4 \sum spill_{ikt} + \beta_5 \sum policy_{it} + \beta_6 forshare_{ikt} + \gamma_i + \kappa_k + \lambda_t + \varepsilon_{ikt}$$

Where:

oprev = operating revenue in constant 2000 prices

cap = fixed assets in constant 2000 prices

labour = number of employees

mat = volume of materials in constant 2000 prices

spill = various spillover measures

policy = various trade policy measures[21]

forshare = percentage of shares held by foreign shareholders

α = constant

γ = country fixed effects

κ = sector fixed effects

λ = year fixed effects

i = country subscript

k = sector subscript

t = time subscript

ε = error term

We start with an OLS estimation of this production function in which where fixed effects account for unobserved variables at the country, year and sector level. These fixed-effects can in particular account for unobserved productivity shocks or variations among countries, sectors and years in the dataset. Robust standard errors are used to correct for heteroscedasticity.

The second series of estimations is based on clustered standard errors. As we use both firm- and sector-level data in the regressions, there is a potential bias that can lead to an underestimation of the standard errors, generating statistical significance for the variables at the sector level (including our horizontal, forward and backward linkages) when it does not exist. This is known in the literature as the "Moulton Correction" (Moulton, 1990).

The third series of estimations introduces a change in the fixed effects. Instead of country, sector and time fixed effects (as in the above equation), we use firm-level fixed effects. It is a robustness check to assess whether we still have significant spillovers when all firms' specificities are accounted for. The regressions are run on domestic firms only (with a foreign share lower than 10%) as the foreign share is most of the time constant over the years (and hence collinear with the fixed effects). As we have relatively few observations per firm and some of the firm-level variables do not show a lot of variation across years, the results of these estimations should be analysed with caution. Also, from a theoretical point of view, one can wonder whether firm fixed effects are not likely to capture part of the spillovers we would like to measure.

Lastly, we propose a dynamic system panel estimation with the Arellano-Bover/ Blundell-Bond GMM estimator (Arellano and Bover, 1995; Blundell and Bond, 1998). The potential bias for which we would like to correct is the "simultaneity bias". It results from the endogeneity at the firm level between the level of productivity and the choice of inputs of labour, material and capital inputs.

Some authors have used the Olley-Pakes approach (Olley and Pakes, 1996) or the Levinsohn and Petrin approach (Levinsohn and Petrin, 2003) to correct for the simultaneity bias.[21] These methods rely on the use of investment or intermediate inputs as proxies for unobserved productivity shocks and to account for the endogeneity in the selection of inputs. As we don't have these data, we prefer to use a dynamic panel estimation technique whereby the lagged output is used as an instrument and lagged variables are introduced for the firm inputs. The "Arellano-Bond systems GMM estimator" is regarded as providing consistent estimators for a production function with firm-level data, especially in the case of many panels and few periods in the dataset. As with the firm fixed effects, we remove the foreign share from these regressions and the dataset is limited to domestic firms to capture an impact on the productivity of local firms.

Box 3. **The interaction between trade openness and FDI spillovers**

While a positive correlation is generally found between trade openness and FDI flows, explaining why lower trade barriers are associated with higher firm productivity (both domestic and foreign) is a question of a different nature. The first explanation that can be advanced is that trade openness affects a firm's motive for investing.

Efficiency-seeking FDI requires access to imports of intermediate goods and services and is thus dependent on an open trade regime, whereas resource-seeking FDI is likely to ignore high trade barriers as long as they do not prevent the firm from acquiring or using needed domestic resources. In the case of tariff-jumping FDI, trade protection can even represent the motivation for the firm to invest as a way to circumvent border barriers. As a consequence, one can expect an ambiguous impact of trade protection on FDI flows (with the two competing and opposing effects of discouraging efficiency-seeking FDI and attracting market-seeking FDI).

In the case of FDI spillovers, the impact is likely to be less ambiguous if one accepts the idea that efficiency seeking FDI is more conducive to spillovers than resource-seeking or market-seeking FDI. The existence of backward linkages and the positive impact of trade openness on productivity spillovers that we have found are consistent with such an assumption. There is anecdotal and case study evidence indicating that interactions between domestic and foreign firms are strong, and that MNEs can be involved in improving the productivity of their suppliers. This is more likely to happen in a vertical specialisation network in the context of efficiency-seeking FDI and this type of FDI is assumed to respond positively to trade liberalisation.

Also related to the firm's motive for investing, open markets are more likely to attract competitive companies. As the competitive pressure is one channel through which firms have incentives to increase their productivity, trade liberalisation also plays a positive role in the competition effect from FDI. Barriers to entry make markets less contestable and can lead to firms increasing their rents. With trade and FDI liberalisation, markets are contestable and incumbent firms have to rely on innovation and efficiency gains to maximise profits.

One of the reasons why spillovers might be higher in more competitive markets is that competition may induce greater technology transfer from MNE parent companies to their affiliates in order for the affiliate to compete effectively against its domestic competition. In turn, local firms operating alongside more technologically advanced affiliates will have greater opportunities for learning new technologies. This is likely to reduce the technology gap between domestic and foreign affiliated firms, thus increasing the opportunities for potential spillovers.

Lastly, an open trade regime means that domestic companies export more and that more domestic companies are in sectors in which the host economy has a comparative advantage. Exporting firms are generally found to be more productive, and thus it is consistent to find a positive relationship between trade openness and higher firm productivity controlling for foreign presence in the sector. Export-oriented firms, including export-oriented foreign affiliates, tend to be larger because they produce for the world market, rather than just for the local market. A consequence of this is that they are likely to present a better opportunity for local suppliers to benefit from economies of scale in production (which boosts productivity).

4. Results

Turning to the results generated for the sample of developed countries used in this paper, coefficients for the core variables (capital, labour, and materials) are within the bounds of the literature and significant at the 1% level. Consistent with the literature, we also observe a fairly high "goodness of fit" for the models, with R^2 values in the range of 0.85-0.96. Annex Table A.3.1 presents the results of the regressions at the aggregate level, using an OLS estimation of the production function with year, country and sector fixed effects, as well as a dynamic panel estimation.

We start with robust standard errors to correct for heteroscedasticity. In Column (1), we test the existence of horizontal spillovers. The foreign share controls for the presence of foreign firms in the sample of companies and thus the coefficient found for spillovers through horizontal linkages reflects an impact on domestic firms. The positive and significant coefficient for the foreign share shows that foreign companies tend to be more productive than domestic firms. It is a result consistent in all the regressions estimated. When only horizontal spillovers are tested in the equation, we find a positive and significant coefficient indicating that domestic companies in sectors with a higher number of foreign firms benefit from increased productivity. Such a result cannot be interpreted as a direct causal relationship between FDI and productivity. It could be the case that foreign firms have picked sectors that are more likely to have become more productive over the years. This is the limit of the analysis carried out on the basis of the methodology proposed here.

In Column (2), we introduce backward and forward linkages in the equation. We note that the sign of the horizontal variable has changed and is now negative, suggesting a negative impact on productivity from horizontal linkages (that is, the foreign presence within the same industry). We observe in some cases a change in the sign of horizontal spillovers across our regressions. Other studies have found the variable to be insignificant (*e.g.*, Javorcik, 2004), and does not appear to be an issue among the backward, forward and horizontal linkages. The sectoral analysis provided in Annex Table A.3.3 highlights that there are marked differences across sectors in the sign of spillovers through horizontal linkages, which could explain the conflicting results.

Backward linkages seem, however, more robust across the regressions and also exhibit higher economic significance. Again, the sectoral analysis reveals that positive spillovers through backward linkages are found only in specific sectors and can be negative in others. It is not surprising with regard to previous literature and the theoretical considerations reviewed in Section 1. As far as forward linkages are concerned, we also observe differences among sectors that make the variable not robust enough at the aggregate level. But the general trend appears to show that these linkages are associated with lower productivity, suggesting that domestic firms do not learn as much from their suppliers as they do from their customers.

In Column (3), the spillover effects are decomposed into primary, manufacturing and services sectors. From this decomposition we learn that the positive coefficient for backward linkages is driven by services industries. No such positive spillovers are found on average for primary and manufacturing industries. Regarding forward linkages, the three sectors show the same negative coefficients but we note that the severity of the decrease in productivity is lower for services. Hence the conclusion made in this report of the importance of looking at spillovers in services.

The rest of the Table presents robustness checks, focusing on the measures of horizontal, backward and forward spillovers. In Columns (4) to (6) clustered standard errors are used (Moulton correction). The results are not significantely altered. There are, however, differences. One can see in Column (5) that the coefficient for horizontal spillovers is insignificant. In Column (6), it is positive but of a lower magnitude than in Column (3) for a similar specification. Spillovers through backward linkages and forward linkages have unchanged coefficients but backward linkages in the primary sector and forward linkages in services are no longer significant. It means that we should not give too much importance to the negative sign observed in Column (3) for these two types of linkages since the coefficients are not robust to the Moulton correction.

Box 4. **How can we explain backward linkages?**

The quantitative analysis suggests that in our sample of countries, FDI spillovers exist via vertical backward linkages (but not to a significant extent through vertical forward linkages). What exactly are backward linkages?

Anecdotal evidence and case studies highlight different mechanisms through which foreign firms transfer knowledge or provide incentives to domestic suppliers to increase their productivity. A first mechanism relies on quality control and testing. Multinationals often send engineers or consultants to their suppliers to control the quality of the inputs they provide and to inspect their facilities. These visits are generally an opportunity to provide suggestions on how to improve the production process. Domestic suppliers can also be asked to send samples for testing and some feedback is given with suggestions for quality improvement. Such mechanisms illustrate the dual nature of FDI spillovers that are derived on the one hand by a transfer of knowledge and on the other hand on competitive pressures or incentives to improve productivity. If the buyer is not satisfied by the quality control or testing, this can lead to the termination of the contract between the domestic and foreign firm.

Foreign firms can be more directly involved in increasing the productivity of their suppliers when they offer training to the workers of the domestic firm. For example, employees can be trained in the parent company of the subsidiary that buys inputs from local suppliers. While this represents a cost for the buyer, it can be in its interest to increase the productivity of its suppliers. There is lastly a potential scale effect when domestic companies start to sell to affiliates of foreign companies. By becoming part of a larger production network, the domestic company is likely to export to the parent company or other affiliates in third countries, thus increasing the size of its production with economies of scale that lead to higher productivity. Managers from US and Japanese companies report that they often recommend a good supplier to other affiliates.

One cannot completely rule out the possibility of a "self-selection" effect in the correlation between backward linkages and higher productivity in the sense that MNEs can cherry pick the most productive suppliers. However, this does not necessarily contradict the existence of FDI spillovers. Foreign presence can still help firms to be more productive.

Source: Blalock and Gertler (2005), Javorcik and Spatareanu (2005).

In Columns (7) to (9), additional regressions are included to show whether results are robust when including firm fixed effects. These effects are estimated on a low number of observations (on average there are 5 years of observation for each company) and can to a certain extent be collinear with some of the firm variables (when they show no significant

time variation). The regressions are run on domestic firms only (with a foreign share lower than 10%) to avoid such collinearity issues with the share of foreign ownership. Horizontal linkages have a negative coefficient in all these regressions. We note also a change in the sign of forward linkages in the manufacturing and services sectors (with now positive and significant coefficients). Backward linkages have a negative coefficient at the aggregate level but we still have a positive and significant coefficient for spillovers through backward linkages in the services sector.

The last part of Annex Table A.3.1 (Columns 10 to 12) presents results of a dynamic panel estimation where we check for the endogeneity in input selection. Regressions are also run on domestic companies because the foreign share would be collinear with some of the instruments in such estimation. One lag has been used for the dependent variable (operating revenue), as well as labour, capital and material inputs (these choices have no major impact on the results, we tried also two lags). The coefficients obtained are generally smaller than in the other regressions, indicating that it is useful to correct for the potential endogeneity in input selection. For variables that were already noted as not particularly robust, such as the horizontal spillovers, there is a change in the sign. The sector decomposition in Column (12) confirms that there is a positive relationship between the foreign presence in downstream sectors (backward linkages) and the productivity of domestic firms in the services sectors. Interestingly, positive spillovers are also found in agriculture sectors.

Annex Table A.3.2 presents the results of regressions including three trade policy variables. Both the tariff variable and the trade component of the Index of Economic Freedom show a negative sign, which is expected as higher tariffs and a higher index mean more protection and we have explained in Box 1.3 why we believe trade openness is conducive to higher FDI spillovers. The FDI restrictiveness index has also a strong negative sign, indicating that barriers to FDI are not only likely to restrict capital flows but have also a large negative impact on productivity. As a proxy for barriers to Mode 3 trade in services, the negative sign and strong signigicance of the coefficient of the index can also be interpreted as the negative impact of limiting the presence of foreign services suppliers in the domestic economy. When only the tariff, the Index of Economic Freedom or the FDI restrictiveness index is introduced in the regression, we cannot tell much about the interaction between trade policy and FDI spillovers. We just have an indication that an open trade regime is generally associated with higher productivity.

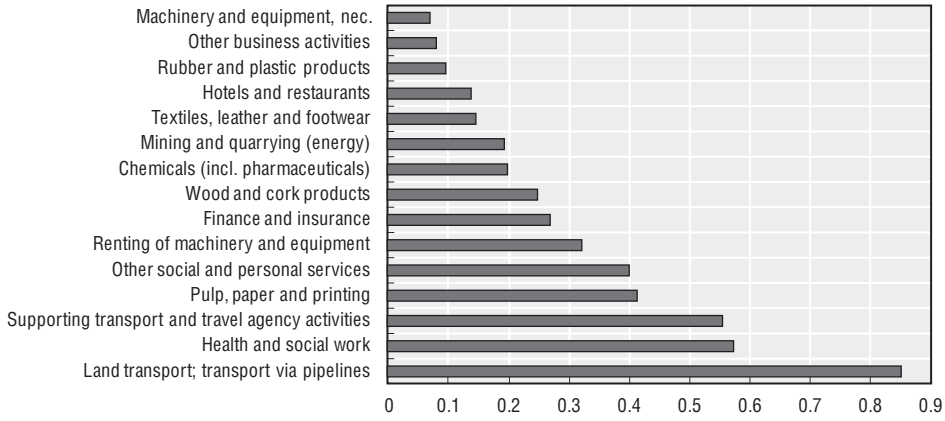
This is why in Columns (2), (4) and (6) we propose an analysis based on interaction terms. These interaction terms are calculated by simply multiplying the trade variables by the different linkages calculated. One should be cautious in interpreting these two columns. The coefficients for each trade indicator and each type of spillover (horizontal, backward and forward) have to be read *together*. Tariffs are only for goods and so Column (5) reflects the results for the backward and forward variables found for the manufacturing sector (hence the insignificant coefficient for backward spillovers). There is a positive interaction between the trade component of the Index of Economic Freedom and backward linkages. This can be understood by setting the index to zero (free trade). The positive coefficient found for backward linkages is not only stronger than in other regressions but the overall output of the firm is no longer affected by the negative coefficients estimated for the impact of the trade index variable and the interaction term between the index and the backward linkages. Spillovers are thus higher when the trade regime is liberal.

Overall, the analysis shows that there is stronger evidence in favour of spillovers via backward linkages than there is for spillovers via forward linkages, and that spillovers can be economically significant in services sector. There are potentially horizontal spillovers but differences among sectors lead to a coefficient at the aggregate level that is not always positive and robust.

These differences can be seen in Annex Table A.3.3 where regressions (with the fixed effect model) are run at the sector level. Among the services sectors, for example, one observes that the horizontal linkage coefficient for the health and social work sector is strongly significant and positive, whereas the coefficient for computer and related activities has a similar magnitude, but takes a positive sign. We observe a similar back-and-forth among the manufacturing sectors, although deviations from the aggregate measure are partly explained by sectors with a relatively small number of observations. These competing forces probably contribute to the ambiguous result we see on the aggregated horizontal measure.

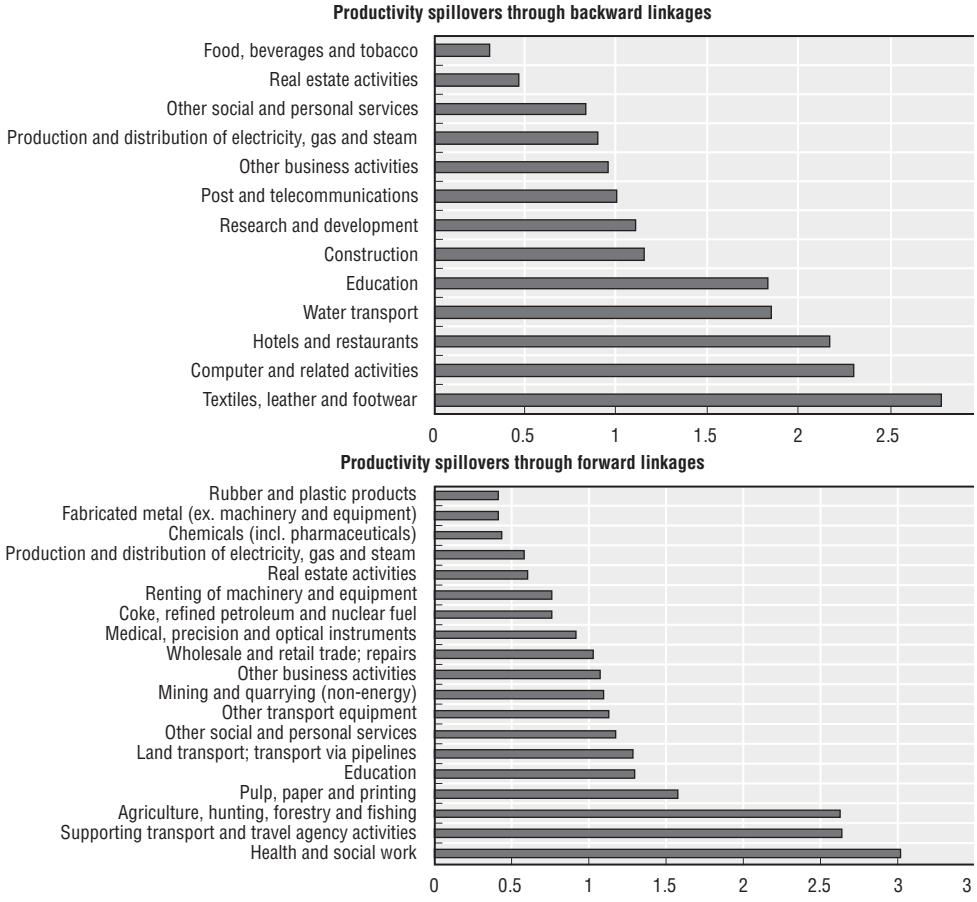
On average, spillovers effects are stronger in services sectors, a result not highlighted so far in the literature. Figure 4 presents the sectors where we found the highest horizontal spillovers, while Figure 5 illustrates the sectors with significant positive spillovers through backward and forward linkages.

Figure 4. **Sectors with spillovers through horizontal linkages**



Source: Based on results in Annex Table A.3.3. Only positive and significant coefficients are reported.

Figure 5. **Sectors with spillovers through backward and forward linkages**



Source: Based on results in Annex Table A3.3. Only positive and significant coefficients are reported.

5. Policy implications and concluding remarks

The quantitative analysis presented in the previous section leads to several important policy conclusions.

1. ***Trade liberalisation is associated with stronger FDI-related spillovers and higher productivity.*** There is a significant and positive correlation between the degree of trade openness and output when measuring the impact of foreign presence in the domestic economy. A policy of openness to trade tends to attract relatively more productive foreign firms whose efficiency stimulates domestic firms to improve their productivity in order to compete effectively. Thus, trade liberalisation can be seen as an important component of any reform package designed to help countries maximise the benefits of FDI.

2. ***Encouraging foreign presence in the services sectors can generate strong positive productivity effects in the economy.*** The analysis presented in this study suggests that it is in services industries that the productivity-enhancing effects of FDI are the strongest. In our sample of firms, spillovers from backward linkages occur mainly in services sectors. The fact that earlier studies tended to focus on manufacturing firms can explain why the literature has been somewhat sceptical about the existence of FDI spillovers and why it is important to include services in the analysis.

3. ***The potential for knowledge-related spillovers from FDI varies considerably across sectors.*** Results obtained at a relatively detailed sector level indicate that the potential for FDI-related spillovers varies considerably. Among sectors, for example, computer and related activities, hotels and restaurants, construction, post and telecommunications and other business activities showed strong FDI spillovers via backward linkages. In addition, FDI-related spillovers via forward linkages are found in agriculture, land transport, mining, but also services sectors such as wholesale trade and retail or other business activities.

While the quantitative analysis could not cover developing economies for which firm-level data and input-output tables are not easily available, some of the policy implications derived from this study can be extended to emerging economies. It is in the context of trade and investment liberalisation that FDI spillovers can contribute to productivity growth. Country case studies generally show that knowledge spillovers are significant contributors to productivity growth in the post- rather than pre-liberalisation phase (see Jacob and Szirmai (2007) on Indonesia). The ambiguous results of some empirical studies on FDI spillovers in developing countries may fail to capture productivity effects because they do not take into account trade reforms or other reforms that are part of the complementary policies required for a positive impact of foreign investment; this issue merits further research.

The role of multinationals in the diffusion of technology is increasingly recognised. In the past, MNEs were regarded as a threat to the domestic economy, as policymakers feared that they would extract rents from local customers and suppliers or abuse key resources. This view has changed in part because MNEs face a more competitive business environment, and they increasingly rely upon vertically integrated production networks in an effort to improve efficiency. Consequently, it is increasingly in their interest to cultivate reliable, long-term relationships with suppliers and responsibly use host country resources. Open trade policies are part of this competitive environment that can prevent MNEs from adopting predatory or rent-seeking practices, while at the same time encouraging them to produce partly abroad and to share some of their knowledge with local partners.

While trade theory suggests that an open trade regime increases efficiency and productivity, investment is one channel through which this happens as it flows to the sectors in which a country has a comparative advantage. By definition, a multinational must have some advantage that allows it to successfully compete with domestic producers. This advantage could be a proprietary technology, but it could also take the form of specialised management skills, marketing, and branding, among others (Kokko, *et al*., 2001). This is important when one considers the spillover effects of these advantages on the domestic economy, since an open trade regime can allow investment to flow into productive sectors, and the spillover benefits from FDI will occur precisely in those sectors that policymakers would want to encourage.

One of the reasons why spillovers might be higher in more competitive markets is that stronger competition may induce greater knowledge transfer from MNE parent companies to their affiliates in order for the affiliate to compete effectively against its domestic rivals. In turn, local firms operating alongside more technologically advanced foreign affiliates will have greater opportunities for learning new technologies. This is likely to reduce the technology gap between domestic and foreign affiliated firms, thus increasing the opportunities for potential spillovers.

Moreover, an open trade regime implies that domestic companies tend to export more and that more domestic companies are in sectors in which the host economy has a comparative advantage. Exporting firms are generally more productive, and thus it is consistent to find a positive relationship between trade openness and higher firm productivity controlling for foreign presence in the sector. Export-oriented firms, including export-oriented foreign affiliates, tend to be larger because they produce for the world market, rather than just for the local market. A consequence of this is that they are likely to present a better opportunity for local suppliers to benefit from economies of scale in production (which boosts productivity). Thus, trade liberalisation can be seen as an important component of any reform package designed to help countries maximise the benefits of FDI.

Yet FDI-related spillovers are not automatic. There will be instances in which foreign firms will be reluctant to share their knowledge, or they may have very few interactions with domestic companies, thus limiting the FDI spillover effects. In addition, host country characteristics, such as absorptive capacity, determines whether a particular firm can make use of the potential knowledge transfer embodied in spillovers. And while openness to trade is positively associated with FDI spillovers, increased openness can create difficult adjustment challenges, as in cases where increased competition in the domestic market drives the least productive domestic companies out of business. Policymakers thus need a comprehensive approach, with policies to employ adjustment-related assistance complemented by policies that encourage an environment conducive to FDI-related spillovers.

Notes

1. In 1974, Richard Caves pioneered this approach, which has been refined by a number of scholars who over time have used improved data and empirical methods.
2. For example, a certain threshold of human capital is needed to induce significant spillovers.
3. Some studies show that technology transfer via licensing is positively and significantly correlated with the strength of intellectual property right protection, particularly for patents (Park and Lippoldt, 2005).
4. See Crespo and Fontoura, 2006.
5. Some studies have, for example, shown that US parts suppliers in the automobile industry have improved their technology and productivity following the entry of Japanese car makers (Okamoto, 1999). Japanese car makers were neither more productive nor actively transferring technology to US firms, but the competition effect led to an increase in productivity for US car makers.
6. Using R&D as a proxy for the level of technological capacity, Keller and Yeaple (2003) find evidence of positive FDI spillovers in high technology sectors in the United States. Similarly, Kinoshita (2001) finds evidence of positive spillovers for the Czech Republic in the presence of a given level of R&D spending within the domestic firm.
7. See, for example, Imbriani and Reganati (1999), who find that regional characteristics within Italy influenced whether domestic firms benefitted from foreign presence.
8. Using data for Indonesia, Blomström and Sjöholm (1999) find that export-oriented domestic firms do not benefit from FDI spillovers, whereas firms that service only the domestic market do benefit from foreign presence. In contrast, Sinani and Meyer (2003) do not find any evidence to this effect. Other research focuses on firm size, and also produces contradictory evidence (see, for example, Girma and Wakelin [2001] and Aitken and Harrison [1999]).
9. See Blomström and Sjöholm (1999) on Indonesia, Dimelis and Louri (2002) on Greece, and Javorcik (2004) on Lithuania.
10. An important exception can be found in Javorcik (2004), who provides a thoughtful analysis of inter-industry spillovers using firm-level data for Lithuania.

11. As noted in Görg and Greenaway (2003), Hanson (2000) does not find significant evidence for spillovers in the case of Intel's investment in Costa Rica, whereas research conducted around the same time by Larraín, Lopez-Calva and Rodríguez-Clare (2000) argues that Intel's investment in Costa Rica has indeed generated positive spillovers in the Costa Rican economy.
12. An overview of the interrelationships between trade policy, domestic investment and FDI can be found in OECD (2005).
13. As the horizontal linkage represents the average value of the foreign share in the firms of the sector, the value is between 0 and 1. Thus, a sector with a score of 1 includes only firms that are wholly-owned subsidiaries of foreign companies, and a score of 0 indicates a sector which includes only domestic firms.
14. Using only the value of domestic outputs represents a departure from the methodology of Javorcik (2004). By only considering domestic inputs and output relationships, we have a better sense of how foreign presence affects the domestic economy.
15. The inclusion of the horizontal linkage in the equation accounts for intra-industry inputs, so they are excluded in the aggregate.
16. Figure 1 provides an indication of the foreign presence in each sector; an analysis of the productivity spillovers that can be derived from these linkages is presented in Section 3.
17. The dependent variable in our model is operating revenue at constant prices, a close but not perfect measure of firm output.
18. Several empirical studies on FDI spillovers are based on this firm-level dataset. Most of these studies are, however, country specific (*e.g.*, Javorcik and Spatareanu (2003) on Romanian firms. A cross-country approach is followed here.
19. For example, one advantage of using panel data rather than cross-sectional data is that the estimates are much less sensitive to omitted variable bias because they do not assume that one year of data is representative of the long-run equilibrium.
20. The trade measures include the applied weighted average tariff rate from the TRAINS database, the trade indicator from the Heritage Foundation's Index of Economic Freedom (this measure takes into account both tariff and certain non-tariff barriers). To cover trade in services in Mode 3, we look also at restrictiveness on inward FDI using OECD indicators (see Golub, 2003 and Koyama and Golub, 2006). These indicators quantify FDI restrictions on foreign equity limits, screening and approval requirements, input and operational measures, the movement of people, and rules governing management and Boards of Directors.
21. See Arnold (2005) for an overview of the methods available for estimating productivity at the firm-level.

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ANNEX 1

The Dataset

The dataset covers the following countries for the period 1993-2006, although the number of observations per year varies: Austria, Belgium, Finland, France, Germany, Hungary, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Spain, and Sweden. The sectoral classification used in the dataset can be found in the table below.

Table A.1.1. **The sectoral classification**

Sectoral Classification (ISIC Rev. 3)	
	Primary
1 + 2 + 5	Agriculture, hunting, forestry and fishing
10 + 11 + 12	Mining and quarrying (energy)
13 + 14	Mining and quarrying (non-energy)
	Manufacturing
15 + 16	Food products, beverages and tobacco
17 + 18 + 19	Textiles, textile products, leather and footwear
20	Wood and products of wood and cork
21 + 22	Pulp, paper, paper products, printing and publishing
23	Coke, refined petroleum products and nuclear fuel
24	Chemicals (including pharmaceuticals)
25	Rubber and plastics products
26	Other non-metallic mineral products
27	Iron and steel/Non-ferrous metals
28	Fabricated metal products, except machinery and equipment
29	Machinery and equipment, nec.
30	Office, accounting and computing machinery
31	Electrical machinery and apparatus, nec.
32	Radio, television and communication equipment
33	Medical, precision and optical instruments
34	Motor vehicles, trailers and semi-trailers
35	Building and repairing of ships and boats/Aircraft and spacecraft/Railroad and transport equipment, nec.
36 + 37	Manufacturing nec, recycling (include Furniture)
	Services
40	Production, collection and distribution of electricity, gas and steam
41	Collection, purification and distribution of water
45	Construction
50 + 51 + 52	Wholesale and retail trade; repairs
55	Hotels and restaurants
60	Land transport; transport via pipelines
61	Water transport
62	Air transport
63	Supporting and auxiliary transport activities; activities of travel agencies
64	Post and telecommunications
65 + 66 + 67	Finance and insurance
70	Real estate activities
71	Renting of machinery and equipment
72	Computer and related activities
73	Research and development
74	Other business activities
75	Public administration and defence; compulsory social security
80	Education
85	Health and social work
90 + 91 + 92 + 93	Other community, social and personal services
95 + 99	Private households with employed persons and extra-territorial organisations and bodies

Input-output data comes from the 2007 edition of the OECD Input-Output Database for the years indicated in Table A.1.2 below.

Table A.1.2. **Input-output data**

Country	Input-Output Data
Austria	1995/2000
Belgium	1995/2000
Finland	1995/2000
France	1995/2000
Germany	1995/2000
Hungary	1998/2000
Italy	1995/2000
Luxembourg	1995/2000
Netherlands	1995/2000
Norway	1995/2000
Poland	1995/2000
Portugal	1995/2000
Slovak Republic	1995/2000
Spain	1995/2000
Sweden	1995/2000

Table A.1.3. **Variable descriptions**

Variable	Description	Source
Output (lnoprev)	The log of operating revenue in constant 2000 prices	AMADEUS
Labour (lnlabour)	The log of the number of employees	AMADEUS
Capital (lncap)	The log of fixed assets in constant 2000 prices	AMADEUS
Materials (lnmat)	The log the cost of materials in constant 2000 prices	AMADEUS
Foreign share (forshare)	The percentage of shares held by foreign shareholders	Calculated by the authors using AMADEUS
Horizontal linkage (spill)	The average level of foreign ownership across each sector weighted by the firm's share in total sectoral output	Calculated by the authors using AMADEUS
Backward linkage (spill)	A measure of the spillover effects on a producer industry from foreign presence in downstream sectors	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Forward linkage (spill)	A measure of the spillover effects from foreign presence in a producer industry's suppliers	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Backward linkage primary (spill)	A measure of the spillover effects on a producer industry from foreign presence in downstream primary product sectors	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Backward linkage manufacturing (spill)	A measure of the spillover effects on a producer industry from foreign presence in downstream manufacturing sectors	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Backward linkage services (spill)	A measure of the spillover effects on a producer industry from foreign presence in downstream services sectors	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Forward linkage primary (spill)	A measure of the spillover effects from foreign presence in the primary product suppliers of a producer industry	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Forward linkage manufacturing (spill)	A measure of the spillover effects from foreign presence in the manufacturing suppliers of a producer industry	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Forward linkage services (spill)	A measure of the spillover effects from foreign presence in the services suppliers of a producer industry	Calculated by the authors using AMADEUS and the 2007 OECD Input-Output Database
Tariff (policy)	The natural log of the weighted average applied tariff rate in sector *j*	UNCTAD Trains Database
Index of Economic Freedom (IEF) (policy)	The trade indicator in the Index of Economic Freedom	Heritage Foundation
FDI Rectrictiveness Index (policy)	The value of the OECD FDI regulatory restrictiveness index in sector *j*	OECD (Koyama and Golub, 2006)

ANNEX 2

The Amadeus Database and the Foreign Share Calculations

We use a subset of Bureau Van Dijk's AMADEUS dataset that includes the top 1.5 million companies out of 9 million available. Companies are selected on the basis of their size as well as certain additional criteria to generate a representative sample in terms of sectors and countries. The sample includes some SMEs, with about half of the companies in the sample having less than 20 employees. Among the firms in the sample, 208 796 firms contained the data required for our study, including ownership information. The final sample thus includes 17 countries with a total of 1 193 634 observations. On average, there are 5 years of observations for each company.

The foreign share variable that we calculate for each company is defined as the percentage of shares held by foreign shareholders. Both direct and indirect ownership is taken into account. A foreign shareholder is defined as a corporation from a foreign country. Private individuals are not regarded as foreign shareholders. Firstly, there is no information on their nationality in the AMADEUS ownership database and it is not possible to distinguish between domestic and foreign individuals. Secondly, assuming they are from a different country, they are not expected to have any active role in the management of the company and therefore are not part of the "foreign presence" that we would like to measure in relation to potential productivity spillovers. Public shareholders are regarded as domestic as it is unclear whether foreign public shareholders are also classified as public shareholders in the AMADEUS ownership database (similar to the situation involving private individuals, there is no information reported on the country of origin of public shareholders). Likewise, when a corporation is listed as a shareholder but the information is missing on its nationality, it is not included in the calculation of the foreign share.

Not all shareholders are listed by Bureau Van Dijk, but the ownership database is quite extensive (it includes 21 million active links) and many of the shareholders listed have a negligible share so that generally all the main shareholders should be covered. However, the nationality of shareholders is not always easy to identify as a shareholder can be a subsidiary of another foreign or domestic company. We rely on the information on the "global ultimate owner" when available to identify the nationality of the investor. There are several possible definitions of the ultimate owner in AMADEUS. The one that was used here relies on a minimum percentage of 25% at each step of the path from a subject company to its ultimate owner. The ultimate owner (the "end" of the path) is identified through the independence indicator reported by Bureau Van Dijk when the company is regarded as independent and has no owner.

An issue related to the difficulty in identifying ultimate owners is that the total number of shares retained by the listed shareholders (*i.e.* the "total ownership") sometimes exceeds 100%. This means that sometimes, participation is counted more than once. As an example, consider the following scenario: Company B has a direct participation of 20% in company A but company B is fully owned by company C which is also reported as an indirect shareholder in company A. If the link between companies B and C is not known and is thus not taken into account, the addition of the shares detained by B, C and other shareholders is likely to be greater than 100%. It can affect the foreign share calculated when the same participation is regarded as foreign in one case and domestic in another (if in the above example company B is a domestic company and company C is a foreign company). There are, however, very few companies in which the total ownership is above 100% in the dataset, and since in most of these instances the firm is either fully domestic or foreign, any mistake in the total of shares has no impact on the foreign share calculated.

The main limitation to the ownership information in AMADEUS is that only the most recent information is reported. It is therefore not possible to follow changes in ownership and events such as mergers or acquisitions. We thus assume that the ownership structure is unchanged over the years in the panel. To see the extent to which this may affect the results, the main regressions are also estimated over a shorter time period corresponding to the years for which the ownership information is likely to be more robust (2004-2006). The results are quite similar, at least regarding the sign and magnitude of the main variables, including the foreign shares.

Again, the foreign share is susceptible to change only when domestic owners become foreign or *vice versa*. Ownership changes that are between domestic or foreign companies have no consequence for the foreign share calculated. In any case, the bias introduced in the analysis by the lack of information on past ownership is expected to be small as the dataset includes many more observations corresponding to recent years for which the ownership information is accurate.

ANNEX 3

Regression Results

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Table A.3.1. **Regressions at the aggregate level**

	OLS fixed effects – Robust standard errors			OLS fixed effects – Clustered standard errors			OLS fixed effects (with firm fixed effects)			Dynamic panel estimation		
Dependent variable: operating revenue	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Labor input	0.345***	0.340***	0.341***	0.345***	0.340***	0.341***	0.287***	0.291***	0.290***	0.123***	0.129***	0.132***
	(0.000910)	(0.000848)	(0.000867)	(0.00521)	(0.00334)	(0.00349)	(0.00214)	(0.00216)	(0.00216)	(0.00448)	(0.00454)	(0.00448)
Capital input	0.127***	0.132***	0.133***	0.127***	0.132***	0.133***	0.113***	0.110***	0.109***	0.0526***	0.0527***	0.0532***
	(0.000550)	(0.000534)	(0.000543)	(0.00305)	(0.00258)	(0.00273)	(0.000876)	(0.000872)	(0.000870)	(0.00251)	(0.00249)	(0.00245)
Material input	0.416***	0.400***	0.407***	0.416***	0.400***	0.407***	0.439***	0.440***	0.440***	0.359***	0.363***	0.364***
	(0.000781)	(0.000683)	(0.000709)	(0.00448)	(0.00399)	(0.00368)	(0.00182)	(0.00185)	(0.00185)	(0.00450)	(0.00455)	(0.00452)
Foreign share	0.201***	0.226***	0.211***	0.201***	0.226***	0.211***						
	(0.00168)	(0.00176)	(0.00176)	(0.00651)	(0.00586)	(0.00593)						
Horizontal linkages	0.198***	–0.0340***	0.0375***	0.198***	–0.0340	0.0375*	–0.197***	–0.195***	–0.177***	–0.0857***	–0.0742***	–0.0291**
	(0.00604)	(0.00425)	(0.00426)	(0.0105)	(0.0229)	(0.0198)	(0.00853)	(0.00865)	(0.00869)	(0.0122)	(0.0121)	(0.0118)
Backward linkages		0.506***			0.506***			–0.804***			–0.640***	
		(0.00834)			(0.0503)			(0.0251)			(0.0397)	
Forward linkages		–1.743***			–1.743***			0.738***			–0.0464**	
		(0.0121)			(0.0558)			(0.0151)			(0.0204)	
Backward Primary			–0.236***			–0.236			–0.202***			0.646***
			(0.0610)			(0.477)			(0.0653)			(0.0851)
Backward Manufacturing			–0.120***			–0.120**			–1.951***			–1.177***
			(0.00937)			(0.0532)			(0.0400)			(0.0715)
Backward Services			0.911***			0.911***			0.430***			0.248***
			(0.0177)			(0.140)			(0.0337)			(0.0440)
Forward Primary			–3.602***			–3.602***			–0.995***			–1.456***
			(0.0409)			(0.220)			(0.0559)			(0.100)
Forward Manufacturing			–1.888***			–1.888***			1.227***			–0.485***
			(0.0126)			(0.0625)			(0.0393)			(0.0677)
Forward Services			–0.197***			–0.197			0.462***			–0.0108
			(0.0192)			(0.128)			(0.0182)			(0.0251)
Operating revenue (L1)										0.757***	0.751***	0.724***
										(0.0108)	(0.0110)	(0.0108)

Table A.3.1. **Regressions at the aggregate level** *(cont.)*

	OLS fixed effects – Robust standard errors			OLS fixed effects – Clustered standard errors			OLS fixed effects (with firm fixed effects)			Dynamic panel estimation		
Dependent variable: operating revenue	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector	Horizontal linkages	Backward and forward linkages	Decomposition by sector
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Labor input (L1)										–0.0742***	–0.0764***	–0.0695***
										(0.00351)	(0.00368)	(0.00361)
Material input (L1)										–0.279***	–0.279***	–0.270***
										(0.00551)	(0.00556)	(0.00544)
Capital input (L1)										–0.0283***	–0.0259***	–0.0235***
										(0.00234)	(0.00232)	(0.00229)
Observations	1 159 345	1 139 400	1 139 400	1 159 345	1 139 400	1 139 400	955 641	942 004	942 004	733 192	722 943	722 943
R-squared	0.865	0.852	0.852	0.865	0.852	0.852	0.968	0.968	0.968	n.a.	n.a.	n.a.

Standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

Table A.3.2. **Regressions with the trade variables**

Dependent variable: operating revenue	Average weighted tariff		Index of economic freedom		FDI restrictiveness index	
	(1)	(2)	(3)	(4)	(5)	(6)
Labor input	0.329***	0.329***	0.373***	0.374***	0.351***	0.348***
	(0.00163)	(0.00162)	(0.000864)	(0.000864)	(0.00096)	(0.00097)
Capital input	0.134***	0.134***	0.143***	0.143***	0.123***	0.123***
	(0.00107)	(0.00107)	(0.000540)	(0.000540)	(0.00059)	(0.00059)
Material input	0.462***	0.463***	0.397***	0.397***	0.412***	0.413***
	(0.00162)	(0.00162)	(0.000718)	(0.000718)	(0.00085)	(0.00084)
Foreign share	0.123***	0.122***	0.269***	0.269***	0.216***	0.217***
	(0.00243)	(0.00242)	(0.00180)	(0.00180)	(0.0018)	(0.0018)
Horizontal linkages	0.164***	0.0626***	0.134***	–3.288***	0.164***	–0.500***
	(0.00479)	(0.00610)	(0.00448)	(0.384)	(0.0064)	(0.020)
Backward linkages	–0.0485***	–0.0438**	0.836***	1.256***	–0.808***	–0.945***
	(0.0133)	(0.0177)	(0.00860)	(0.804)	(0.013)	(0.041)
Forward linkages	–0.388***	–0.246***	–0.988***	–19.74***	–0.311***	–0.160***
	(0.0170)	(0.0209)	(0.0106)	(0.948)	(0.013)	(0.043)
Trade variable (see column heading)	–0.00469***	0.00313**	–0.0864***	–1.342***	–5.521***	–7.157***
	(0.000390)	(0.00138)	(0.0192)	(0.0420)	(0.020)	(0.061)
Interaction with horizontal linkages		0.0375***		0.795***		4.679***
		(0.00158)		(0.0891)		(0.13)
Interaction with backward linkages		–0.00835		–0.0969		1.168***
		(0.00557)		(0.187)		(0.30)
Interaction with forward linkages		–0.114***		4.358***		–1.061***
		(0.00734)		(0.220)		(0.31)
Observations	337 609	337 609	1 138 031	1 138 031	977 082	977 082
R-squared	0.916	0.916	0.841	0.841	0.860	0.860

Robust standard errors in parentheses. *** p < 0.01, ** p < 0.05, * p < 0.1.

Table A.3.3. **Spillovers at the sector level**

Industry	Industry name	Horizontal	Backward	Forward	Nb obs.	R-squared
1	Agriculture, hunting, forestry and fishing	–0.560***	0.178	2.621***	13.389	0.945
2	Mining and quarrying (energy)	0.194*	–0.626**	–0.202	812	0.973
3	Mining and quarrying (non-energy)	–0.0918	–0.114	1.090***	5.986	0.946
4	Food, beverages and tobacco	–0.196***	0.299***	–0.853***	37.800	0.983
5	Textiles, leather and footwear	0.146**	2.784***	–1.378***	23.750	0.981
6	Wood and cork products	0.250***	–2.973***	–0.505***	12.839	0.979
7	Pulp, paper and printing	0.414***	–0.364***	1.574***	27.459	0.975
8	Coke, refined petroleum and nuclear fuel	–0.0284	–2.307***	0.756*	684	0.985
9	Chemicals (incl. pharmaceuticals)	0.200***	–0.834***	0.432***	10.782	0.982
11	Rubber and plastic products	0.0966***	–1.755***	0.410***	15.131	0.984
12	Other non-metallic mineral products	–0.227***	–0.557***	–0.494***	18.030	0.984
13	Iron, steel and non-ferrous metals	–0.0601	–0.0123	–0.526**	4.112	0.990
15	Fabricated metal (ex. machinery and equipment)	–0.442***	–1.544***	0.413***	42.734	0.976
16	Machinery and equipment, nec.	0.0699*	–2.182***	0.00454	25.457	0.978
17	Office, accounting and computing machinery	0.0618	–0.332	–1.004	947	0.977
18	Electrical machinery and apparatus, nec.	–0.188***	–1.169***	–0.474***	9.049	0.982
19	Radio, television and communication equipment	–0.220***	–0.770***	–0.119	3.925	0.974
20	Medical, precision and optical instruments	–0.170***	–1.049***	0.912***	5.787	0.976
21	Motor vehicles, trailers and semi-trailers	–0.136**	–1.886***	–0.763**	5.855	0.986
22	Other transport equipment	–0.348***	–0.460***	1.128***	3.453	0.973
25	Manufacturing nec. and recycling (incl. furniture)	–0.355***	0.0377	0.0659	14.785	0.973
26	Production and distribution of electricity, gas and steam	–0.541***	0.908**	0.580***	4.284	0.976
29	Collection, purification and distribution of water	–1.248***	–2.960***	–0.128	1.742	0.977
30	Construction	–0.607***	1.155***	–0.121*	106.553	0.963
31	Wholesale and retail trade; repairs	–0.572***	–3.576***	1.029***	321.934	0.979
32	Hotels and restaurants	0.140***	2.169***	–1.612***	29.909	0.966
33	Land transport; transport via pipelines	0.852***	–0.115	1.278***	26.860	0.960
34	Water transport	–0.746***	1.850***	–0.206	1.465	0.975
35	Air transport	–0.785***	–2.276**	–0.713	515	0.972
36	Supporting transport and travel agency activities	0.555***	–3.139***	2.636***	17.053	0.956
37	Post and telecommunications	–0.0491	1.029	–2.143**	2.634	0.967
38	Finance and insurance	0.271***	–2.594***	–0.580	2.956	0.967
39	Real estate activities	–0.129	0.460*	0.605***	29.546	0.927
40	Renting of machinery and equipment	0.323***	–0.673**	0.753***	6.076	0.958
41	Computer and related activities	–0.775***	2.305***	–1.718***	15.141	0.947
42	Research and development	0.0532	1.134*	–1.060	1.528	0.958
43	Other business activities	0.0822***	0.955***	1.074***	50.708	0.969
45	Education	–0.0856	1.839**	1.291***	2.695	0.949
46	Health and social work	0.575***	–2.898***	3.013***	14.302	0.968
47	Other social and personal services	0.402***	0.827***	1.170***	23.065	0.951

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

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Conditions for Positive Spillovers for FDI: A Case Study of Georgia, Kyrgyzstan, Moldova and Ukraine

by
Alina Kudina and Malgorzata Jakubiak*

This paper examines the motives behind foreign direct investments located in a group of four Commonwealth of Independent States (CIS) countries (Ukraine, Moldova, Georgia and Kyrgyzstan) based on a survey of 120 enterprises. The results indicate that non-oil MNEs are predominantly oriented towards local markets. On average, MNEs in these four countries operate as "isolated players", weakly co-operating with local firms but strongly linked to their parent companies. The surveyed firms procure a low share of their supplies locally. For this reason, the possibility for spillovers arising from co-operation with foreign-owned firms in the CIS is rather low. There is a lack of efficiency-seeking investment that poses further concerns about the nature of FDI in the region. The most important problems for the surveyed foreign firms are the volatility of the political and economic environment, ambiguities in the legal system, and corruption.

* Alina Kudina, Assistant Professor of International Business, Warwick Business School, University of Warwick. Malgorzata Jakubiak, Research Fellow, CASE Center for Social and Economic Research. Correspondence should be addressed to: *alina.kudina@ubs.ac.uk*.
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1. Introduction

The importance of transition economies as investment sites for multinational enterprises (MNEs) has drastically increased over the past decade. With economic liberalisation of Central and Eastern European countries and the former Soviet Union republics, and strong growth in China and the East Asian economies, vast market and production opportunities have opened up for multinational businesses. Although a number of MNEs have successfully managed to capitalise on these opportunities, some firms have been significantly less successful in their internationalisation efforts. Various internal and external factors have been shown considerably to affect the success of MNEs in transition economies (Peng and Heath 1996; Khanna and Palepu 1997; Luo and Peng 1999; Isobe et al 2000; Peng and Luo 2000; Uhlenbruck and De Castro 2000).

Among transition economies, the region of the Commonwealth of Independent States (CIS) has experienced a boom in foreign direct investment (FDI) in recent years. The magnitude of capital inflows resembles the FDI attracted to Central and East Europe (CEE) in the 1990s. In 1999, FDI going to CEE countries contributed to a major growth of productivity of local industries and services, acting as an important source of modern technologies and managerial knowledge.

The aim of the current analysis is to explore the motives for FDI in the smaller CIS countries (Ukraine, Moldova, Georgia and Kyrgyzstan), as well as to analyse how the business and industry environment in these countries affects foreign investors. The study targets three groups of investors with potentially different investment motives: market-seekers, resource/labour-seekers and efficiency-seekers (classification after Dunning, 1993). This analysis complements earlier results which largely centred on Russia (Rogacheva and Mikerova, 2003, and Ledayeva 2007) by showing what aspects of the investment climate are of particular concern to investors into the CIS. It also increases our understanding of the problems which investors are facing in the CIS by differentiating among various investment types.

We approach this task by surveying foreign-owned companies located in the four CIS countries (120 firms in total). The survey took place in 2007-2008. Oil and resource-attracting countries were dropped from the analysis. In this way we were able to see the analogies with the CEE or South-East European (SEE) countries, which have attracted mainly non-oil FDI.

The paper is structured as follows. Part 2 presents basic theoretical and empirical studies on the motives for FDI in general and in the CEE/CIS setting in particular. Part 3 describes key facts about FDI flows into the region. Part 4 investigates the survey findings followed by an econometric analysis of the data. The last section concludes the paper and offers some suggestions to policy makers.

2. Investment motives

The literature on FDI identifies three common investment motives: resource-seeking, market-seeking and efficiency-seeking (Dunning, 1993).

The availability of natural resources, cheap unskilled or semi-skilled labour, creative assets and physical infrastructure promotes resource-seeking activities. Historically, the most important host country determinant of FDI has been the availability of natural resources, *e.g.* minerals, raw materials and agricultural products.

Even when it was prominent as an FDI determinant, the presence of natural resources by itself was not sufficient for FDI to take place. Comparative advantage in natural resources usually gave rise to trade rather than to FDI. Investment took place when resource-abundant countries either lacked the large amounts of capital typically required for resource extraction or did not have the technical skills needed to extract or sell raw materials to the rest of the world. In addition, infrastructure facilities for getting the raw materials out of the host country and to its final destination had to be in place or needed to be created (UNCTAD, 1998).

Labour-seeking investment is usually undertaken by manufacturing and service MNEs from countries with high real labour costs, which set up or acquire subsidiaries in countries with lower real labour costs to supply labour-intensive intermediate or final products. Frequently, to attract such production, host countries have set up free trade or export processing zones (Dunning, 1993).

Market-seeking investment is attracted by factors like host country market size, per capita income and market growth. For firms, new markets provide a chance to stay competitive and grow within the industry as well as to achieve scale and scope economies. Traditionally, market size and growth as FDI determinants related to national markets for manufacturing products sheltered from international competition by high tariffs or quotas that triggered "tariff-jumping" FDI (UNCTAD, 1998, 107). Apart from market size and trade restrictions, MNEs might be prompted to engage in market-seeking investment, when their main suppliers or customers set up foreign production facilities and in order to retain their business they need to follow them overseas (Dunning, 1993, 58).

Efficiency-seeking FDI is intended to rationalise the structure of established resource-based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities. Efficiency-seeking MNEs take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and market structures by concentrating production in a limited number of locations to supply multiple markets (Dunning, 1993, 59). In order for efficiency-seeking foreign production to take place, cross-border markets must be both well developed and open, therefore it often flourishes in regionally integrated markets (Dunning, 1993, 59).

Many of the larger MNEs pursue multiple objectives and most engage in FDI that combines the characteristics of each of the above categories. The motives for foreign production may also change as, for example, when a firm becomes an established and experienced foreign investor (Dunning, 1993, 56).

3. Evidence on determinants of FDI in the current New Member-States (NMS) and Western Balkans

3.1. Market-seeking investors

The research on the determinants of FDI in Central and Eastern Europe has been relatively abundant. Table 1 presents these studies according to the research period and region. A number of the studies find that investors in the CEE countries have been market driven. For example, papers by Resmini (1999) and later ones by Merlevede and Shoors (2004) and Johnson (2004) show that investors have been looking for new market opportunities. The same conclusion was obtained by Shapiro and Tang (2004). This motive was of particular importance in the 1990s, when many investors decided to open production facilities in the CEE due to high import protection in these countries.

Table 1. **Studies on FDI determinants in transition according to the analysed period**

Studies	Period studied	Countries studied
Bevan, Estrin, 2000	1994-1998	CEE
Campos, Kinoshita, 2003	1990-1998	CEE, Baltic, CIS
Carstensen, Toubal, 2003	1993-1999	CEE
Lansbury, Pain, Smidkova, 1996	1991-1993	CEE
Merlevede, Schoors, 2004	1997-1999	CEE, CIS
Resmini, 1999	1990-1995	CEE
Smarzynska, Wei, 2000	1995-1999	Worldwide
Smarzynska, Wei, 2002	1995-1999	USA
Tondel, 2001	1994-1998	CEE, CIS
Bandelj, 2002	1990-2000	CEE
Bevan, Estrin, 2004	1994-2000	CEE
Botric, Skuflic, 2005	1996-2002	SEE
Brada, Kutan, Yigit, 2004	1993-2001	CEE, Balkans
Globerman, Shapiro, Tang, 2004	1995-2001	CEE
Johnson, 2006	1993-2003	CEE
Malesky, 2006	1992-2004	Worldwide
Demekas, Horwath, Ribakova, Wu, 2005	2000-2002	SEE
Hunya, 2002	2000-2002	SEE
Meyer, 2005	Late transition	Worldwide
Shiells, 2003	2001	CIS
Strach, Everett, 2006	2001	Czech Republic

Note: SEE includes usually ex-Yugoslavia plus Albania, Bulgaria and Romania. CEE countries include the Czech Republic, Hungary, Poland, Slovakia (and sometimes Slovenia). CIS stands for the Commonwealth of Independent States.

3.2. Resource-seeking investors

It is also widely argued that FDI and economic openness are positively related (Botric and Skuflic 2005, Resmini 1999, Bevan and Estrin 2000, Smarzynska and Wei 2002). Campos and Kinoshita (2003) examined the effect of cumulative external liberalisation (which reflected a removal of trade controls and quotas, moderation of tariff rates and foreign exchange rate restrictions) on FDI inflows and found this indicator highly significant and positive. Botric and Skuflic (2005) concluded that the increasing trade with other economies will contribute to the stronger integration of SEE countries with other economies in the region and positively influence FDI.

The prospect of increased integration with their highly developed neighbours within the EU usually meant a fall in overall protection throughout the 1990s. At the end of 1990s and at the beginning of 2000s, the CEE countries and the Baltic States were already waiting for EU accession. Several studies examined the effect of anticipated membership (Bevan and Estrin 2000, 2004, Merlevede and Shoors 2004, Globerman, Shapiro, and Tang 2004) on the willingness of outside firms to invest in the CEE. Prospects of EU membership turned out to be positively and significantly related to incoming FDI.

On the one hand, the removal of trade barriers probably made exporting to these countries more profitable than capturing a share of the market through FDI. On the other hand, there is evidence that the fall in protection enhanced further FDI inflows. We argue here that, in the case of the CEE and the Balkan countries, prospects of closer economic links with the EU and a fall in transaction costs made foreign firms more eager to exploit cheap and relatively skilled CEE/SEE labour.

The cost of labour was often found to be significant and negative in equations estimating FDI determinants (Demekas, Horwath, Ribakova, Wu 2005, Smarzynska, Wei 2002). Merlevede and Shoors (2004) examined more closely the sensitivity of the influence of labour cost in transition economies by interacting this variable with a time variable. They measured the evolution of unit labour costs in each country during the period studied relative to other countries in the sample and found that this variable by itself was not significant, but when interacted with a time variable, it had a significantly negative impact on FDI. This indicates that the impact of relative unit labour cost as a determinant becomes more important during the transition period. Another aspect considered by investors is the quality of labour. Lansbury, Pain and Smidkova (1996) included an indicator of research activity (the relative stock of patents granted to residents of the host economy) as a measure of the quality of human capital. They found both relative labour cost and an indicator of research intensity to be significant, which is consistent with the notion that some investors are attracted to Central Europe by a combination of relatively low labour costs and the availability of skilled workers in particular sectors and countries.

3.3. Efficiency-seeking investors

The efficiency-seeking motive of foreign investors into CEE countries is a relatively recent one. It started to gain importance around the years 2004-2007, when ten new CEE and SEE countries entered the EU. However, signs of it could be seen even earlier. For example Campos and Kinoshita (2003) showed that foreign investments in the CEE and Baltic states were attracted by the existence of agglomeration effects, and were positively influenced by the rule of law and the quality of the administration. Tests of the responsiveness of FDI inflows into the CEE countries to differences in relative taxation *vis-à-vis* older EU members have so far yielded mixed results. Lahreche-Revil (2006) added data on some of the current new members[1] to their EU15 sample and tried to separate the effects of corporate taxation in the new EU members for the period 1990-2002. The only strong and general conclusion of the study is that taxation may drive FDI flows, but only within the EU15. This factor is irrelevant when FDI outflows from old to new members are considered. A similar conclusion was obtained earlier by Carstensen and Toubal (2004) who took the difference in statutory rates between two countries as a variable determining bilateral FDI flows for the sample of the CEE countries in 1993-1999 and concluded that the estimated parameter value was small and not significant. In contrast, Edmiston *et al.* (2003) suggested

that the imposition of an additional special tax rate reduced FDI as a per cent of GDP and higher tax rates led to lower inflows of FDI in the Former Soviet Union (FSU) and CEE countries.

4. Determinants of FDI in the CIS

4.1. Resource-seeking investors

The abundance of natural resources in the CIS has been one of the most important determinants of FDI. Shiells (2003) showed that FDI in the CIS up to the early 2000s was related to the extraction of natural resources, the construction of pipelines transporting these energy resources, large privatisations, and debt/equity swaps to pay for energy supplies. The disappointing level of FDI at that time reflected the weak investment climate in the region, particularly because of incomplete structural reforms. Campos and Kinoshita (2003) also found resource-seeking to be the key motive for FDI in the CIS, whereas this factor had no effect for non-CIS transition countries.

Tondel (2001) stressed that, according to IMF estimates, between 75% and 82% of total FDI in Azerbaijan was in the oil and gas industry. Furthermore, of each dollar invested in other parts of economy, 30 cents went to the oil and gas industry. Up to 2006, most FDI in Georgia was related to pipeline transportation. In Kazakhstan, which recorded the highest FDI per capita in the CIS (second only to Azerbaijan), most investments have also been directed towards the natural resource sector. The abundance of energy resources in Russia was also cited as an important determinant of FDI (Rogacheva and Mikerowa 2003, Ledayeva 2007). Ledayeva (2007) found that, after the 1998 Russian financial crisis, the importance of large cities, the availability of oil and gas resources, and legislative risk all increased in importance, while the importance of sea ports and political risk decreased. Also, the study showed that the cost of production in Russia did not attract FDI.

4.2. Market-seeking investors

Many studies of FDI in the CIS point to the paramount importance of market-seeking motives for investors. The earliest of this kind is by Collins and Rodrick (1991). Access to the domestic market of the FSU was reported to be a major motive for investment just at the time when the Soviet Union was falling apart. The survey was conducted among 54 larger companies operating in the USSR in 1990-91. The second most important determinant was proximity to the European Community.

Market-seeking motives were also found to be highly important in later studies. Tondel (2001) found both market-seeking and natural resource-seeking motives to be highly relevant for FDI in the CIS. More recent results by Johnson (2006) also suggest that FDI in the CIS has been both market- and resource-driven. Market size measured by GDP per capita in the CIS countries and an oil dummy were both positive and significant in Johnson's equations, while wages were negative.

Market-seeking motives were also found to be driving FDI into Russia. According to the results of a survey by Rogacheva and Mikerova (2003), the main motive for investment in Russia was market potential (obtaining 9 points of 10). Natural resources were also important in view of significant investment (6 points) in the Russian oil sector. Strategic location (1 point) was the main concern for the multinational companies doing business all over the world. Low costs (1 point) were recognised as insignificant. Interestingly, the

political and economic situation in Russia was deemed stable enough to invest. The market-seeking motive in Russia was also confirmed by Ledayeva (2007).

Table 2 compares studies of motives for FDI into the CIS and current new EU member states. This simplified review shows that foreign investors seek markets both in the CIS and in the NMS. The difference is that natural resource-seeking factors prevail in the CIS, while factors that relate to the efficient use of labour and cross-border efficiency are important in the NMS setting.

Table 2. **The relation between FDI determinants and the character of investment decision**

Group of countries	Variables determining FDI inflows
CIS	**Resource-seeking factors**
	Abundance of natural resources
	Campos, Kinoshita, 2003
	Johnson, 2006
	Merlevede, Shoors, 2004
	Shiells, 2003
	Market-seeking factors
	Market size (growth)
	Tondel, 2001
	Johnson, 2006
	Merlevede, Shoors, 2004
	Efficiency-seeking factors
	n.a.
Current new EU members and Western Balkans	**Resource-seeking factors**
	Labour
	Horwath, Ribakova, Wu, 2005
	Smarzynska, Wei, 2002
	Merlevede, Shoors, 2004
	Lansbury, Pain and Smidkova, 1996
	Market-seeking factors
	Market size (growth)
	Johnson, 2006
	Merlevede, Shoors, 2004
	Population
	Johnson, 2006
	Efficiency-seeking factors
	Institutions
	Campos, Kinoshita, 2003
	Transition progress
	Tondel, 2001
	Agglomeration
	Campos, Kinoshita, 2003
	Privatisation method
	Merlevede, Shoors 2004
	Botric, Skuflic 2005

Source: Author.

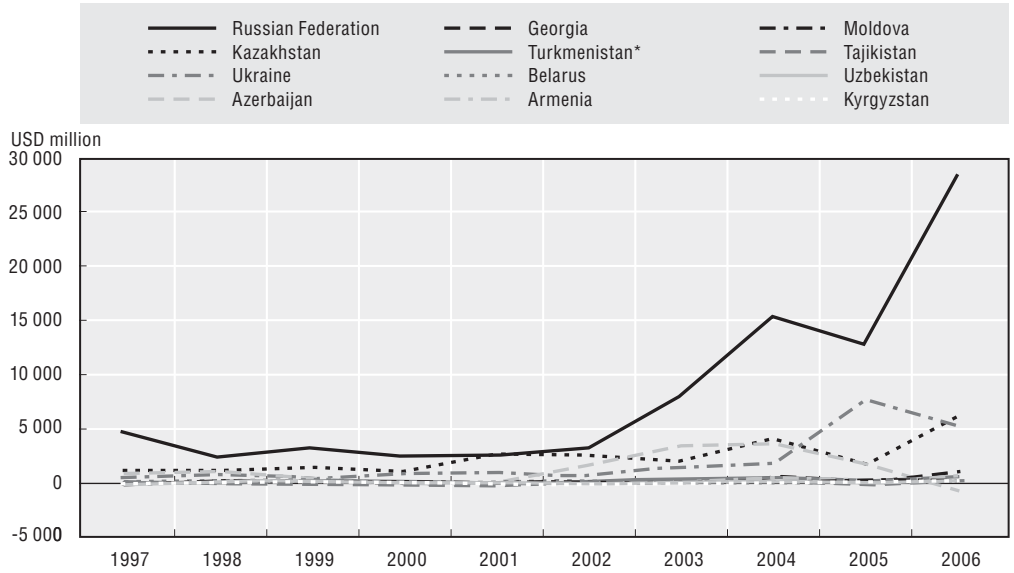
5. FDI inflows in the CIS

FDI inflows to the whole CIS region averaged about US$19 bn a year from 2000 to 2006. Over half (US$11 bn a year on average) went to the Russian Federation (see Figure 1). This investment was mainly directed to the extraction and transportation of the energy

resources. Two other CIS countries with abundant energy resources, Kazakhstan and Azerbaijan, attracted US$3 bn and US$1 bn per annum respectively during 2000-2006.

In comparison, the eight CEE countries which joined the EU in 2004[2] recorded collectively US$25 bn in FDI inflows per annum on average in 2000-2006. The largest country of this group, Poland, attracted on average US$9 bn per year mainly due to the development of the financial intermediation and manufacturing sectors in this period. Poland was followed by the Czech Republic with US$6 bn on average in 2000-2006.

Figure 1. **FDI inflows to the CIS, 1997-2006**



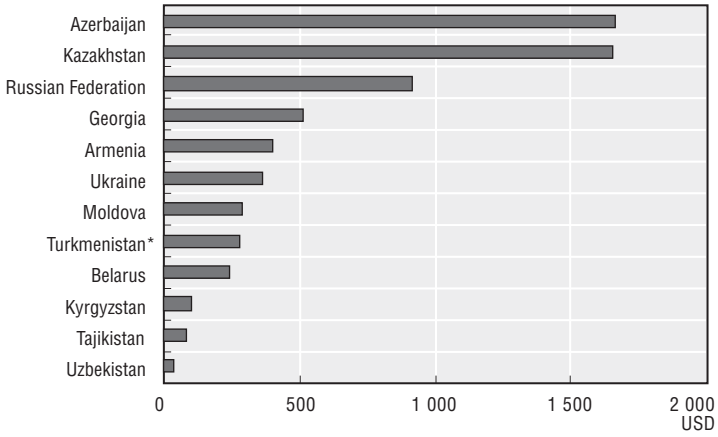
Note: * Turkmenistan was in the CIS in 1991-2005; associate member since 2005.
Source: UNCTAD.

In terms of the accumulated FDI stock per capita, energy-resources and/or energy transit CIS countries lead (see Figure 2). Azerbaijan and Kazakhstan accumulated an FDI stock of over US$1 500 per capita in 2005, while that of Russia was close to US$1 000 and that of Georgia about US$500. As a comparison, the per capita FDI stock in Croatia in 2005 was US$2 800, and those for Romania and Bulgaria were over US$1 000. FDI per capita in the CEE countries ranged from US$2 700 in Poland to US$9 400 in Estonia.

Some CIS economies have been highly dependent on FDI, in spite of a low stock of FDI per capita. In Tajikistan, FDI inflows in the 2000s have accounted for the majority of all investment in the country, reflecting a lack of domestic resources. Over one third of overall investment in resource-rich Azerbaijan and Kazakhstan and in consumption-driven Moldova was made by foreigners during 2000-2006. On the other hand, Uzbekistan, Belarus and Russia depend little on FDI. Less than 10% of all investment in these countries was made by foreign firms.

In general, the CIS countries are on average less FDI-dependent than the CEE and SEE countries.[3] The average share of foreign firms in total investment in the CEE countries[4] in 2000-2006 was around 23%, and in the SEE countries[5] 26%. It also reflects the fact that on average the CIS countries are still less open to FDI than their Eastern, Central and Southern European neighbours.

Figure 2. **FDI stock per capita in the CIS in 2005**



Note: * Turkmenistan was in the CIS in 1991-2005; associate member since 2005.
Source: UNCTAD.

Table 3. **FDI inflows in per cent of domestic investment in CIS, 1997-2006**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Commonwealth of Independent States (CIS)	8.9	9.8	13.4	8.4	9.0	10.5	14.2	17.7	13.3	17.1
Tajikistan	*11.1*	*16.9*	*3.7*	*39.6*	*11.6*	*48.3*	*13.0*	*100.0***	*27.5*	*100.0***
Azerbaijan	*71.7*	*60.0*	*27.2*	*2.5*	*16.8*	*65.5*	*83.9*	*72.0*	*30.7*	*–*
Kazakhstan	*36.7*	*33.1*	*53.9*	*40.5*	*53.9*	*43.8*	*29.4*	*36.9*	*11.9*	*27.6*
Moldova, Republic of	*20.5*	*20.2*	*17.5*	*64.1*	*41.7*	*31.0*	*20.1*	*27.1*	*28.0*	*29.7*
Georgia	*37.4*	*28.7*	*11.3*	*17.4*	*15.2*	*20.1*	*32.3*	*33.6*	*24.0*	*54.5*
Armenia	*19.5*	*72.0*	*40.3*	*29.6*	*18.7*	*22.1*	*18.7*	*27.2*	*19.0*	*16.4*
*Turkmenistan**	*9.8*	*4.8*	*8.2*	*8.9*	*11.8*	*22.1*	*17.5*	*27.0*	*24.3*	*40.2*
Kyrgyzstan	*37.9*	*51.7*	*22.6*	*-*	*1.9*	*1.8*	*17.4*	*54.4*	*11.3*	*45.7*
Ukraine	*6.3*	*9.1*	*8.2*	*9.7*	*10.6*	*8.5*	*13.8*	*11.7*	*43.0*	*21.0*
Russian Federation	*6.6*	*6.3*	*11.7*	*6.2*	*4.7*	*5.6*	*10.0*	*14.3*	*9.2*	*16.3*
Belarus	*9.9*	*5.1*	*13.9*	*4.5*	*3.4*	*7.7*	*3.8*	*2.6*	*4.0*	*3.4*
Uzbekistan	*3.2*	*3.1*	*2.6*	*2.3*	*3.2*	*3.0*	*3.3*	*7.0*	*3.0*	*5.4*

Note: * Turkmenistan was in the CIS in 1991-2005; associate member since 2005.
** Own estimate.
Source: UNCTAD.

In our subsequent research, oil and resource-rich countries were dropped from the analysis as we would like to capture possible analogies with the CEE/SEE countries (which have attracted mainly non-oil FDI). Such FDI in the CEE/SEE countries contributed to the major growth of productivity, and this is why this kind of investment is of most interest here in this paper. Taken together, the survey covers countries that attracted about 16% of overall FDI flows to the CIS in 2006.

6. Survey results

6.1. Survey design

This section presents the results of a survey of 120 foreign owned-companies located in Georgia, Moldova, Kyrgyzstan and Ukraine. The representatives of the companies in each country were asked a set of identical questions about their reasons for investing in the CIS,

their impression of the business environment and impediments they face in their everyday activities. The survey was conducted in 2007-2008.

While drafting the questionnaire, existing findings on the investment motives in the CIS, CEE and SEE (described in the preceding part of this paper) were considered. The questions about the business environment of foreign-owned firms were formulated in such a way that allowed us to draw conclusions about the nature of production chains and check for the existence of various linkages between foreign-owned and local firms. There is evidence that the existence of such linkages (especially of the vertical type) has facilitated knowledge spillovers from foreign-owned to domestic firms in some of the current new member EU states in the 1990s. The most relevant examples may be those of Romania and Lithuania (see Javorcik and Spartaneu 2006, Altomonte and Pennings 2006, Smazynska-Javorcik 2004). Therefore, it was interesting to check whether such spillovers can be detected in the CIS as well.

6.2. Description of the sample

The sample consisted of 30 foreign-owned companies each from Ukraine, Moldova and Georgia, 29 from Kyrgyzstan and 1 from Kazakhstan. Most foreign companies operating in these countries started their business in the 1990s. The median company has been in business for 8 years, has revenues of about US$4.7 mn, and employs 145 people. Company profiles differ among the countries significantly. The Ukrainian companies are the largest in the sample with average annual revenues over five times higher than those of Moldovan companies, who still earned twice as much as Kyrgyz companies, which are the smallest in the sample. The average market share of Georgian companies is less than 20%, whereas it is higher at 28% in Ukraine and Kyrgyzstan. Moldovan foreign-owned companies hold leading positions in the local market, with an average market share of about 47%.

Most foreign companies operating in these countries started their business in the 1990s. For Moldova, Ukraine and Kyrgyzstan, foreign subsidiaries have been in the CIS market for 8-9 years on average and in Georgia for about 6 years.

On average, companies differ significantly among countries in the scope of their business. Foreign companies invested much more in Ukraine and Georgia compared to Moldova and Kyrgyzstan, thus generating higher revenues. The annual revenue of companies investing in Ukraine is about US$80 mn, which is more than five times higher than for Moldovan companies, while the amount of capital invested exceeds the average investment of Moldovan companies by almost three times. The foreign companies working in Kyrgyzstan that participated in our research were the smallest in terms of the scope of their business.

As for personnel employed, foreign companies in Ukraine are also the largest (about 500 employees on average), followed by Moldovan (370), Georgian (237) and Kyrgyz companies (232). The distribution of companies according to the personnel employed seems to be close to the normal distribution with an exception of the thick tail' in the upper end. This thick tail is made up of several big companies employing over 1 000 workers.

The industry structure of the interviewed companies reflects the FDI distribution by industries in the countries, at least in Ukraine and Moldova. Most companies are working in financial services, the food industry, trade, transport and communications and construction. These activities are developing very fast in the CIS countries, yielding high revenues and thus attracting foreign investors. At the same time, the substantial investment inflow is also the key reason behind the rise of these sectors.

Table 4. **Sample statistics**

	Profile	Min	Max	Average
1.	**Years in the country**			
	Ukraine	2	18	8.4
	Moldova	2	17*	8.8*
	Kyrgyzstan	2	15	7.7
	Georgia	1.0	17.0	6.2
2.	**Annual revenue (turnover) of the subsidiary, US$ million**			
	Ukraine	0.03	1 233.0	80.7
	Moldova	0.009	121.1	13.8
	Kyrgyzstan	0.3	30.0	6.8
	Georgia	0.3	280.0	43.7
3.	**Total amount of capital invested, US$ million**			
	Ukraine	0.06	600.0	67.1
	Moldova	0.0004	112.4	21.0
	Kyrgyzstan	0.2	50.0	8.7
	Georgia	0.15	160.0	39.9
4.	**Personnel employed**			
	Ukraine	7	3,500	502
	Moldova	10	1,653	370
	Kyrgyzstan	6	1,200	232
	Georgia	12	1,200	237
5.	**Domestic market share,%**			
	Ukraine	0.5	100.0	28.8
	Moldova	0.4	99.1	46.6
	Kyrgyzstan	5.0	100.0	28.7
	Georgia	0.0	100.0	19.6

Note: Numbers are simple averages. * for Moldova, the numbers exclude answers given by three companies, who stated that they have been in the market (while being foreign-owned) from 60-134 years ago. We disregard those answers, as it seems that respondents described when a given firm started its activities (probably being initially foreign-owned), instead of answering when an enterprise was re-privatised in the post-Soviet era.
Source: Survey results.

Table 5. **Distribution of surveyed companies by sector**

Industry	Ukraine	Moldova	Kyrgyzstan	Georgia	Total
Agriculture	1			1	2
Food industry	4	4	7	4	19
Woodworking, pulp and paper industry, publishing	1		1		2
Textile and leather industry	1		1	1	3
Oil refineries		3	1	2	6
Production of chemicals	2		1	1	4
Machinery and equipment	2		1		3
Mining	1			2	3
Energy		1		3	4
Financial services	4	7	4	8	23
Retail and wholesale trade	7	2	4	1	14
Transport and Communications	3	4	4	1	12
Construction	1	4	4		9
Other activities	3	5	2	6	16
Total	**30**	**30**	**30**	**30**	**120**

Source: Survey results.

6.3. Factors attracting investors into CIS

One of the main objectives of this survey was to explore the nature of FDI coming to CIS countries. As we have mentioned before, investment motives are often classified either as market-seeking (when investing firm wants to supply products and services to a recipient country market) or as resource-seeking (intending to benefit from cost-efficient production in a recipient country) and/or as efficiency-seeking (looking for labour-productivity advantage or local specific creative assets).

We have tested the investment motives by asking interviewees to answer several questions: about the strategic role of the subsidiary established in the host CIS country, directly about their investment motives, and about the share of production which is exported (for details, see Annex 1).

6.4. Market-seeking

This motive clearly comes out as a dominant one in the sample. The companies that participated in the survey hold a substantial share of the recipient country's market. Average domestic market share for Ukrainian and Kyrgyz firms is close to 30%, while Moldovan investors hold leading positions with an average market share of about 47%. Only in Georgia do foreign investors estimate that they posses less than 20% of local market share. This means that a majority of the surveyed firms managed not only to supply their host markets but also to secure dominant positions in these markets.

The percentage of local production of final and intermediate goods that is exported is rather low at 17% and 30% on average (see question 7, Annex 2), with the exception of Moldova[6]. About 70% of all the production of final goods is destined for local markets. Some companies even mentioned that they faced a lot of problems when trying to export their products to other countries, particularly to Russia.

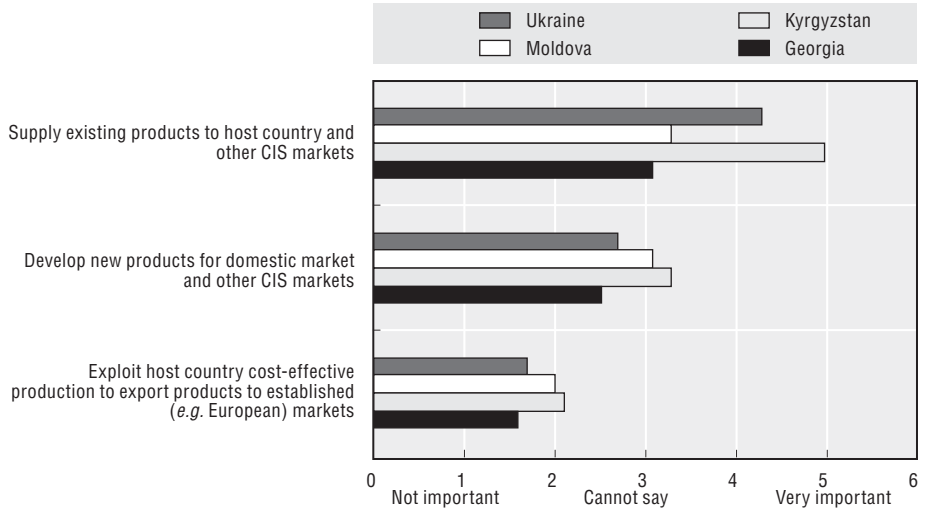
The role of the CIS affiliates in the operations of the parent companies as a supplier of existing products to the host country market and to other CIS markets was assessed on average as rather important (see Figure 3). The companies noted that the growing markets produce high demand, which is very positive for further expansion of their businesses.

This outcome is supported by the results of the assessment of investment motives. The interviewees were asked to grade reasons for opening business activity in the CIS by ranking each of options from 1 (unimportant) to 5 (very important). Most companies mentioned the ability "to serve the host country market" as the most important motive in all three economies (see Figure 4). Companies in Moldova and Kyrgyzstan mentioned the ability to avoid import duties while supplying domestic market as another reason to invest.

6.5. Resource-seeking

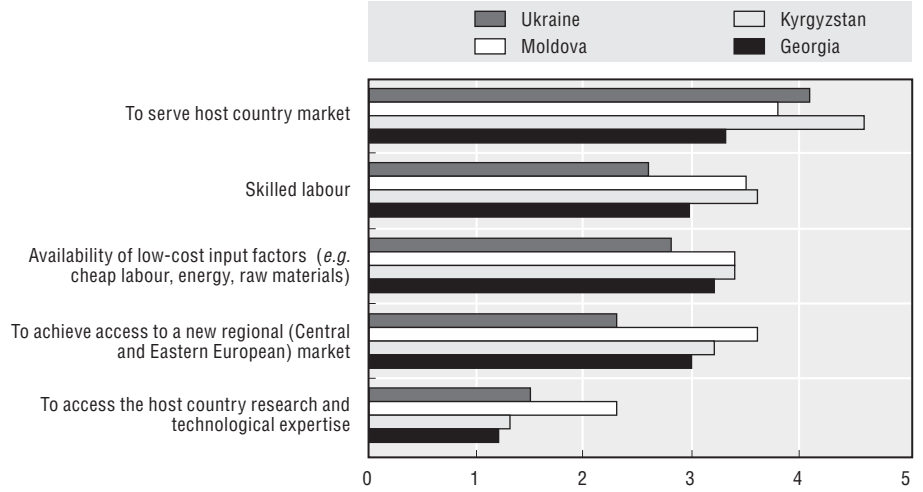
The second and third most important investment motives varied across the countries, although they were predominantly concentrated around the use of low-cost factors of production (including natural resources) and skilled labour. In Ukraine and Georgia, the second most important motive was the availability of low-cost factor inputs, *i.e.* cheap labour, energy and raw materials. This is explained by the availability of rich natural resources along with cheap labour and by the close proximity to the EU in the case of Ukraine. In the case of Georgia, it is probably explained by high investments in pipeline transportation. The desire to use Kyrgyz skilled labour, followed by the availability of low-cost input factors were also behind the decision to invest in Kyrgyzstan. Interestingly, the

Figure 3. **Strategic roles of CIS subsidiaries in operations of their parent companies**



Note: Numbers are simple averages.
Source: Survey results.

Figure 4. **Reasons to invest in the CIS**



Note: Higher number indicates that a given reason is more important. Numbers are simple averages.
Source: Survey results.

second most important motive for investing in Moldova was the ability to access the new regional market (Central and Eastern European), which can be attributed to country's proximity to the "new" EU states. This motive can be also attributed to the willingness to exploit Moldovan labour and other resources (graded as the third most important motive). The possibility to access regional markets was also found to be important for investors in Georgia (meaning access to the whole Southern Caucasus) and in Kyrgyzstan (Central Asia).

6.6. Efficiency-seeking

Access to the host country's research and technological expertise was assessed as the least important reason to invest in the four countries (see Figure 4), which suggests that investments are not yet efficiency-seeking. This is also confirmed by the answer that the exploitation of cost-effective production in the CIS for the purpose of exporting products to the EU was not an important strategy for parent companies. Moreover, the surveyed firms export on average rather small volumes of intermediates (17% of the production of firms producing intermediate goods is exported), which means that they are weakly integrated in vertical production chains.[7]

The results of the survey indicate that the predominant motive for investing in the four CIS countries has been market-seeking. The second important reason is resource-seeking. Foreign investors in the surveyed CIS firms do not seek efficiency yet.

6.7. Business environment of foreign firms

When analysing industry-specific FDI determinants, we relied upon Jacobides (2006) who assumes that the similarities and dissimilarities in the use of factors of production in the vertically-integrated production chain among countries shape the globalisation prospects and the effects that FDI may produce in a host country. Hence, the second part of our questionnaire was designed to reveal the impact of FDI in a recipient country. The companies were asked to estimate the extent to which their business can be divided into separate components and the degree of similarity of vertical and horizontal value-chain structures between home and recipient country, as well as to give feedback on the performance of their CIS subsidiary. Also, some additional questions let us draw conclusions on the importance of industry-level FDI determinants.

The recipients estimated the similarity of industry value-chain structures at 3.4 points (according to 1-5 scale, where 1 – not similar at all, 5 – very similar) which suggests that the structures are perhaps similar. Country averages did not differ much, though the answers of Moldovan firms suggested a higher degree of similarity. When asked to distinguish between the differences/similarities in vertical and horizontal industry structures (where vertical structure refers to systems of in-bound logistics, manufacturing, outbound logistics, organised sales, and horizontal industry structures are defined as the number of industry participants, their functions and market shares), the respondents gave similar answers, broadly indicating that they are unable to assess the degree of similarity/dissimilarity of vertical *vis-à-vis* horizontal value chains.

The differences between home and host country value-chain structures were not perceived as a significant impediment for business expansion in the recipient country. The total average was estimated at 2.0 points, while the results vary among countries (see Question 21 in Annex 2.A1). Foreign companies that established their business in Kyrgyzstan estimated the impact of different structures as insignificant (1.2 point), Ukrainian and Georgian ones as rather insignificant (2.1 and 2.0 points correspondingly), while the impact on Moldovan subsidiaries was unknown (2.8 points).

The activities of foreign affiliates to a large extent depend on the parent companies' multinational businesses. Firstly, 42% of the company's value chain components are supplied from the home countries, while only 17% are provided by local suppliers (see Question 15 in Annex 1 for details). An especially large share of value chain components (about 60%) are imported by Ukrainian foreign affiliates, whereas Moldovan, Georgian and

Kyrgyz companies import only 21%, 46% and 39% respectively. Ukraine's reliance on imports can be explained by the large number of companies engaged in retail trade among firms which took part in the survey.

The largest part of imported value chain components (received from parent companies) are technologies and know-how (42% of total), materials (24%), components and parts take about 20% and final products account for about 14% (see Question 8 in Annex 2.A1). As for the open option, the majority of Ukrainian companies reported that marketing technologies brought from parent companies were of great value. Also, in all countries financing and working capital were named as an important resource received from a parent company. Among other resources mentioned were consulting services with regard to major business processes and equipment.

The companies were also asked to comment on the success of their business depending on the performance of local and multinational partners. As it turned out, on average the success of the operations of a subsidiary depends more on the performance of international industry participants (3.4 points) than on the performance of local industry participants (3.0 points). This confirms the earlier findings about the importance of parent company and multinational links to the subsidiaries. Unfortunately, the local environment is not sufficiently developed to offer companies products of the necessary quality for their business, so they have to maintain close links with their international partners.

The average number of key local suppliers among all four countries was significantly below the number of key local customers/distributors (18 and 74 respectively, total average among four countries). The last finding supports the earlier described outcome of our research on the market-oriented nature of investment in the CIS countries. While much of the resources are supplied from abroad, the final products are targeted to the local market, which explains the significant number of local distributors and customers.

Overall, the results suggest rather pessimistic implications for the influence of technological spillovers on the productivity of domestic firms. It was shown in studies examining CEE data that the highest productivity-increasing gain for local firms takes place when foreign-owned, technologically superior firms buy local supplies, teach suppliers and help them acquire new technologies. In the case of this sample, it seems that spillovers from FDI, if they exist, are rather limited to certain firms and sectors of economic activity. Moldova has the most favourable supplier to customer ratio, which suggests that the potential for spillovers may be the highest there. But even in Moldova, the average number of domestic customers of a foreign subsidiary is three times higher than the average number of local suppliers. Foreign firms in the surveyed CIS markets seem to buy supplies locally only when it is necessary, and concentrate on capturing domestic demand.

6.8. Major impediments

In order to check the investor's attitude towards the investment climate in these countries, we asked respondents to assess the importance of major problems creating difficulties for doing business in the host countries. Each of the respondents ranked the importance of the problem from 1 to 5 (1 – the least important, 5 – the most important).

Based on our analysis, the most urgent problems in the surveyed CIS countries are the volatility of the political environment, the uncertain economic situation, the ambiguity of the legal system and corruption. However, the top three ones differ among countries. Political and economic instability, together with the lack of physical infrastructure, are of

particular concern for foreign companies operating in Kyrgyzstan and in Georgia. All other problems (with the exception of finding a business partner in Georgia) are relatively less important. Ukraine and Moldova are more stable in political terms and foreign investors perceive the extensive bureaucracy, corruption and uncertainties connected to domestic legislation as the main obstacles for their businesses. This means that neither difficulties connected with establishing the Ukrainian government in late 2007, nor problems with the uncertain status of Transnistria in Moldova are important obstacles for expanding business activities by foreigners in the two European CIS countries.

The high level of corruption in the CIS, which is acknowledged to be a serious deterrent to FDI inflows, is confirmed by Corruption Perception Index 2006, where Ukraine is ranked 104th and Kyrgyzstan 145th out of 163 developed and developing countries of the world (Transparency International, Global Corruption report 2007). Interestingly, the perception about corruption in Moldova, although still high, is much lower. Moldova ranked 81st on that list (Transparency International, Global Corruption report 2007). The perception of corruption in Georgia is relatively low, probably indicating successful efforts of the Georgian authorities to fight petty corruption.

Table 6. **Assessment of problems faced by foreign investors in the CIS**

Problem	Ukraine	Moldova	Kyrgyzstan	Georgia	Total average
Volatility of the political environment	3.4	3.3	4.5	2.8	3.5
Uncertainty about the economic environment	3.3	3.4	4.4	2.9	3.5
Ambiguity of the legal system	3.9	3.5	3.5	2.7	3.4
Corruption	4.0	3.9	3.1	2.1	3.3
Bureaucracy	3.9	3.9	3.1	2.0	3.2
Lack of physical infrastructure	2.5	2.8	3.9	2.9	3.0
Backward technology	2.4	2.9	3.1	2.4	2.7
Lack of business skills	2.4	2.6	3.1	2.7	2.7
Finding a suitable partner	2.5	2.9	2.3	2.8	2.6
Problems in establishing clear ownership conditions	3.2	2.9	1.7	2.4	2.6

Note: A higher number indicates that a given impediment is more important. Numbers are simple averages.
Source: Survey results

The problem of establishing clear ownership rights was a relatively important obstacle faced by firms operating in Ukraine and Moldova, but much less so for those located in Georgia or Kyrgyzstan. Existing infrastructure, technologies and management skills of the local workforce do not seem to be much of a problem for foreign investors operating in Ukraine and in Moldova, however it is perceived as an important obstacle in Georgia. Finding a suitable partner seems not to be a problem either in Ukraine or in Kyrgyzstan, whereas it is a relatively important obstacle in Moldova and Georgia. Among other impediments investors mentioned were problems with tax administration, which involves difficulties in paying taxes, VAT refunds and complicated tax regulations.

6.9. Performance of subsidiaries

Interestingly, companies that have invested in Kyrgyzstan assessed the performance of local subsidiaries as very good (4.5 points). Foreign firms in Ukraine and Moldova were also perceived by their representatives as performing relatively well (Ukraine – 4.3 points and Moldova 4.1 points) while Georgian subsidiaries were rated as performing worst of all at 3.7 points (although still as rather "relatively successful").

7. Econometric analysis

In this section we present findings from the subsequent econometric analysis we have conducted based on the survey results. In particular, we were interested to see whether there were any differences among the three different types of investors (market-seekers, resource-seekers and efficiency-seekers) with respect to the levels of their satisfaction with their CIS operations, problems they were encountering in their countries of operation, and particularities of their modes of operation.

To estimate our models we employ ordered logistic analysis (based on a maximum likelihood estimation) as we are working with categorical data. This method is the most appropriate for this type of data as it allows us to obtain consistent, efficient and powerful estimates (see Greene, 2002; Agresti, 2002 and Allison, 1999). We use STATA 9.0 to conduct the estimation.

7.1. Dependent variables

We employ a number of dependent variables in this study. Our first dependent variable is a manager's perception of the subsidiary's performance. This and all other variables in our survey were measured on a five-point Likert scale. More specifically, the question was, "Please evaluate the performance of your [the country where the subsidiary is] subsidiary". This, of course, is not a true measure of performance as such, but a satisfaction effect, which is also subject to individual biases. However, by analysing managers' satisfaction with the performance of a subsidiary we are in a position to gauge which factors contribute to higher or lower satisfaction with performance.

The other dependent variables employed are the various problems the survey participants are encountering during their operations in the host countries. We have tried all 10 individual problems specified in the questionnaire. However, we report only six of them (the ones which yielded significant results). These variables are: 1) volatility of the political environment, 2) uncertainty of the economic environment, 3) ambiguity of the legal system, 4) corruption, 5) difficulties in finding a suitable partner, and 6) problems in establishing clear ownership conditions. With these dependent variables, we analyse how the different investment motivation/orientation of a subsidiary and other firm-specific and industry-related variables affect the perceived problems of operating in the respective countries.

7.2. Independent variables

This study employs a number of independent/explanatory variables in order to explain possible differences in the perceived performance and problems of operating in a particular country. As we have already mentioned, the key independent variables employed are related to the investment motive/orientation of the subsidiary. These are the answers to the question 10 of the questionnaire "Why did you choose to invest in [the country where the subsidiary is]?" The following five options were considered: 1) cheap factor inputs; 2) skilled labour; 3) local market; 4) regional market; and 5) local R&D expertise.

The two other independent variables are related to the similarities/differences in the industry's value chain structures between host and home countries. These factors have been shown to affect the investor's behavior to a significant extent (see Jacobides, 2006). The corresponding two variables are called "Sector Similarity" and "Sector Modularity", which are the answers to questions 20 and 16 of the questionnaire respectively.

The next two independent variables are linked to the subsidiary's embeddedness dependence on the host/home country environment a propos the links with the local/global value chain partners. The corresponding variables are called "Local Relationships" and "Foreign Relationships" and constitute the answers to questions 13 and 14 of the questionnaire respectively.

The remaining control variables are measured on a continuous scale and relate to basic firm characteristics, *e.g.* turnover (annual, US$ mn), years of operation, personnel, investment (initial, US$ mn), market share (per cent, in a host country). Also, we add country dummy variables to control for country effects.

7.3. The results

The results of our analysis are reported in Table 7. It shows seven specifications with the dependent variables described. The first specification (S1) analyses the factors which influence the performance of foreign-owned companies in the CIS. We find that having market-, skilled labour-, and cheap input-orientation affects the performance positively with market-orientation having the strongest impact in absolute terms. Hence, we find that market-seeking companies are more likely to perform better in our sample of CIS countries.[8] Also, the similarity of the value chains along with the ease with which the production process can be broken into separate parts is shown to increase the probability of good performance of the subsidiaries.

The other variables turned out to be insignificant, apart from the dummy for Georgia (with a negative sign) reflecting that the companies operating in Georgia are less likely to report satisfaction with their performance than firms in other countries.

The other six specifications analyse factors which affect the perceived problems of MNE's operations in the four countries. Differentiating among the different investment orientations, we find that investors seeking cheap inputs in the CIS are more likely to complain about the ambiguity of the legal system and problems in establishing clear ownership rights. As legal matters are one of the key factors which determine success of resource-seeking operations, *i.e.* all contractual arrangement related to the use of the key resource, we find them to be of paramount importance for this type of investor.

At the same time, investors seeking skilled labour are most likely to be affected by the uncertainty of the economic environment. We would expect these investors to produce something relatively sophisticated for the local market/exports, and since economic uncertainty amplifies all business-related risks, then this problem becomes of the highest concern to them.

Interestingly, market-seeking investors do not seem to view one problem as more important to them than the rest. The situation is somewhat different for those investors trying to access the regional market: for them the problems in finding a suitable partner are more likely to matter. And finally, corruption is more likely to be reported as a problem by investors who are seeking to tap into R&D expertise in the CIS region. Interestingly, investors interested in R&D potential are found to be less likely to complain about corruption. This is a surprising outcome, which so far we have failed to explain.

Of the other variables, sector similarity appears to be one of the most important alleviators of problems which are encountered in the CIS by foreign investors (as all coefficients have negative signs) – hence the similarity of the value chains helps to overcome the problems investors are experiencing in the region. This is in line with the

Table 7. **Estimation Results**

	Dependent Variables						
	Performance	Political environment	Economic environment	Legal system	Corruption	Finding a partner	Ownership rights
Independent variables							
FDI motives:	S1	S2	S3	S4	S5	S6	S7
Cheap factors	0.39*	–0.11	–0.25	0.43**	0.04	–0.40	0.47*
	(0.10)	(0.62)	(0.27)	(0.05)	(0.85)	(0.51)	(0.07)
Skilled labour	0.49*	0.19	0.45*	0.14	0.14	0.28	–0.11
	(0.07)	(0.45)	(0.09)	(0.58)	(0.57)	(0.28)	(0.69)
Local market	0.53*	–0.5	0.19	0.09	0.05	0.28	–0.04
	(0.07)	(0.84)	(0.47)	(0.67)	(0.82)	(0.23)	(0.87)
Regional market	0.17	0.20	0.19	0.23	0.21	0.32**	0.11
	(0.327)	(0.19)	(0.47)	(0.12)	(0.15)	(0.04)	(0.51)
R&D expertise	0.09	0.38	0.35**	0.23	–0.57**	–0.07	0.42
	(0.797)	(0.19)	(0.03)	(0.37)	(0.04)	(0.76)	(0.12)
Other variables							
Local relationships	–0.23	–0.09	–0.19	–0.38*	–0.20	0.12	–0.07
	(0.33)	(0.23)	(0.41)	(0.06)	(0.32)	(0.58)	(0.74)
Foreign relationships	0.15	0.06	0.42**	0.11	0.22	–0.24	0.14
	(0.48)	(0.75)	(0.05)	(0.59)	(0.28)	(0.23)	(0.53)
Sector similarity	0.64**	–0.28	–0.75***	–0.13	–0.05**	–0.33	–0.47**
	(0.02)	(0.23)	(0.00)	(0.55)	(0.03)	(0.15)	(0.05)
Sector modularity	0.42**	0.06	–0.58**	–0.013	–0.32	0.07	0.23
	(0.05)	(0.38)	(0.02)	(0.95)	(0.11)	(0.74)	(0.34)
Turnover	–0.01	0.00	–0.01	–0.02**	–0.01	0.01	0.01*
	(0.34)	(0.97)	(0.18)	(0.04)	(0.56)	(0.58)	(0.07)
Years of operation	–0.01	–0.01	–0.03	–0.03**	0.01	0.00	–0.01
		(0.72)	(0.16)	(0.04)	(0.57)	(0.90)	(0.58)
Personnel	–0.00	0.00	–0.01	–0.01*	0.00	0.00	–0.001
	(0.97)	(0.29)	(0.17)	(0.09)	(0.97)	(0.72)	(0.31)
Investment	0.01	0.01	0.01	–0.01	–0.01	–0.001	–0.001
	(0.27)	(0.62)	(0.18)	(0.24)	(0.91)	(0.86)	(0.36)
Market Share	0.01	–0.01	–0.01	–0.02**	0.01	0.004	–0.004
	(0.19)	(0.79)	(0.55)	(0.05)	(0.39)	(0.66)	(0.61)
D-Ukraine	0.61	–2.89***	–1.15	1.79**	2.11***	0.69	4.33***
	(0.462)	(0.00)	(0.16)	(0.02)	(0.00)	(0.39)	(0.00)
D-Georgia	–1.58*	–3.98***	–3.59***	–1.76**	–1.72**	1.76**	3.04***
	(0.05)	(0.00)	(0.00)	(0.02)	(0.02)	(0.20)	(0.00)
D-Moldova	–1.32	–3.39***	–1.83**	1.33*	2.19***	1.58**	3.91***
	(0.15)	(0.00)	(0.02)	(0.08)	(0.00)	(0.040)	(0.00)
Pseudo R-squared	0.26	0.23	0.35	0.19	0.20	0.09	0.21
LR chi2	49.25	59.63	81.40	47.31	55.64	24.18	55.70
Number of observations	87	88	88	88	88	88	88

* p-values in parentheses.

global expansion logic put forward in Jacobides (2006). Sector modularity (*i.e.* ease in fragmenting production processes), on the other hand, helps to alleviate the uncertainty of the economic environment to investors in the CIS.

Investment in activities which are embedded in local value chains lowers the probability of complaining about the legal systems in the CIS, whereas close links with foreign value chain partners amplify the problems caused by the uncertainty of the economic environment. As we already mentioned, significant involvement with local partners creates a number of situations where legal disputes can potentially arise, which then have to be resolved within highly imperfect local legal systems. As to the latter finding, it can be

explained by the fact that the closer the links with foreign partners, the more a firm relies on import/export operations which make it dependent on macroeconomic stability in the host country, in terms of exchange rate stability, inflation, monetary policy, etc.

A number of firm-level variables appeared to correlate significantly with the problems caused by the ambiguities of the legal system. The number of years of operation in the CIS is negatively related to the difficulties caused by this ambiguity: more recent subsidiaries are more likely to complain about legal obstacles. The companies which have been in the country for a few years have already developed some capabilities which help them in dealing with this ambiguity, which younger companies lack.

Similarly, the size of the company (measured by both turnover and number of employees) affects the legal ambiguity in a negative way, *i.e.* the smaller the company, the more likely it is to suffer from legal problems. Again, smaller companies probably do not have enough resources to deal effectively with legal problems, whereas bigger companies have more leeway which allows them to overcome the related difficulties. The company's market share is also negatively related to legal ambiguities – we think that effect here is similar to the size effect, as bigger companies typically have larger market share and *vice versa* . We interpret these findings in the following way: given imperfect legal systems in the CIS, larger companies are able to lobby effectively, so that once a company is "big enough", it can cope with the ambiguity of legal systems relatively well and is less likely to report difficulties. In other words, it is possible that informal links with policy makers are more important for bigger companies in the CIS than any given institutional solution.

In contrast, the relationship between the size of the company (turnover) and problems in establishing clear ownership rights is positive. The bigger the company, the larger the probability that ownership rights are a problem. It can be explained by the fact that ownership rights/corporate governance issues become more significant as the company grows larger, and given the shortcomings of the legal systems in the surveyed countries these problems are likely to amplify in significance at that stage.

Country effects prove to be one of the most significant factors affecting the various problems foreign companies are facing in the CIS. This is not surprising, taking into account the significant differences among countries with regard to the perception of major problems.

8. Conclusions

This paper is devoted to the analysis of motives for FDI into four smaller CIS countries. It also explores the problems which foreign investors incur in these countries. Furthermore, we analyse how different investors profiles (market-, resource- and efficiency-seeking) affect the problems they are encountering in their countries of operation, and particularities of their modes of operation.

Our analysis shows that market-seeking is a dominant motive for investors in our sample. The companies hold a substantial share of the recipient country's market, with a small part of their products being exported. The growing CIS markets produce high demand, which foreign investors are aiming to capture by further expanding their business. This motivation is similar to that of foreign investors into CEE countries in the early 1990s. Our econometric analysis reveals that a market-seeking orientation is also the most profitable one. It has the most positive effect on investment performance, followed by

skilled labour and cheap input orientations. Hence, serving the local market is the most beneficial strategy for investors.

The second and third most important investment motives vary across countries, being predominantly focused on the use of low-cost factors of production (including natural resources) and skilled labour. We expect that, together with closer integration within the global economy (and particularly the EU in the case of the European CIS countries) and the fall in overall protection, cheap CIS labour will attract new waves of investment, similar to what has been happening in the CEE and SEE countries. It is very important though, that the skills of the CIS labour force match the needs of the labour markets.

Investors do not yet seek efficiency by producing in the CIS, which is one of the key reasons for investment in the CEE/SEE countries.

There is a need to address the following impediments (so that they do not override possible profits from using cheap CIS labour): political instability in Kyrgyzstan and Georgia, and extensive bureaucracy, corruption and uncertainties connected to domestic legislations in Moldova and Ukraine.

Our econometric analysis shows that the ambiguity of the legal system and problems in establishing clear ownership rights are of biggest concern for investors seeking cheap factors of production in the CIS, whereas the uncertain economic environment is the most harmful for investors seeking skilled labour. The latter problem is also the most significant for investors trying to tap in into local R&D, hence improving macroeconomic stability should be of the primary importance to the government aiming to attract skilled labour- and R&D-seeking FDI, the types which are considered to bring the largest benefits in terms of host country development.

The problems stemming from ambiguities in the legal system are also amplified if a foreign company has close links with local businesses, or is smaller or younger. Hence, improving the legal system will help foreign companies to develop their operations in the CIS countries with less trouble, and hence contribute to the host country's development much sooner.

Overall, the results suggest rather pessimistic implications for the influence of technological spillovers on the productivity of domestic firms. It was shown in studies examining CEE data that the highest productivity-increasing gain for local firms takes place when foreign-owned, technologically superior firms buy local supplies, teach suppliers and make them acquire new technologies. In the case of our sample, it seems that spillovers from FDI, even if they exist, are rather limited to certain firms and sectors of economic activity. Moldova has the most favourable suppliers-to-customers ratio, which suggests that the potential for spillovers may be the highest there. But even in Moldova, the average number of domestic customers of a foreign subsidiary is three times higher than the average number of local suppliers. Foreign firms in the surveyed CIS markets seem to buy supplies locally only when it is necessary and concentrate on capturing domestic demand.

Policy makers could assist in attracting more and higher quality FDI into the CIS countries by:

- Improving macroeconomic and political stability and reducing ambiguities in the legal system.

- Of particular concern is the reported lack of efficiency-seeking investors in the region, as well as insufficient links of foreign owned businesses with local companies. Again, removing legal deficiencies could stimulate the more active involvement of foreign companies with local businesses, as well as the development of infrastructure (transport, industrial).
- The other impediment to efficiency-seeking (R&D) investment was found to be high corruption levels – and this is the avenue where the governments can go a long way to help alleviate the problem, yet political willingness is the key here as it will define effectiveness of any action taken in this respect.
- Once the most acute problems are solved, CIS governments may also promote linkages with the domestic economy (through business incubators, information clearing houses) and/or build local technological capabilities (support R&D, high tech industrial parks, training institutions). But this is a rather longer-term prospect. What can help immediately is the improvement of the intellectual property rights regime.

Notes

1. Eight new member States that entered the EU in 2004, the CEECs.
2. The Czech Republic, Estonia, Hungary, Latvia, Lithuania. Poland, Slovakia and Slovenia.
3. Although there are exceptions of resource-rich Tajikistan, Azerbaijan and Kazakhstan.
4. The Czech Republic, Estonia, Hungary, Latvia, Lithuania. Poland, Slovakia and Slovenia.
5. Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro.
6. Where the majority of both intermediate and final goods are exported.
7. With the exception of the Moldovan companies. Foreign subsidiaries producing intermediates in Moldova export over 50% of their production.
8. Or rather being more likely to positively assess their performance in the CIS. In the subsequent discussion, we ignore the fact that these are the perceptions of the managers, not really the financial results themselves.

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ANNEX 1

Detailed Results of the Survey

Profiles	Min.	1st quartile	2nd quartile	3rd quartile	Max.	Average
Ukraine						
1. Years in the country	2.0	4.5	9.0	11.0	18.0	8.4
2. Annual revenue (turnover) of the subsidiary, US$ million	0.03	3.1	10.5	67.7	1 233.0	80.7
3. Personnel employed	7.0	38.0	136.0	272.8	3 500.0	501.5
4. Total amount of your capital invested in the subsidiary, US$ million	0.06	0.17	3.5	49.8	600.0	67.1
5. Market share in the country, %	0.5	15	22.0	27.0	100.0	28.8
Moldova						
1. Years in the country	2.0	7.0	9.0	12.0	17.0	8.8
2. Annual revenue (turnover) of the subsidiary, US$ million	0.0091	0.3	1.8	5.2	121.1	13.8
3. Personnel employed	10.0	82.0	297.0	440.0	1 653.0	369.2
4. Total amount of your capital invested in the subsidiary, US$ million	0.0004	0.3	3.0	32.6	112.4	21.0
5. Market share in the country, %	0.3790	30.0	44.0	70.0	99.1	46.6
Kyrgyzstan						
1. Years in the country	2.0	4.0	8.0	10.8	15.0	7.7
2. Annual revenue (turnover) of the subsidiary, US$ million	0.3	1.8	3.0	7.0	30.0	6.8
3. Personnel employed	6.0	50.0	120.0	300.0	1 200.0	232.4
4. Total amount of your capital invested in the subsidiary, US$ million	0.2	0.5	3.0	10.0	50.0	8.7
5. Market share in the country, %	5.0	10.0	20.0	30.0	100.0	28.67
Georgia						
1. Years in the country	1	3	4	10	17	6.2
2. Annual revenue (turnover) of the subsidiary, US$ million	0.25	1.50	6.00	68.00	280	43.7
3. Personnel employed	12	35.00	120.00	302.50	1 200	237.6
4. Total amount of your capital invested in the subsidiary, US$ million	0.1500	7.10	20.00	66.25	160	39.9
5. Market share in the country, %	0.0	2.0	8.0	25.0	100.0	19.6
7. What percentage of the following is exported? Please indicate %	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	
– Intermediate products	12.63	51.7	1.1	3.0	17.1	
– Final products	10.63	58.6	28.8	23.7	30.4	
8. Which products the Ukrainian subsidiary receives from parent company? Please tick	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	% of total
– Technology, know-how	17	22	26	21	86	41.95%
– Materials	8	8	17	16	49	23.90%
– Components parts	7	4	16	14	41	20.00%
– Final products	10	7	11	1	29	14.15%
– Others (please specify)						0.00%
Total	**42**	**41**	**70**	**52**	**205**	**100.00%**
9. What is the strategic role of the subsidiary in your MNE group's operations?	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	
Please rank from 1 to 5 (1 – unimportant, 5 – very important):						
a) Supply existing products to country's and other CIS markets	4.3	3.3	5.0	3.1	3.9	
b) Develop new products for country's and other CIS markets	2.7	3.1	3.3	2.5	2.9	

Profiles	Min.	1st quartile	2nd quartile	3rd quartile	Max.	Average
c) Exploit country's cost-effective production to export products to established (*e.g.* European markets)	1.7	2.0	2.1	1.6	1.9	
10. Why did you choose to invest in the country? Please evaluate each of the reasons presented below	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	
Please rank from 1 to 5. (1 – the least important, 5 – the most important):						
a) Availability of low-cost input factors (*e.g.* cheap labour; energy; raw materials)	2.8	3.4	3.4	3.2	3.2	
b) Skilled labour	2.6	3.5	3.6	3.0	3.2	
c) To serve country's market	4.1	3.8	4.6	3.3	4.0	
d) To achieve access to a new regional (Central and Eastern European) market	2.3	3.6	3.2	3.0	3.0	
e) To access the countrys' research and technological expertise	1.5	2.3	1.3	1.2	1.6	
f) Other (please specify)						
11. What do you think are the current problems investors face in the country?						
Please rank from 1 to 5. (1 – the least important, 5 – the most important):						
a) Volatility of the political environment	3.4	3.3	4.5	2.8	3.5	
b) Uncertainty of the economic environment	3.3	3.4	4.4	2.9	3.5	
c) Ambiguity of the legal system	3.9	3.5	3.5	2.7	3.4	
d) Corruption	4.0	3.9	3.1	2.1	3.3	
e) Bureaucracy	3.9	3.9	3.1	2.0	3.2	
f) Finding a suitable partner	2.5	2.9	2.3	2.8	2.6	
g) Problems in establishing clear ownership conditions	3.2	2.9	1.7	2.4	2.6	
h) Lack of physical infrastructure	2.5	2.8	3.9	2.9	3.0	
i) Backward technology	2.4	2.9	3.1	2.4	2.7	
j) Lack of business skills	2.4	2.6	3.1	2.7	2.7	
12. Does your parent MNE company have investments in other Eastern European countries?						
Yes	19	28	13	17	77	
No	11	2	17	13	43	
13. What is the extent to which the success of your operations in the recipient country depend on the performance of and relationships to other local industry participants (*e.g.* other supply chain partners, providers, etc)?	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	
Please rank from 1 to 5. (1 – very small, 5 – very substantial)	3.5	3.6	2.4	2.5	3.0	
14. What is the extent to which the success of your operations in the recipient country depend on the performance of and relationships to other international industry participants (*e.g.* other supply chain partners, providers, etc)?						
Please rank from 1 to 5. (1 – very small, 5 – very substantial)	3.6	3.4	3.8	2.6	3.4	
15. What part of the value chain components or activities are NOT produced in house by your subsidiary?, %	43.4	12.0	48.5	31.0	33.7	
15a. Imported to the country from the home country (or other subsidiaries), %	61.1	21.1	38.8	46.0	41.8	
15b. Supplied by local (recipient country) companies, %	26.1	13.8	10.3	16.0	16.6	
16. How easy is it to break up the activities of your sector in separate components / modules? (*i.e.*, to what extent are there or can there be firms specialising in each part of the value chain?)						
Please rank from 1 to 5. (1 – very difficult, 5 – very easy):	2.7	3.0	3.1	2.3	2.8	
17. What is the number of your local key suppliers/partners?						
Please indicate	12.4	27.9	13.2	17.5	18.2	
18. What is the number of your local key customers/distributors?						
Please indicate	53.4	82.4	85.8	71.9	74.3	
19. Does your company have close relationships with buyers/suppliers in your home country?						
Please rank from 1 to 5. (1 – not at all, 5 – very close):	3.5	3.9	3.5	3.6	3.6	
20. How similar is the structure of your industry in your home country to the structure of the industry in the recipient country?	Ukraine	Moldova	Kyrgyzstan	Georgia	Total	
Please rank from 1 to 5. (1 – not at all, 5 – greatly):	3.2	3.6	3.1	3.7	3.4	
20a. The vertical structure of the industry in my home country is the same as in the recipient country. (*i.e.*, there are similar segments along the value chain)						
Please rank from 1 to 5. (1 – not at all, 5 – greatly):	3.3	3.2	3.2	3.5	3.3	

Profiles	Min.	1st quartile	2nd quartile	3rd quartile	Max.	Average
20b. The horizontal structure of the industry in my home country is the same as in Ukraine (*i.e.,* the industry participants in the recipient country are like those in the home country)						
Please rank from 1 to 5. (1 – not at all, 5 – greatly):	2.9	3.2	2.8	3.5	3.1	
21. To what extent did differences in the structure of the value chain or the way firms in the industry collabourate pose a problem for your expansion?						
Please rank from 1 to 5. (1 – not at all, 5 – they are a great problem):	2.1	2.8	1.2	2.0	2.0	
22. (If there were some problems due to the value chain / industry structure), we anticipated the differences in the industry structure in the recipient country						
Please rank from 1 to 5. (1 – strongly agree, 5 – strongly disagree):	2.4	2.7	3.9	2.6	2.9	
23. How difficult was it for you to overcome the differences in the industry structure?						
Please rank from 1 to 5. (1 – quite easy, 5 – very difficult):	2.3	2.9	1.8	2.2	2.3	
24. How easy is it for your company to work in the recipient country?						
Please rank from 1 to 5. (1 – very difficult, 5 – very easy):	3.2	3.2	3.7	3.5	3.4	
25. Please evaluate the performance of your subsidiary.						
Please rank from 1 to 5. (1 – very poor, 5 – very successful)	4.3	4.1	4.5	3.7	4.2	

ANNEX 2

Statistics on FDI in CIS

Table 2.A2.1. **Percentage of FDI stock in Moldova by economic activity, 2000-2005**

	2000	2001	2002	2003	2004	2005
Agriculture	3.4%	4.9%	5.7%	5.2%	6.0%	5.9%
Manufacturing	14.5%	26.7%	26.0%	31.8%	22.3%	21.0%
Production and distribution of energy	12.8%	17.6%	10.2%	8.8%	10.6%	7.9%
Construction	1.8%	1.4%	1.2%	1.3%	1.7%	2.6%
Wholesale and retail sale	9.0%	7.9%	6.5%	6.9%	15.4%	11.6%
Transport and telecommunications	43.8%	24.3%	31.1%	24.9%	22.5%	21.3%
Financial activities	1.3%	2.4%	2.6%	1.2%	1.4%	1.4%
Real estate transactions	7.1%	7.6%	8.2%	10.6%	12.6%	16.9%
Public administration	0.7%	1.0%	1.0%	1.7%	1.6%	3.8%
Education	2.1%	2.0%	1.8%	1.6%	1.1%	1.4%
Health and social assistance	0.3%	0.1%	0.3%	0.4%	1.5%	1.0%
Other sectors	3.0%	4.1%	5.4%	5.6%	3.3%	3.9%

Source: Moldovan National Bureau of Statistics.

Table 2.A2.2. **Percentage of FDI stock in Ukraine by economic activity, 2002-2006**

	2002	2003	2004	2005	2006
Total (US$ million)	**4 555**	**5 472**	**6 794**	**9 047**	**16 375**
Agriculture, hunting and forestry	2%	2%	3%	2%	2%
Fishery	0%	0%	0%	0%	0%
Industry	54%	52%	50%	43%	31%
Of which food industry and processing of agricultural products	*18%*	*16%*	*15%*	*12%*	*7%*
Construction	3%	3%	3%	3%	2%
Wholesale and retail trade	17%	17%	17%	18%	12%
Hotels and restaurants	3%	3%	3%	3%	2%
Transport and communication	7%	7%	8%	7%	5%
Financial activity	8%	8%	7%	8%	6%
Real estate	4%	4%	6%	7%	6%
State management	0%	0%	0%	0%	0%
Education	0%	0%	0%	0%	0%
Public health protection and social help	3%	2%	2%	2%	1%
Collective, civil and private services	1%	2%	2%	2%	1%
Investment undistributed by regions*	0%	0%	0%	4%	32%

Note: * Data on direct investment are obtained from the National Bank of Ukraine and State Property Fund of Ukraine (on difference between market and nominal value of shares, property, etc., not published in statistical reports of selected enterprises). Data are for the beginning of a year.
Source: State Statistics Committee of Ukraine.

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Regulatory Takings, Stabilisation Clauses and Sustainable Development

by
Lorenzo Cotula*

This article examines the implications of the regulatory taking doctrine and of stabilisation clauses for host state regulation in pursuit of sustainable development goals – specifically, for regulation raising the social and environmental standards applicable to investment projects. First, the article recalls the key elements of the international law on regulatory takings, and compares them to the legal standards applicable under a selection of stabilisation clauses. This analysis reveals that increasingly broad stabilisation clauses tend to ensure a level of regulatory stability that far exceeds that accorded by general international law under the regulatory taking doctrine. Second, the article analyses options to mitigate the constraints on host state regulation by limiting the scope of stabilisation clauses through a "compliance with international law" exception, and by building into these clauses some degree of evolution of applicable social and environmental standards.

* Lorenzo Cotula is Senior Researcher – Law and Sustainable Development, International Institute for Environment and Development (IIED), UK. Correspondence should be addressed to: (*lorenzo.cotula@iied.org*). This article builds on and further develops earlier work namely: Lorenzo Cotula "Strengthening Citizens' Oversight of Foreign Investment: Investment Law and Sustainable Development" International Institute for Environment and Development (2007); Lorenzo Cotula, "Stabilization Clauses and the Evolution of Environmental Standards in Foreign Investment Contracts", 17 *Yearbook of International Environmental Law 2006*; and Lorenzo Cotula, "Reconciling Regulatory Stability and Evolution of Environmental Standards in Investment Contracts: Towards a Rethink of Stabilization Clauses", 1(2) *Journal of World Energy Law and Business* (2008). Over time the thinking reflected in this article has benefited from comments and suggestions from David Hunter Sheldon Leader, Andrea Shemberg, Mathias Siems, Stephen Tierney, Thomas Wälde and Halina Ward.

1. Framing the issue

As trade and investment liberalisation intensifies, many low – and middle-income countries are stepping up efforts to attract foreign direct investment. At the same time, these efforts are increasingly subject to scrutiny in terms of their ability to support, or undermine, key sustainable development goals like poverty reduction, realisation of human rights and environmental sustainability.

Legal arrangements are an important part of the overall package that a country can offer to potential foreign investors. They define the terms and conditions of foreign investment, the way its costs and benefits are shared and, ultimately, the extent to which it contributes to sustainable development goals.

To investors, legal arrangements are important to protect their assets and entitlements, and to ensure stability of the regulatory framework governing their activities. Once the bulk of a long-term and capital-intensive investment is made, the investor is a "hostage" of the host state: on the one hand, the financial viability of the investment project depends on the investor's ability to capture projected cash flows, while, on the other hand, the investor is vulnerable to host government action that may undermine such financial viability or even expropriate the investor's assets altogether.[1]

Legal arrangements to promote regulatory stability include provisions of general international law, such as those concerning the regulatory taking doctrine, and project-specific commitments embodied in foreign investment contracts between foreign investors and host states (stabilisation clauses). Under the regulatory taking doctrine, regulation that undermines the investment's commercial viability may be deemed as a taking of property, and require the host state to pay compensation. Under commonly used stabilisation clauses, the host government commits itself not to change the regulatory framework in a way that affects the economic equilibrium of the project, and to compensate the investor if it does so.

While these legal arrangements can help shelter investment from undue host state interference, they may also distort the pursuit of sustainable development – the policy imperative to balance economic, environmental and social considerations. For instance, the requirement to pay compensation may make it more difficult for host states – particularly poorer ones – to adopt new regulation raising social and environmental standards, if this affects the economic equilibrium of the investment project or undermines its commercial viability. In other words, commitments on regulatory stability shelter the economic equilibrium of an investment project from changes in environmental and social standards, and may as a result "freeze" a non-optimal balance between social, environmental and economic considerations.[2]

These tensions between investment protection and sustainable development goals call for the development of innovative approaches that can reconcile the investors' legitimate need to ensure stability of the investment climate with efforts to maximise the contribution of foreign investment to the pursuit of sustainable development goals.

The past few years have witnessed growing debate on the implications of the regulatory taking doctrine for environmental and other regulation.[3] Less attention has been paid to constraints on host state regulation stemming from stabilisation clauses. Very recently, both the academic literature and the work of human rights organisations have started to scrutinise the way in which stabilisation clauses can constrain government efforts to pursue human rights goals.[4]

This article examines the implications of the regulatory taking doctrine and of stabilisation clauses for host state regulation in pursuit of sustainable development goals – specifically, for regulation raising the social and environmental standards applicable to investment projects. First, the article recalls the key elements of the international law on regulatory takings, and compares them to the legal standards applicable under a selection of stabilisation clauses. This analysis reveals that increasingly broad stabilisation clauses tend to ensure a level of regulatory stability that far exceeds that accorded by general international law under the regulatory taking doctrine. Second, the article analyses options to mitigate the constraints on host state regulation by limiting the scope of stabilisation clauses through a "compliance with international law" exception, and by building into these clauses some degree of evolution of applicable social and environmental standards.

2. The regulatory taking doctrine

Under international law, host states have the sovereign right to expropriate assets and to regulate activities within their jurisdiction, based on the principle of permanent sovereignty of states over natural resources. This principle was affirmed in UN General Assembly Resolution 1803 of 1962 and is generally recognised as being a principle of customary law.[5]

However, international law sets conditions with which host states expropriating foreign investors' assets must comply. Namely, takings must be for a public purpose, in a non-discriminatory way, on the basis of due process, and against the payment of compensation. These requirements are spelled out in a large number of international instruments,[6] bilateral investment treaties,[7] and arbitral awards.[8] They are widely regarded as being part of customary international law, although controversy still exists on the international standard of compensation.

International law defines in very broad terms the "taking of property" to which these four conditions for lawful expropriation apply. In establishing whether a taking has occurred, the government's *intention* to expropriate and the form of government interference are "less important" than the *impact* of government action on the investor's assets.[9] Such an impact may include regulatory measures that substantially affect the *value* of the investor's property rights, in particular, regulatory measures that interfere with property rights "to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated."[10] As a result, a taking may occur even where no formal transfer of ownership takes place, for instance, where the investor is "deprived of fundamental rights of ownership" through taxation or regulation, provided that this deprivation is "not merely ephemeral" ("regulatory taking" or "indirect expropriation").[11]

This broad definition of taking is explicitly affirmed in most recent investment treaties. For example, article 1110(1) of the North American Free Trade Agreement (NAFTA) requires compensation for both "direct" and "indirect" expropriation; the latter includes "measures tantamount to expropriation." In *Metalclad v.* Mexico (a NAFTA case), the arbitral

tribunal held: "Expropriation under NAFTA includes not only open, deliberate and acknowledged transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use of reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State".[12]

In this specific case, the tribunal found that the arbitrary denial of a construction permit and the adoption of an "ecological decree" establishing a protected area in the project site amounted to indirect expropriation, as they prevented the operation of the investor's waste management facility. The facility had obtained all of the necessary federal permits but was opposed by the municipality (which denied the construction permit) and by the state government (which issued the ecological decree).

Such a broad definition of expropriation has raised concerns over a "regulatory chill" – the idea that the obligation to pay compensation for regulatory change may make it more difficult for host states to regulate in "socially desirable" areas such as human rights or environment protection – including to comply with their evolving international obligations.

The international case law suggests that the threshold beyond which the obligation to pay compensation is triggered is quite demanding, however. In *Pope & Talbot v. Canada* (another NAFTA case), the arbitral tribunal argued that, for a regulatory taking to occur, a "substantial deprivation" of property rights must be shown, whereby the investor "will not be able to use, enjoy, or dispose of the property". Criteria to assess the extent of the deprivation include whether the investor is in control of the investment, whether the government manages the day-to-day operations of the company, whether the government interfered with payment of the project dividends, and whether the investor retains full ownership and control of the investment.[13]

The "substantial deprivation" test developed in *Pope & Talbot* seems equivalent to that of "radical deprivation" used in *Tecmed v. Mexico*.[14] It was followed in several recent arbitral awards, including *CMS Gas Transmission Company v. Argentina,* which found that no expropriation had occurred;[15] *LG&E Energy v. Argentina*, which also found no expropriation;[16] *Siemens v. Argentina*, which found that host state measures did amount to expropriation;[17] *Enron v. Argentina*, which found no expropriation;[18] *Vivendi v. Argentina*, which found that expropriation had occurred;[19] *Sempra v. Argentina*, which found no expropriation.[20]

3. Stabilisation clauses

3.1. *Concept and content*

Stabilisation clauses aim to "stabilise" the terms and conditions of an investment project, thereby contributing to manage non-commercial (that is, fiscal, regulatory) risk. They involve a commitment by the host government not to alter the regulatory framework governing the project, by legislation or any other means, outside specified circumstances (*e.g.* consent of the other contracting party, restoration of the economic equilibrium and/or payment of compensation).[21]

Stabilisation clauses come in all shapes and forms. Early stabilisation clauses committed the host state not to nationalise, and/or required the consent of both contracting parties for contract modifications ("intangibility clauses"). More recent stabilisation clauses have evolved into diverse and sophisticated tools to manage non-commercial risk associated with the investment project.[22] Their scope has tended to

broaden, so as to include changes in the regulatory framework falling short of expropriation or contract modification. This includes stabilisation of specific aspects of the investment project, such as its fiscal regime or its tariff structure. But it also includes much broader commitments to stabilise the regulatory framework governing the investment project.

For instance, under the so-called "freezing clauses", the applicable domestic law is the one in force at the time the contract is concluded, to the exclusion of subsequent legislation; while under "consistency clauses" the domestic legislation of the host state only applies to the project if consistent with the investment contract.[23] Freezing and consistency clauses feature for instance in the contractual arrangements for the Chad-Cameroon oil development and pipeline project.[24]

"Economic equilibrium clauses" constitute another type of stabilisation clause. They link alterations of the terms of the contract to a renegotiation of the contract in order to restore its original economic equilibrium or, in absence, to the payment of compensation. In other words, differently to freezing clauses, economic equilibrium clauses stabilise the economic equilibrium of the contract rather than the regulatory framework itself: regulatory changes are possible so long as action is taken to restore the economic equilibrium. Economic equilibrium clauses may also empower arbitrators to determine adjustments to the contract if negotiations fail.[25] Economic equilibrium clauses feature for instance in the 1997 AGIP/British Petroleum/Etal-Kazakhstan "Kashagan" Production-Sharing Agreement (PSA)[26] and in contractual arrangements for the West African Gas Pipeline (WAGP).[27]

In recent years, use of economic equilibrium clauses has increased, compared to other types of stabilisation clauses such as freezing clauses.[28] The reason for the growing popularity of economic equilibrium clauses is their greater flexibility and versatility. Despite their relative decline, freezing clauses are still used, however.[29] In some cases, freezing and economic equilibrium clauses are combined in the same contract – for instance, in the Chad-TOTCO Convention of Establishment for the Chad-Cameroon oil pipeline,[30] and in the Host Government Agreements (HGAs) for the Baku-Tbilisi-Ceyhan (BTC) oil pipeline.[31]

Stabilisation clauses are seen as important by lenders, particularly in non-recourse financing techniques in which lending securities are provided by projected cash flow rather than by the investor's assets (project finance).[32] Lenders are interested in a secure stream of revenue to ensure timely debt repayment. Host state regulatory change that undermines projected cash flows may affect the debt repayment schedule. Because of this, lenders may require tight stabilisation clauses as a condition for the "bankability" of the project – which in turn increases pressure on the investor to extract such a clause from the host state.[33]

3.2. Legal value and effect

The legality and binding nature of stabilisation clauses was upheld in *Texaco v. Libya*,[34] as well as in *Kuwait v. Aminoil*, *AGIP v. Congo* and *Revere Copper v. OPIC*,[35] and (implicitly) in *Methanex v. US*.[36] This view reflects the dominant position in international arbitration awards. In addition, the legal value of stabilisation clauses may be reinforced by provisions in investment treaties, whereby a state commits itself to honour contractual undertakings *vis-à-vis* nationals of another state party ("umbrella clause").[37] In *CMS Gas Transmissions v. Argentina,* international arbitrators held that umbrella clauses make *iure imperii* violations

of contractual stabilisation commitments (to the exclusion of purely commercial disputes arising out of a contract) a breach of the investment treaty.[38]

Two qualifications need to be made, however. First, the *Texaco*, *Aminoil*, *AGIP* and *Revere Copper* awards all involved expropriations rather than lesser forms of regulatory change. Their authority on the legality and binding nature of stabilisation clauses therefore relates to commitments not to nationalise rather than not to regulate. On the other hand, the legality and binding nature of stabilisation clauses restricting the right to regulate, and the consequences of regulatory changes not amounting to expropriations have not yet been properly tackled in published arbitral awards. Economic equilibrium clauses may not pose significant problems, as they do not prevent host state regulation so long as the economic equilibrium is restored. But freezing clauses establish a more fundamental limitation of state sovereignty, compared to commitments not to expropriate and to economic equilibrium clauses. Therefore, it is doubtful that such a fundamental limitation of sovereignty would be enforceable if a host state were to unilaterally impose new regulation on an investment project. Doubts on the ability of freezing clauses to prevent host state regulation have been expressed by several commentators.[39]

Second, legal validity under international law does not evade issues concerning the legality of stabilisation clauses under the domestic law of the host state, including constitutional principles on the separation of powers and on the competence of the executive to enter into commitments that prevail over legislation adopted by parliament (freezing and consistency clauses). Issues concerning legality under domestic law are likely to vary across national legal systems. Where stabilisation commitments are indeed unconstitutional, the implications of this may be complicated by the longstanding principle of international law whereby states cannot plead the provisions of their domestic legal system to justify non-compliance with, or legal challenges to their international obligations. In *Revere Copper v. OPIC*, the arbitral tribunal held that "under international law the commitments made in favor of foreign nationals are binding notwithstanding the power of Parliament and other governmental organs under the domestic Constitution to override or nullify such commitments".[40]

Yet, if an analogy is made between treaties and contracts, insights may come from article 46 of the Vienna Convention on the Law of Treaties. While confirming the general principle that states cannot invoke domestic law rules, this provision also contains an exception for "rules of […] internal law of fundamental importance". Arguably, constitutional provisions such as the principle of separation of powers do constitute internal rules of fundamental importance, which the host state cannot violate through entering into investment contracts and which a diligent investor should be aware of before concluding such contracts with the host state.[41]

Beyond the legality of stabilisation clauses, a key issue is the legal effect of such clauses if their provisions are violated. Violations may include outright expropriation in breach of an intangibility clause, or regulatory change in breach of a freezing clause. In the case of economic equilibrium clauses, parties are under an obligation to negotiate in good faith so as to restore the economic equilibrium following regulatory change; but they are not under an obligation to reach an agreement.[42] Therefore, while failure to agree does not breach the clause, violations may include refusal to renegotiate, or intentional obstructing of negotiations, accompanied by refusal to compensate as provided by the clause.[43]

Issues concerning the consequences of breaches of stabilisation clauses have been tackled in some arbitral awards, although mainly with regard to expropriation. In this context, payment of compensation emerges as the main legal effect of such breaches.[44] The amount of compensation depends on a range of factors – the costs incurred by the investor because of the violation (*e.g.* higher costs caused by regulatory change in breach of a freezing clause); the investor's legitimate expectations generated by the presence of a stabilisation clause (as held by arbitrators in *Liamco* and *Aminoil*);[45] the restoration of the economic equilibrium, in the case of economic equilibrium clauses.

The obligation to pay compensation for violations of a stabilisation clause creates the need to determine the threshold beyond which this obligation is triggered. Given the great diversity of stabilisation clauses, trigger events vary considerably depending on the specific contractual formulation. Under freezing clauses, the host state must usually pay compensation if it applies regulatory changes to the investment project. On the other hand, economic equilibrium clauses are only triggered where a minimum threshold is met – namely, where the economic equilibrium of the contract is affected. At this point, parties to the contract come under an obligation to negotiate in order to restore the economic equilibrium; failure to do so (or to comply with alternative routes provided by the clause) triggers a violation of the clause.

Some economic equilibrium clauses provide guidance for determining at what point the economic equilibrium can be deemed to have been affected. For instance, the clauses included in the WAGP and Kashagan contracts cited above refer to a standard of "material" impact ("material adverse affect" or "material decrease in project benefits or company value", in the WAGP IPA; "materially adverse effects" on economic benefits, in the Kashagan PSA). The economic equilibrium clause used in the BTC contracts, on the other hand, merely refers to regulatory change impairing implementation or adversely affecting value – without requiring these effects to be "material".

Compared to the regulatory taking doctrine and despite significant variation across contracts, stabilisation clauses tend to significantly lower the threshold beyond which host states must pay compensation. Freezing clauses require payment of compensation for regulatory change regardless of its impact. Economic equilibrium clauses entail a shift from "substantial deprivation" of property rights to lesser impacts on the economic equilibrium of the project. Even the standard of "material impact" used in some economic equilibrium clauses appears to be significantly lower than the "substantial deprivation" standard. What is required for this threshold to be met is not government interference that affects the very viability of an investment project but, rather, less intrusive forms of government action that affect the cost-benefit equilibrium of the investment.

Thus, regulatory change including legislation, the judicial or administrative interpretation of existing provisions, and other measures that affect the economic equilibrium of the investment project would require the government to pay compensation, even if those measures per se do not amount to regulatory taking. That said, the amount of compensation payable for breach of a stabilisation clause is not necessarily comparable to that payable under the regulatory taking doctrine. By definition, a regulatory taking entails a substantial deprivation of property rights. The amount of compensation reflects therefore the fact that an expropriation has taken place. On the other hand, stabilisation clauses may trigger payment of compensation for lesser interferences in the economic equilibrium of the contract. Apart from extreme cases where breach of a stabilisation clause amounts to expropriation, the

aim is not to compensate the investor for expropriation but, rather, to restore the economic equilibrium of the contract. Compensation is therefore likely to be lower than compensation payable for a full expropriation. On the other hand, in cases involving a regulatory taking, the existence of a stabilisation clause may increase the amount of compensation for the taking beyond what would be payable under general international law, due to the legitimate expectations that such a clause generates.

4. Implications for host state regulation in pursuit of sustainable development

The previous section showed that increasingly broad stabilisation clauses have evolved from commitments not to nationalise to more sophisticated arrangements restricting host state regulation through "freezing" or "economic equilibrium" devices; that these clauses tend to be upheld by international arbitrators; and that violations of these clauses require host states to pay compensation. These host state commitments to regulatory stability must be set against the backdrop of the remarkable changes in international social and environmental standards that have occurred over the past few decades.

A growing body of international law on environmental protection has emerged through an increasing number of international environmental treaties, reflecting, in part, the momentum generated by international conferences such as the 1972 UN Conference on the Human Environment in Stockholm and the 1992 UN Conference on Environment and Development in Rio, as well as through the increasing integration of environmental aspects in treaties with a broader remit.[46] The International Court of Justice (ICJ)[47] and other international dispute settlement bodies[48] have also begun to pay more attention to environmental issues. Activities that only a few decades ago were subject to very limited environmental regulation are now subject to stricter standards. In addition, international environmental law increasingly emphasises prevention and minimisation of environmental damage, rather than compensation for damage incurred – as evidenced, for example, by the growing number of international provisions concerning environmental impact assessment.[49]

Similarly, international social standards have been raised considerably as a result of developments in international human rights and labour law. In the human rights field, international law has undergone major development since 1948, when the Universal Declaration on Human Rights (UDHR) was adopted. This has happened, among other things, through the adoption of new treaties, both at global level (particularly the 1966 UN Covenants) and at the regional level (*e.g.*, in Africa, the 1981 African Charter on Human and Peoples' Rights and subsequent Protocols); through case law applying international treaties;[50] and through "General Comments" issued by UN bodies responsible for overseeing implementation of international treaties, which clarify the meaning of treaty provisions. The past few decades have witnessed a clarification of international human rights standards, the strengthening of international institutions responsible for overseeing them, and growing numbers of states becoming parties to international human rights treaties.

As international customary law crystallises or an international treaty is ratified, the host state enters an international obligation to bring its domestic legal system in line with the new international standards. In other words, rising international standards (in terms of both content and scope of application) may require host states to take regulatory measures to ensure that their domestic legislation complies with the higher international standards.

Host state regulation raising social and environmental standards, including ratification of international treaties and domestic legislation to comply with evolving international obligations, may well fall within the scope of a stabilisation clause. This is particularly case where regulatory change has the effect of raising the costs of an ongoing investment project – for instance, due to tighter requirements on compensation for takings of or damage to property, or due to increased protection of ecosystems or species affected by the investment project.

Whether social or environmental regulation does fall within the scope of a stabilisation clause depends on the wording of the clause and on the nature of the regulatory measures. As discussed, the scope of some stabilisation clauses is limited to tax issues, to the exclusion of social and environmental standards – although environmental regulation may still be caught in the net if it takes the form of tax incentives rather than command-and-control measures.

On the other hand, many clauses are worded in much broader terms to encompass *any* regulation that may affect the project, and may even explicitly include social and environmental standards. For instance, the above-mentioned HGAs for the BTC oil pipeline contain very broad stabilisation clauses, and explicitly include social and environmental standards. Article 7(2) of the BTC-Turkey HGA requires the government of Turkey to restore the economic equilibrium if this is affected "directly or indirectly, as a result of any change (whether the change is specific to the Project or of general application) in Turkish Law (*including* any Turkish Laws regarding Taxes, *health, safety and the environment*) […], including changes resulting from the amendment, repeal, withdrawal, termination or expiration of Turkish Law, the enactment, promulgation or issuance of Turkish Law, the interpretation or application of Turkish Law (whether by the courts, the executive or legislative authorities, or administrative or regulatory bodies) […]" (article 7(2)(xi), emphasis added).

This provision is very broad in that: 1) it defines regulatory change in very broad terms, to encompass not only legislation but also judicial or administrative interpretation of existing legislation (and article 7(2)(vi) explicitly includes ratification of international treaties); 2) it covers both general legislation and discriminatory measures that target the investment project; and 3) it explicitly includes regulation in health, safety and environmental matters.

Provisions of this type may create disincentives for host states to adopt legislation or ratify treaties raising social and environmental standards, and to apply such standards to ongoing investment projects. Doing so would require the state to restore the economic equilibrium of the contract, or to compensate the investor. For poorer states where public finances are not in a healthy shape due to resource constraints and/or debt burdens, this legal liability may make it more difficult to raise social and environmental standards.

Alternatively, host states may exclude ongoing investment projects from the application of the regulatory change. In other words, they may still adopt new regulation but insulate from it investment projects covered by stabilisation clauses. This method raises issues for the coherence of the overall legal framework, as similar investment projects may be governed by different rules. It raises problems in light of two factors:

- the often considerable size of investment projects where wide-ranging stabilisation clauses are used, both in economic terms relative to the host state's national economy, particularly in poorer developing countries, and in terms of possible social and environmental impacts;[51] and

- the usually long duration of investment contracts, possibly spanning several decades (for example, twenty-five years renewable in the Cameroon-COTCO Convention and forty years in the BTC-Turkey HGA).

As a result of these two factors, applying new social and environmental standards only to future investment projects may delay the application of new regulation to a major share of economic activity for several decades.

Whether the outcome is "regulatory chill" or "selective regulation" that excludes ongoing investment projects, the operation of stabilisation clauses may entail the continued application of social and environmental regulation below international standards for decades to come. This is particularly problematic in poorer developing countries where the national legal framework setting social and environmental standards at project inception may be not well developed.

Besides the continued application of low standards for decades to come, this situation also shifts to the host state the risk of currently unknown social and environmental hazards which may be discovered in future and which may be prevented or minimised through new regulation. For instance, should new research show that technology or materials used for an investment project are harmful for human health or the environment, host state regulation that bans or restricts such technology or materials may attract the obligation to compensate the investor – thereby creating disincentives for host states to regulate and/or to apply new regulation to ongoing projects.

In addition, stabilisation clauses may create distortions in legal policy, with host states favouring ways to pursue sustainable development goals that are less costly for ongoing investment projects – even if they are less effective in pursuing their goal. This may entail, for instance, favouring compensation for environmental damage over injunctions to prevent damage from occurring in the first place. This situation can occur because injunctions may negatively affect the speed of project implementation (and therefore the economic equilibrium of the project) – for instance, by requiring that construction works be halted until compliance with new regulation is assured.[52]

In making it more costly for host states to raise social and environmental standards in line with evolving international law, and in favouring measures that are less costly to the investor even if they are less effective, broad stabilisation clauses of the kind examined in this study may trigger tensions between different host government obligations — namely between the obligation to honour contractual commitments (*pacta sunt servanda*), possibly backed by umbrella clauses embodied in investment treaties, on the one hand, and the obligation to comply with evolving international (human rights, environmental) law, on the other. Their focus on safeguarding the economic equilibrium may also foster tensions between the three pillars of sustainable development – economic, social and environmental – and "freeze" suboptimal balances between these pillars.

In practice, legal claims are only part of the story in the long-term contractual relationships that typically characterise investment projects. Much depends on the balance of negotiating power between the different stakeholders involved in the project – foreign investors and host states, but also lenders, NGOs, local groups affected by the project, and others. Recent experience with renegotiation of investment contracts, particularly in the oil and gas sector, illustrates that even tight stabilisation clauses may not prevent host state action backed by political determination and changes in the balance of negotiating power. Such balance of power tends to evolve as a result of changing

circumstances, of the unfolding of the different stages of project implementation (from negotiation to construction through to operation and decommissioning[53]), and of the economic and political cycles characterising the relevant industry (*e.g.,* as for the petroleum sector, changes in oil prices and in availability of capital and technology[54]).[55]

However, these considerations do not affect the relevance of the above discussion. Legal claims based on stabilisation clauses provide "markers", "magnetic points" that may be relied on by the investor or the host state, thereby influencing their negotiating power and possibly affecting negotiation outcomes.[56] Using concepts developed by Tai-Heng Cheng, I would argue that broad stabilisation commitments tend to shift negotiating power from the host state to the investor through four types of processes: "trigger", whereby investors are vested with enforceable entitlements; "drain", whereby the exercise of state sovereignty is constrained as a result of those entitlements; "transfer", whereby the power lost by host states does not "vanish" but is devolved to other actors such as foreign investors or arbitral tribunals; and "restore", whereby the host state can ultimately restore its power (for instance through payment of compensation), but at a price that can be quite steep.[57]

Besides relations between investor and the host state, stabilisation clauses may affect other aspects of the balance of negotiating power, in a way that may make new regulation more unlikely. First, governments are not monolithic entities – different agencies and even different officials may have different priorities and agendas. For example, the ministry responsible for environmental protection and that in charge of petroleum operations, or even the national oil company, may have very different interests with regard to new regulation. The obligation to pay compensation under broad stabilisation commitments may provide ammunition to those resisting regulatory change, and undermine the negotiating power of those agencies that are pushing for change.

The obligation to pay compensation may also affect negotiations between the host state and NGOs calling for tighter social and environmental standards to be applied to the investment project. The host state may resist NGO demands by claiming that it has "tied hands" as a result of its contractual obligations. This is particularly an issue where, lacking genuine commitment to improving social and environmental standards, the host state is ready to use these concerns as a lever for renegotiating the distribution of control and economic benefits;[58] but also to drop pursuit of those concerns once its higher-priority economic objectives are achieved.

This analysis suggests that, from a legal point of view, stabilisation clauses may create a "regulatory chill" in social and environmental standards – and they may do so to a more significant degree than the regulatory taking doctrine. This conclusion does not change when the analysis of legal claims is brought together with an analysis of evolving power relations among stakeholders involved in an investment project – as stabilisation clauses may affect the balance of negotiating power between those stakeholders in a way that makes it more difficult to improve applicable standards.

5. Reconciling stabilisation and evolution in social and environmental standards

Investment contracts are usually carefully negotiated deals. Their provisions define a delicate economic equilibrium shaped by the rights and obligations of the parties. The contracts would be undermined if one of the parties could rely on a different body of law (for instance, international law) to alter that equilibrium in an arbitrary way.

At the same time, freezing the regulatory framework, or requiring the host state to bear the costs of regulatory change, would lead to unsatisfactory situations where regulatory change is required by a genuine public purpose or by evolving international law. Regulatory stability is a legitimate need for investors to be reassured that they will be able to reap the benefits of their investment; but it cannot create a "straitjacket" on the ability of host states to regulate for the common good. This situation requires exploring options to reconcile the regulatory stability provided by stabilisation clauses, itself a legitimate need for investors, with the need to enable evolution in social and environmental standards.

This section explores two such options: 1) limiting the scope of stabilisation clauses through an explicit or implicit "compliance with international law" exception; and 2) following an evolutionary approach to the application of contract provisions, including stabilisation clauses. These two options are complementary and mutually reinforcing. They aim to redefine the legal claims of the investor and the host state; but also, indirectly, to alter the balance of power between these actors in negotiations relating to changes in social and environmental standards. Through redefining legal claims and shifting negotiating power, the combined use of these options may ease some of the constraints on host state regulation stemming from stabilisation clauses.

5.1. *Limiting the scope of the stabilisation clause*

The first option entails limiting the scope of stabilisation clauses through exempting "socially desirable" host state regulation from their remit. Contractual practice with stabilisation clauses developed as an attempt to shelter investors from arbitrary host state interference at a time when the bulk of the investment is made and the balance of negotiating power shifts in favour of the host state. Yet the gradual broadening of the scope of stabilisation clauses has brought within their remit much more than just arbitrary treatment. The stabilisation clauses used in the contracts for the Chad-Cameroon project are in no way limited to arbitrary (*e.g.* discriminatory) regulatory change. And as discussed, the clauses used in the BTC HGAs *explicitly* include both discriminatory treatment and regulation of general application.

A first way of reconciling regulatory stability with evolution in social and environmental standards entails rolling back the scope of stabilisation clauses to their original focus on arbitrary treatment. At the very minimum, this entails excluding social and environmental regulation that genuinely pursues a public purpose from the remit of these clauses – even more so where such regulation is required by evolving international law.

With regard to human rights, the merits of this approach have been discussed by Sheldon Leader.[59] According to this author, state sovereignty is limited by the international obligation to realise fundamental human rights. In providing commitments to the investor, the host state cannot impair the human rights held by individuals and groups that may be affected by the investment project. Therefore, stabilisation clauses are valid and legally binding, but their scope is restricted in that they cannot impair the human rights held by third parties; and they cannot prevent genuine host state action to progressively realise human rights. In other words, this approach entails building a human rights exception into stabilisation clauses, whether explicitly or implicitly; host state regulation to promote the full realisation of human rights is outside the scope of the stabilisation clause.[60]

This approach may be broadened beyond the human rights field to encompass a broader range of international law obligations concerning social and environmental

standards. It is accepted that host states may commit themselves not to exercise their sovereign *rights*, such as the right to nationalise. As discussed above, this argument was central in the reasoning developed by the *Texaco* arbitrator to reconcile stabilisation clauses with state sovereignty.[61] It must also be accepted, however, that states may not contract out of compliance with their *obligations* under international law. Indeed, it is well established in international law that state sovereignty is not unlimited, but qualified, among other things, by international obligations concerning the realisation of human rights and the protection of the environment.[62] Therefore, states cannot commit themselves not to exercise rights they do not have – such as a right to exercise sovereignty in a way that does not take account of international obligations. In other words, states cannot commit themselves not to take measures that they are required to take under international law. On the basis of this reasoning, the scope of stabilisation clauses is limited by a "compliance with international law" exception, whether explicitly or implicitly.

An example of *explicit* exception is provided by the 2003 BTC Human Rights Undertaking. The undertaking is a unilateral commitment of the BTC consortium not to interpret the very broad stabilisation clause that is included in the BTC contracts (cited earlier) in a way that prevents host state regulation from pursuing not only human rights but also environmental goals (as reflected in the formula "health, safety, and environmental" standards (HSE)), provided that such regulation meets specified requirements aimed at preventing host state abuse. While the undertaking is a unilateral commitment on the part of the consortium, it "constitutes a legal, valid and binding obligation" and cannot be revoked without the consent of the host states.[63]

Under the undertaking, the BTC consortium commits itself not to assert claims that are inconsistent with host state regulation, provided that this is "reasonably required by international labour and human rights treaties to which the relevant Host Government is a party from time to time [or] otherwise … required in the public interest in accordance with domestic law in the relevant Project State from time to time, provided that such domestic law is no more stringent than the highest of European Union standards as referred to in the Project Agreements, including relevant EU directives … those World Bank standards referred to in the Project Agreements, and standards under applicable international labour and human rights treaties".[64]

The undertaking also commits BTC not to seek compensation under the economic equilibrium clause "in connection with … any action or inaction by the relevant Host Government that is reasonably required to fulfil the obligation of the Host Government under any international treaty on human rights (including the European Convention on Human Rights), labour or HSE in force in the relevant Project State from time to time to which such Project State is then a party".[65]

The BTC Human Rights Undertaking is an innovative tool seeking to strike a balance between ensuring the stability of the investment climate and enabling the host state to adopt legislation in pursuit of human rights or environmental goals. It does not repeal the broad stabilisation clauses embodied in the BTC HGAs. However, it commits the BTC consortium not to invoke these clauses against any regulatory measures that are genuinely pursuing human rights or environmental goals.

It is interesting to note that the BTC Undertaking itself makes no explicit reference to limiting the scope of the stabilisation clause to arbitrary treatment alone. In practice, its provisions can still be used to distinguish arbitrary action from interventions that

genuinely pursue a public purpose. First, the undertaking requires that regulation be "reasonably required" to comply with international obligations or to meet a public need. While this expression is admittedly vague, it can provide a first legal hook for discerning the public purpose or arbitrariness of state action.

Second, the undertaking refers to international treaties as a benchmark to define whether government action falls within the "exception" established by the undertaking. In other words, new human rights or environmental regulation is within the scope of the exception only if it is in line with international standards. This is important to the investor since introducing exceptions to the stabilisation clause creates the risk that such exceptions are used by the host state as a "Trojan horse" to introduce measures harming the investment project with only minimal links to (real or spurious) human rights or environmental concerns.

At the same time, the formulation of the undertaking effectively sets a cap on host state regulation: the host state is exempted from the obligation to compensate only if the regulatory change does not go beyond internationally recognised standards. This may not be an issue in countries where domestic legislation is significantly below international standards. But it may cause problems in areas where international standards themselves are not well developed, and in cases where host state need to respond quickly to new (or newly discovered) social or environmental hazards which are not yet tackled by international standards.

In addition, the undertaking is an *ex post* tool, which was negotiated only *after* a very broad stabilisation clause had been signed and as a result of civil society mobilisation against that clause. While the undertaking does emphasise its binding nature, questions remain as to the value that international arbitrators would attach to it should a dispute arise. This is particularly so given that, far from being a mutually agreed amendment to the investment contract, the undertaking is a unilateral commitment entered into by the investor alone. Arguably, integrating a "compliance with international law" exception in the contract itself and during the negotiation phase would have been a preferable solution.

An interesting example of this solution, which is focused this time on environmental rather than human rights standards, is provided by the 1997 AGIP/British Petroleum/Etal-Kazakhstan "Kashagan" PSA. Here, the very broad economic equilibrium clause contains a specific exception for regulatory changes concerning environmental protection, provided that such changes are consistent with international environmental standards and are applied in a non-discriminatory basis (section 40.2). Under this clause, the investor is protected against the negative economic impacts of most regulatory change, but regulatory change required to comply with evolving international environmental law standards would not trigger the application of the stabilisation clause.

Unlike the BTC Human Rights Undertaking, the Kashagan PSA provides no further clarification on the relevant international standards that are to be used as a benchmark for environmental regulation. Given the considerable debate that exists on several principles of international environmental law, including both on their content and the extent to which they can be deemed to have crystallised into customary law, this may weaken the strength of the environmental law exception and provide a source of disputes between the parties.

Similarly, the economic equilibrium clause included in Mozambique's Model Exploration and Production Concession Contract 2007 specifically excludes non-discriminatory legislation concerning the protection of health, safety, labour or the environment, or the regulation of

any category of property or activity – provided that social and environmental standards are "reasonable and generally accepted in the international petroleum industry".[66]

It is interesting to note that the Kashagan PSA and Mozambique's Model Concession Contract explicitly refer to discrimination as a ground for discerning what is within or without the scope of the stabilisation clause (differently to the BTC contracts, which explicitly include non-discriminatory regulation). In Mozambique's Model Concession Contract, the key factors to consider when determining whether a new regulatory measures falls within the exception are: 1) whether it is discriminatory; 2) whether it relates to specified issues, namely the protection of health, safety, labour or the environment, and the regulation of property; 3) whether the measure is "reasonable" and its standards are generally accepted in the international petroleum industry.

The BTC undertaking, the Kashagan PSA and Mozambique's Model Exploration and Production Concession Contract illustrate ways of building explicit exceptions into stabilisation clauses, whether *ex post* or *ab initio*. Explicit exceptions of this type remain rare – they are not included, for instance, in the Chad-Cameroon and WAGP contracts cited above. However, a "compliance with international law" exception must be deemed to have been implicitly included even in stabilisation clauses where it does not feature expressly. This follows from the recognition that while host states can use stabilisation clauses to commit themselves not to exercise their sovereign rights, they cannot use them to avoid compliance with their international obligations – as discussed above. In other words, what host states can commit themselves to with stabilisation clauses is limited by their obligations under international law – including international human rights and environmental law.

At the very minimum, this implicit exception must be deemed to include changes in applicable standards flowing from the crystallisation of new norms of customary international law, and from the clarification or progressive development of the host state's existing treaty obligations (*e.g.* through case law or through the work of treaty bodies such as Conferences of the Parties or committees monitoring the implementation of human rights treaties). It should also include changes stemming from the ratification of treaties produced by international organisations of which the host state is a member – such as the United Nations or regional organisations. Indeed, although the host state is strictly speaking not under an international obligation to ratify the treaty, doing so may be part of its responsibilities as member of the relevant organisation – membership that was (or should have been) well known to the investor when negotiating the investment contract.

While a "compliance with international law" exception limits the scope of stabilisation clauses even where it is not explicitly stated, express formulation is likely to improve clarity and certainty in contractual relations – not only with regard to the existence of such exception but also to its scope and conditions. Both the investor and the host state stand to gain from greater clarity and certainty. In this respect, a change in contractual practice is desirable, and the BTC, Kashagan and Mozambique examples may provide a starting point to develop new contractual formulations.

5.2. Evolutionary approach

"Compliance with international law" exceptions may be reinforced by another approach to enabling evolution of social and environmental standards in investment contracts. This second approach relates to the content and interpretation of stabilisation clauses, rather than to their scope. It entails privileging those types of clauses that can

more easily adjust to changes in applicable standards; and interpreting these clauses in an evolutionary way. This "evolutionary" approach may be used in conjunction with the first one – namely, with regard to changes in social and environmental standards that are *within* the scope of the stabilisation clause.

In *Gabíkovo-Nagymaros,* the ICJ held that, while new legal developments such as the emergence of new norms of international environmental law do not undermine existing treaty obligations, new developments must be taken into account in the implementation of those obligations. On this basis, the Court called on the parties to enter into negotiations to re-define the infrastructure project, particularly in relation to its environmental dimensions.[67]

The evolutionary approach applied to treaty obligations in *Gabíkovo-Nagymaros* may also be applied to contractual obligations.[68] Thus, following *Gabíkovo-Nagymaros*, developments in international law are to be taken into account in the implementation of *existing* contractual obligations, particularly through the renegotiation of the terms of the contract.[69] In *Aminoil*, a majority of the arbitral tribunal held that the concession contract at stake "ha[d] undergone great changes since 1948" when it was first signed. In particular, the host state had introduced new elements in the contractual relationship, and the investor had tacitly acquiesced to these changes. The result was not "a departure from [the] contract" but, rather, "a change in the nature of the contract itself, brought about by time, and the acquiescence or conduct of the Parties".[70] The stabilisation clause, argued the majority, was not isolated from the contract but was part of it. Therefore, the clause lost its "former absolute character".[71]

Contractual provisions on applicable "industry standards" in social and environmental matters may facilitate some degree of evolution in the interpretation of the contract. For instance, Article 13 of the Cameroon-COTCO Establishment Convention concerning the Chad-Cameroon pipeline[72] requires COTCO to conduct construction, operation, and maintenance works in accordance not only with domestic legislation as specified in the contract but also with "the international technical and safety standards prevailing in the petroleum industry relating on the one hand to the management and the protection of the environment and on the other hand to the protection of the population". Formulae of this type are commonly used in foreign investment contracts.[73]

The weakness of these provisions is their vagueness — the wording is usually elusive and no international standards applicable in the petroleum industry have been clearly defined as yet. As a result, they offer limited or no possibility for enforcement by the host state. Yet the elusive wording may also be a strength, as reference to standards external to the contractual relationship introduces an element of flexibility. This flexibility can enable evolution in applicable social and environmental standards despite broad stabilisation clauses. It may be argued that the content of the industry standards referred to in the contract must be defined in light of evolving international law.

Although this solution in itself does not enable the host state to regulate in breach of a stabilisation clause, it may allow for international standards to apply to the project. It also sets a reference that has to be taken into account in any contract renegotiation process, and it may strengthen the type of "evolutionary" arguments applied in *Aminoil,* where substantial evolution in the overall contractual relationship within the context of a very long-term contract was held to have affected the strength of the stabilisation clause itself.

Compared to freezing clauses, economic equilibrium clauses coupled with flexible clauses on social and environmental standards appear to lend themselves more easily to

adjustments in applicable standards aimed at bringing these in line with evolving international law. While freezing clauses aim to "freeze" the regulatory framework applicable to the project, economic equilibrium clauses aim to preserve the economic equilibrium of the contract. Regulatory changes which would violate freezing clauses may still be consistent with economic equilibrium clauses if they do not alter the economic equilibrium of the contract, or if the parties restore that equilibrium once it has been affected. In this sense, economic equilibrium clauses are more conducive to adopting an evolutionary approach than freezing clauses.

This is particularly the case where economic equilibrium clauses feature "de minimis" exceptions that exclude the application of the clause to adverse effects are below a minimum threshold. The requirement that adverse effect be "material" for the clause to be triggered, as under the WAGP IPA and the Kashagan PSA cited above, illustrates this. Evolution of social and environmental standards that affects the project to a lesser extent than what can be deemed to be "material" would not trigger the operation of the clause.

6. Conclusion

Under international law, host state regulation raising social and environmental standards may constitute a regulatory taking if it affects the viability of an investment project to such an extent that the investment must be "deemed" to have been expropriated. As a result, the host state would have to compensate foreign investors whose assets or interests are negatively affected by the regulatory measures.

Contractual guarantees (possibly backed up by "umbrella clauses" in investment treaties) may take commitments on regulatory stability a step further. Under increasingly broad stabilisation clauses, changes in the social and environmental standards applicable to an investment project may require the host state to compensate the investor for losses incurred. Under freezing clauses, the obligation to compensate is triggered by the application of a regulatory change to the investment project. Under economic equilibrium clauses, that obligation is triggered by regulatory measures that affect the "economic equilibrium" of the project. In all the examples of stabilisation clauses examined in this study, the threshold beyond which the host government must pay compensation is considerably lower than that which is applicable to regulatory takings under general international law (changes to the "economic equilibrium" of the project rather than "substantial deprivation" of property rights).

Broad stabilisation clauses respond to the investors' need for stability of the regulatory framework, on which the commercial viability of investment projects depends. But they may also have a "chilling effect" on host state regulation, making it more difficult for host states, particularly poorer ones, to comply with evolving international law and improve the social and environmental standards applicable to investment projects within their jurisdiction – particularly when such efforts would raise project costs. In other words, stabilisation clauses shelter the economic equilibrium of an investment project from changes in environmental and social standards, and may as a result "freeze" a non-optimal balance between social, environmental and economic considerations.

These tensions between investment protection and sustainable development goals are all the more important given that waves of privatisation in low and middle-income countries over the past two decades have resulted in private investment being increasingly relied on in the provision of public services. For instance, private investment in water

supply in countries like Argentina and Tanzania have resulted in international arbitration proceedings between investors and host states. Water provision is a business opportunity and involves economic/commercial considerations; but it also raises important social and environmental issues – for instance, with regard to the realisation of the internationally recognised right to water.

Practical measures may be taken to avoid these negative consequences, and to reconcile the investor's legitimate need for regulatory stability with maintaining the capacity of the host state to regulate in pursuit of sustainable development goals. The scope of stabilisation clauses must be deemed to be limited by a "compliance with international law" exception. Exceptions may be explicit, as in the BTC Human Right Undertaking, in the Kashagan PSA and in Mozambique's Model Exploration and Production Concession Contract. But while express formulation improves clarity and certainty, a "compliance with international law" exception must be deemed to exist even in absence of express formulation. An evolutionary approach to formulating and interpreting stabilisation clauses may also enable a degree of evolution in social and environmental standards. This evolutionary approach entails preferring economic equilibrium clauses over freezing clauses; featuring flexible social and environmental standards clauses in the contract; and building "de minimis" exceptions (*e.g.* "material" impact) into the threshold triggering the application of economic equilibrium clauses.

These options to reconcile regulatory stability with evolution in social and environmental standards make "business sense". Integrating an explicit "compliance with international law" exception is good for business because such exception can be deemed to exist even where not explicitly stated in the contract. An explicit exception would increase certainty by clarifying what is within and what is outside the scope of the stabilisation clause. It may also provide the opportunity for international benchmarking along the lines of the BTC Undertaking. Similarly, providing for evolution in contract interpretation makes business sense given that in the real world circumstances change, and attempts to freeze the contract are unlikely to go far. The ongoing shift away from freezing clauses towards economic equilibrium clauses exemplifies this.

Finally, stabilisation clauses should not be looked at in isolation. They are only one of the many tools that investors have in order to mitigate non-commercial risk – together with other tools such as insurance, equity participation by the host state, involvement of international financial institutions such as the World Bank, and investment treaties. Rather than trying to "squeeze everything" into an all-encompassing stabilisation clause, it may make more sense to have a reasonably targeted stabilisation clause, accompanied by a range of other tools that contribute to mitigate non-commercial risk by other means.

Looking at stabilisation clauses in their broader context also requires considering the incentives created by financing arrangements. As discussed, investors may feel under pressure to extract a broad stabilisation clause as part of their efforts to raise finance for the project. In this regard, it may be useful to integrate the notion of social and environmental exceptions to stabilisation clauses in relevant instruments adopted by lenders, such as the Equator Principles.[74]

Notes

1. Thomas Wälde and Abba Kolo, "Environmental Regulation, Investment protection" and "Regulatory Taking in International Law", 50 *Int'l and Comp. L.Q.* 811 at 819 (2001).
2. IIED and partners, "Lifting the Lid on Foreign Investment Contracts: The Real Deal for Sustainable Development", International Institute for Environment and Development (2006).
3. See, for instance, Wälde and Kolo, *supra* note 2; Howard Mann and Konrad von Moltke, Protecting Investor Rights and the Public Good: Assessing NAFTA's Chapter 11 (2003); Andrew Newcombe, *The Boundaries of Regulatory Expropriation in International Law* 20 I.C.S.I.D. Rev. – F.I.L.J. 1 (2005); and OECD (2005) International Investment Law: A Changing Landscape, chapter 2, "Indirect Expropriation"and the "Right to Regulate in International Investment Law".
4. As for the academic literature, see Sheldon Leader, "Human Rights, Risks, and New Strategies for Global Investment", 9 *J. Int'l Econ. L.* 657 (2006); and Olivier de Schutter, "Transnational Corporations as Instruments of Human Development", in P. Alston and M. Robinson, eds., Human Rights and Development: Towards Mutual Reinforcement, 403 (2005). As for the work of human rights organisations, see the reports by Amnesty International UK, "Human Rights on the Line: The Baku-Tbilisi-Ceyhan Pipeline Project" (2003); Amnesty International UK, "Contracting out of Human Rights: The Chad-Cameroon Pipeline Project" (2005); and Global Witness, "Heavy Mittal? A State within a State: The Inequitable Mineral Development Agreement between the Government of Liberia and Mittal Steel Holdings NV" (2006). Most recently, Andrea Shemberg has undertaken a study for the International Finance Corporation and the UN Special Rapporteur on Human Rights and Transnational Corporations and Other Business Enterprises ("Stabilization Clauses and Human Rights"); the study was released on 11 March 2008, and is available at *www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_StabilizationClausesandHumanRights/$FILE/Stabilization+Paper.pdf*. For a sustainable development perspective, see the brief "Lifting the Lid", *supra* note 3, and Lorenzo Cotula, Strengthening Citizens' Oversight of Foreign Investment: Investment Law and Sustainable Development – 4. Investment Contracts, International Institute for Environment and Development (2007).
5. Articles 1 and 4 of UN General Assembly Resolution on the Permanent Sovereignty over Natural Resources (Resolution 1803 (XVII) of 1962). See also Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Government of the Libyan Arab Republic, [1977] 53 I.L.R. 389 [Texaco]; Amoco International Finance Corp. v. Iran, Iran-US Claims Tribunal [1987] 15 Iran-US C.T.R. 189 [Amoco]; Government of Kuwait v. American Independent Oil Co. (Aminoil), Arbitration Award, [1982] 21 I.L.M. 976 [Aminoil].
6. For instance, UN General Assembly Resolution 1803, *supra* note 6 at para. 4.
7. See, for example, NAFTA article 1110(1); ASEAN Investment Agreement, article VI(1); Energy Charter Treaty, article 13.1.
8. For example, Case Concerning Factory at Chorzów (Claim for Indemnity), 1928 P.C.I.J. (ser. A) No. 17; British Petroleum Exploration Company (Libya) Ltd v. Government of the Libyan Arab Republic, [1973] 53 I.L.R. 329 [British Petroleum]; American International Group v. Iran, Iran-US Claims Tribunal, [1983] 4 Iran-US C.T.R. 96; and see also the Texaco, Amoco, and Aminoil cases, *supra* note 6.
9. Tippetts, Abbett, McCarthy, Stratter v. TAMS-AFFA Consulting Engineers of Iran, Iran-US Claims Tribunal [1984] 6 Iran-US C.T.R. 219 at 225-226 [Tippetts].
10. Starrett Housing Corp. v. Iran, Iran-US Claims Tribunal [1983] 4 Iran-US C.T.R. 122 at 154 [Starrett].
11. Tippetts, *supra* note 10, at 225.
12. Metalclad Corporation v. United Mexican States, ICSID (Additional Facility), Arbitration Award, 30 August 2000, 40 (2001) ILM 36, para. 103 [Metalclad].
13. Pope and Talbot Inc v. The Government of Canada, UNCITRAL (NAFTA), Award on the Merits of Phase 2, 10 April 2001, para. 100.
14. Técnicas Medioambientales Tecmed, S.A. v. United Mexican States, Award, ICSID, ARB(AF)/00/2, 23 May 2003, 43 ILM (2004) 133, para. 115.
15. CMS Gas Transmission Company v. The Argentine Republic, Award, ICSID Case No. ARB/01/8 (12 May 2005), 44 I.L.M. 1205 (2005), paras. 262-264.
16. LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic, Decision on Liability, 3 October 2006, ICSID Case No. ARB/02/1, 46 ILM 36 (2007). This tribunal held that the substantial deprivation test is "not satisfied where the investment continues to operate, even if profits are diminished" (para. 191).

17. Siemens A.G. v. Argentina, ICSID Case No. ARB/02/08, Award, 6 February 2007, available at *http://ita.law.uvic.ca/documents/Siemens Argentina Award.pdf*, para. 271.

18. Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic, ICSID Case No. ARB/01/3, Award, 22 May 2007, available at *http://ita.law.uvic.ca/documents/Enron Award.pdfpara*. 245.

19. Compañia de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic, ICSID Case No. ARB/97/3, Award, 20 August 2007, available at *http://ita.law.uvic.ca/documents/VivendiAwardEnglish.pdfparas*. 7.5.11 and 7.5.34.

20. Sempra Energy International v. The Argentine Republic, ICSID Case No. ARB/02/16, Award, 28 September 2007, available at, *http://ita.law.uvic.ca/documents/SempraAward.pdfpara*. 284.

21. On stabilization clauses, see Nagla Nassar, Sanctity of Contracts Revisited: A Study in the Theory and Practice of Long-Term International Commercial Transactions (1995); Thomas Wälde and George N'Di, "Stabilising International Investment Commitments", 31 *Texas Int'l. LJ* 215 (1996); Piero Bernardini, "The Renegotiation of the Investment Contract", 13(1) *I.C.S.I.D. Rev – F.I.L.J.* 411-425 (1998); Peter Muchlinski, Multinational Enterprises and the Law (1999); Klaus Peter Berger, "Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators", 36(3) *Vanderbilt Journal of Transnational Law* 1347-1380 (2003); A.F.M. Maniruzzaman, "Stabilization in Investment Contracts and Change of Rules by Host Countries: Tools for O and G Investors", Association of International Petroleum Negotiators (2007); Peter D. Cameron, "Stabilization in Investment Contracts and Change of Rules by Host Countries: Tools for O and GInvestors", Association of International Petroleum Negotiators (2007); and Cotula, *supra* note 1.

22. Wälde and N'Di, *supra* note 22.

23. Charles Leben, La Théorie du Contrat d'État et l'Évolution du Droit International des Investissements 302 R.D.C. Collected Courses 201 (2003); Wälde and N'Di, *supra* note 22.

24. E.g. articles 24 and 30 of the "Convention of Establishment" between the Republic of Cameroon and the Cameroon Oil Transportation Company (COTCO), approved with Law 97-16 of 7 August 1997 and signed in 1998 [Cameroon-COTCO Convention].

25. Bernardini, *supra* note 22, at 420-421; Bergen, *supra* note 22, at 1370-1378.

26. Section 40.2.

27. West African Gas Pipeline International Project Agreement (IPA) between Benin, Ghana, Nigeria, and Togo, on the one hand, and the West African Gas Pipeline Company Ltd, on the other, signed on 22 May 2003 [WAGP IPA], article 36.

28. See the AIPN studies by Maniruzzaman and by Cameron, *supra* note 22.

29. Apart from the examples from the COTCO-Cameroon Convention cited above (*supra* note 25), see for instance Ghana's Model Petroleum Agreement 2000 (article 26) and the 1997 Niger-TG World Energy Incorporated Agreement for the Exploitation of Hydrocarbons in the Ténéré Block (article 7.1).

30. "Convention d'Établissement" between the Republic of Chad and the Tchad Oil Transportation Company (TOTCO), signed on 10 July 1998 and approved with Law 015/PR/98 of 1998, article 21.3.

31. Host Government Agreement between the Government of Turkey and the MEP Participants, 19 October 2000, articles 7.2, 10.1(iii) and 21.1.

32. Wälde and N'Di, *supra* note 22, at 228-229.

33. Shemberg, *supra* note 5.

34. The arbitrator held that "the right to nationalise is unquestionable today" and part and parcel of state sovereignty; but that contractual commitments not to nationalise are a manifestation and exercise of sovereignty – not its alienation. In other words, sovereignty encompasses the right of states not to exercise their right to nationalise and to enter binding commitments to that effect. *Texaco*, *supra* note …, paras. 59-73.

35. *Kuwait v. Aminoil*, *supra* note 6; *AGIP Company v. People's Republic of the Congo*, Award, 30 November 1979, 21 I.L.M. 726 (1982) [AGIP]; *Revere Copper and Brass, Inc. v. Overseas Private Investment Corporation* (OPIC), [1978] 56 I.L.R. 257 [Revere Copper].

36. *Methanex Corp. v. United States of America*, Final Award, 3 August 2005, *www.state.gov/documents/organisation/51052.pdf*. Although the case did not involve stabilization clauses, the tribunal stated: "As a matter of general international law, a non-discriminatory regulation for a public purpose,

which is enacted in accordance with due process and which affects, inter alios, a foreign investor or investment is not deemed expropriatory and compensable *unless specific commitments had been given* by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation" (para. IV.D.7, emphasis added).

37. See, for example, Article 10(1) of the Energy Charter Treaty.

38. CMS Gas Transmission Company v. The Argentine Republic, Award, ICSID ARB/01/8, 12 May 2005, 44 ILM 1205, paras. 296-303.

39. Berger, *supra* note 22, refers to the legal validity of freezing clauses as "questionable" (at 1360); in the same sense, see also Bernardini, *supra* note 22, at 415.

40. Revere Copper, *supra* note 36, at 1321.

41. I am indebted to Professor Sheldon Leader on this point.

42. See Bergen, *supra* note 22, at 1363-1368. See also Bernardini, *supra* note 22, at 419.

43. Bergen, *supra* note 22, at 1369.

44. AGIP, *supra* note 35, at para. 88; Libyan American Oil Company (Liamco) v. The Government of the Libyan Arab Republic, 12 April 1977, 62 ILR 140, at 196-202.

45. Aminoil, *supra* note 6, paras. 148-149 and 158-159.

46. See, for instance, Article 32 of the 2000 ACP-EU Cotonou Agreement, and Article 19 of the 1994 Energy Charter Treaty.

47. See, for instance, the Case Concerning the Gabcíkovo-Nagymaros Project (Hungary v. Slovakia), [1997] I.C.J. Rep. 92 (25 September), 37 I.L.M. 162 (1998) [Gabčíkovo-Nagymaros case].

48. See, for instance, the World Trade Organization case United States – Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body, Doc. AB-1998 – 4, WT/DS58/AB/R (12 October 1998), 38 I.L.M. 121 (1998).

49. See principle 17 of the 1992 Rio Declaration on Environment and Development, 13 June 1992, 31 ILM 874 (1992); the 1991 Convention on Environmental Impact Assessment in a Transboundary Context, 30 I.L.M. 800 (1991); Article 19 of the 1994 Energy Charter Treaty; Article 206 of the 1982 UN Convention on the Law of the Sea, 21 I.L.M. 1261 (1982); and Article 14 of the 1992 Convention on Biological Diversity, 31 I.L.M. 818 (1992). More generally, as the ICJ stated in Gabčíkovo-Nagymaros, "[i]n the field of environmental protection, vigilance and prevention are required on account of the often irreversible character of damage to the environment and of the limitations inherent in the very mechanism of reparation of this type of damage" (*supra* note 48, para. 140).

50. For instance, in the oft-quoted "Ogoniland" case, the African Commission on Human and Peoples' Rights found that human rights like the right to food and to water were implicitly recognised in the African Charter on Human and Peoples' Rights; it clarified the content of explicitly recognised rights, such as peoples' right to freely dispose of their natural resources; and clarified the nature of state obligations with regard to economic, social and cultural rights; SERAC (The Social and Economic Rights Action Centre) and CESR (The Center for Economic and Social Rights) v. Nigeria, Communication No. 155/96, 27 October 2001, (2001) AHRLR 60 (ACHPR 2001).

51. See, for instance, the considerable importance of the Chad-Cameroon pipeline project for the national economy of Chad and the important concerns raised by civil society on the project's social and environmental standards in both Chad and Cameroon. For example, see Centre pour l'Environnement et le Développement Broken Promises: The Chad-Cameroon Oil and Pipeline Project: Profit at Any Cost (2001); and Centre pour l'Environnement et le Développement, The Chad-Cameroon Oil and Pipeline Project: A Call for Accountability (2002). These concerns led to the establishment of two World Bank Inspection Panels; see *web.worldbank.org/external/projects/main?pagePK=64283627&piPK=73230&theSitePK=40941&menuPK=228424&Projectid=P044305*.

52. As argued by Leader, *supra* note 5.

53. For instance, the investor's negotiating power tends to decrease after the construction phase, when the investor depends on the host state honouring its commitments in order to be able to recover costs and make profits.

54. Wälde, T., "Rule of Law and the Resource Industries Cycles: Acquired Rights vs the Pressures Inherent in the Political Economy of the International energy and Resource industries", 1(1) *Journal of World Energy Law and Business* (2008).

55. For a more detailed discussion of negotiating power in investment projects, see Lorenzo Cotula, "Legal empowerment for local resource control: Securing local resource rights within foreign investment projects in Africa", London, IIED (2007), at 24-28.

56. Wälde, *supra* note 55.

57. Cheng, T., 2005, "Power, Authority and International Investment Law", 20 *Am. U. Int'l L. Rev.* 465, at 470-499.

58. See for instance the recent renegotiations in the Sakhalin and Kashagan petroleum projects in Russia and Kazakhstan, respectively.

59. *Supra* note 5.

60. *Ibid.*

61. *Supra* note 33.

62. In environmental matters, this is explicitly stated in Principle 2 of the Rio Declaration on Environment and Development, *supra* note 50.

63. The Baku-Tbilisi-Ceyhan Pipeline Company, "BTC Human Rights Undertaking", 22 September 2003, sections 3(e) and 6. The undertaking was published by the BTC as a response to pressure from human rights and environmental groups (including a report by Amnesty International UK, *supra* note 5). On the BTC Human Rights Undertaking, see de Schutter, *supra* note 5; and Leader, *supra* note 5.

64. *Ibid.* at section 2(a).

65. *Ibid.* at section 2(d)).

66. Article 27.13.

67. *Supra* note 48.

68. As argued by Abba Kolo and Thomas Wälde, Renegotiation and Contract Adaptation in the International Investment Projects: Applicable Legal Principles and Industry Practices 1 *Transnat'l Dispute Mgmt* 1 (2004).

69. *Ibid.*

70. Aminoil, *supra* note 6 at para. 101.

71. *Ibid.* at para. 100.

72. *Supra* note 25.

73. For instance, see also Article 19.8 of the WAGP IPA, *supra* note 28.

74. The Equator Principles – A Financial Industry Benchmark for Determining, Assessing and Managing Social and Environmental Risk in Project Financing (*www.equator-principles.com*).

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Investment Guarantees and Political Risk Insurance: Institutions, Incentives and Development

by
Kathryn Gordon*

This paper provides information on institutional features and policy practices of investment guarantee programmes, reviews the institutional features of the public and private segments of the political risk insurance market and identifies issues of potential relevance for the investment policy community. Typically, international investment projects for which such insurance is sought are located in developing countries. In recent years, the value of investment guarantees has averaged about 3% of total FDI flows, but about 30% of FDI inflows to developing countries. Thus, investment guarantees and the public and private institutions that provide them influence investment flows to developing countries.

* Kathryn Gordon is a member of the Investment Division of the OECD Directorate for Financial and Enterprise Affairs. Correspondence should be addressed to: *kathryn.gordon@oecd.org*.

1. Introduction

Most OECD governments and many non-OECD governments provide investment guarantees and political risk insurance designed to meet the needs of international investors. Private insurers also provide such services. Typically, international investment projects for which such insurance is sought are located in developing countries. In recent years, the value of investment guarantees has averaged about 3% of total FDI flows, but about 30% of FDI inflows to developing countries.[1] Thus, investment guarantees and the public and private institutions that provide them influence investment flows to developing countries. This document presents comparative institutional information about these insurers, based on a survey of public and private organisations in the sector.

Investment guarantees cover a broad range of products and can be defined as any guarantee and or insurance product that is relevant for international investment.[2] Political risk insurance (PR) is one of these guarantees. The World Bank Group's MIGA (Multilateral Investment Guarantee Fund) defines political risk as:

> *Political risks are associated with government actions which deny or restrict the right of an investor/owner* i) *to use or benefit from his/her assets; or* ii) *which reduce the value of the firm. Political risks include war, revolutions, government seizure of property and actions to restrict the movement of profits or other revenues from within a country.*[3]

PRI is of particular relevance for the international policy co-operation undertaken by the investment policy community. This is because of its focus on developing countries and its potential for altering the behaviour of both international investors and of host country political actors. Understanding its characteristics and functioning will help the international investment policy community in several areas: investment for development (does the investment facilitated by these programs contribute to improved economic, social and environmental performance in host countries?); international investment agreements (how do PRI and international investment agreements interact to promote investment protection and international investment?) and responsible business conduct (how do governments use investment guarantee programs to promote legal compliance and observance of internationally-agreed standards for business conduct?).

The paper is structured as follows: Section 2 sets forth the main insurance concepts that are needed to understand the institutions that provide investment guarantees and PRI. Section 3 presents a fact-finding survey of the institutional characteristics and business practices of the publicly-sponsored investment guarantee providers of 13 OECD countries and 3 non-OECD countries (China, India and South Africa). Section 4 reports on a survey of 63 private PRI providers. The main policy issues raised by these surveys are identified in Section 5.

2. Political risk insurance: essential insurance concepts

This section describes some concepts needed to understand insurance in general and PRI in particular. These are: insurable risk, moral hazard, incomplete contracting, transactions costs, missing markets and insurers of last resort.

2.1. Insurable risks

"Insurable risk" is one of the most basic insurance concepts – it helps define the conditions under which the insurance industry will be able, over the long run, to profitably provide insurance that clients will want to buy. The technical conditions that make a risk insurable are, according to the OECD Insurance Committee: "assessability (probability and severity of losses should be quantifiable); randomness (the time at which the insured event occurs should be unpredictable when the policy is underwritten, and the occurrence itself must be independent of the will of the insured); mutuality (numerous persons exposed to a given hazard should be able to join together to form a risk community within which the risk is shared and diversified)".[4]

Political risks deviate in important ways from this concept of the insurable risk. For example, insured political events may be at least partially under the control of and not "independent of the will of the insured" – by their actions, international investors may be able to influence the likelihood that insured political events will take place. Furthermore, political risks tend to be quite idiosyncratic (they are influenced by the specifics of the host country political environment, the sector and the investor-state relationship). Thus, it may not be the case that insured investors form a homogeneous "risk community" over which political risks can be polled. Political events can unfold over many months or years, they take place within a relationship between investor and the host country officials and reasonable people can (and, as the survey will show, do) disagree about whether or not an insurable event has taken place – thus, at times, political risk is not easily assessable. Finally, the perception in the industry is that political risks are cross-correlated (so that insurers are likely to face multiple claims at the same time).[5]

These deviations from what might be thought of as ideal insurance conditions help to explain PRIs institutional characteristics, especially in the areas of insurance contracting, information gathering, contract monitoring and dispute resolution. The survey shows that the sector is characterized by relatively detailed contracting and reliance on "bespoke" (tailor made) insurance products. There is also a tendency to bundle insurance services with other information-gathering and consulting services. Finally, there is extensive recourse to *ex post* contract dispute resolution such as civil suits, arbitration and mediation.

2.2. Moral hazard and other behavioral effects of insurance

Moral hazard refers to changes in the insured's behaviour that are due to the insurance. Moral hazard is defined as the "incentive for additional risk taking that is often present in insurance contracts and arises from the fact that parties to the contract are protected against loss."[6] In some insurance situations, this takes fairly simple forms – for example, a person who has insured valuable property against theft might take fewer steps to prevent theft. Moral hazard is a fundamental concept in the insurance industry because the design of all insurance products must account for it.

The concept of moral hazard is also relevant for PRI because the PRI coverage lowers insured investors' incentives to reduce their exposures to political risks. For example,

investors might choose to enter riskier investment environments (indeed, one purpose of publicly-provided PRI is to facilitate investments in politically risky environments that would not have occurred without such insurance). Another possibility is that, because they are insured, investors might manage their host country relationships differently – for example, they might be less accommodating when disputes with host governments arise (a study comparing the behaviour of insured and uninsured investors appears to bear this out[7]).

Insurers have a number of tools for dealing with moral hazard. One is "deductibles" in insurance contracts, which mean that the insured party is only reimbursed for part of the damage from the event. This helps to align the insured's interests with those of the insurer. In addition, some investment guarantee and PRI contracts (*e.g.* France's COFACE and the UK's ECGD) attempt to deal with moral hazard through clauses that exclude coverage of events that the insured entity might reasonably have been expected to avoid.[8]

Because PRI deals with relationships between investors and various political actors in host societies (*e.g.* officials from central governments or from lower level governments), the scope for moral hazard in PRI is more far-reaching and complex than for most other types of insurance. Usually, incentive effects of insurance operate only on the behaviour of the insured, but PRI has the potential to influence host country political behaviour as well. This can happen in at least two ways:

- *Reduced market-based incentives for host country reforms and learning opportunities*. PRI might interfere with market-based incentives for host country policy reform (but keeping in mind that OECD work has shown that host country competition for international investment is intense[9]). Knowing that international investors can get PRI cover, host governments may face weakened incentives to seek out credible ways of committing to protect investments (*e.g* enhancing public sector transparency and accountability and developing rules-based ways of resolving disputes with investors). Likewise, it may weaken incentives and learning opportunities for both investors and host governments to find institutions for managing their relationships in a productive and harmonious way throughout the life of the project (*e.g.* during bidding and contracting, monitoring and mutual accommodation in the event of disagreements).
- *Shift in the dynamics of investor-state relationships*. Publicly-sponsored PRI is also likely to influence the host government's evaluation of the risks of undertaking behaviour that is covered by the investment guarantee or PRI contract – in effect, these make the home country a potential actor in the investor-host state relationship. If the investor alerts the home country PRI provider of political events that might lead to a PRI claim, the home government may use diplomatic channels to attempt to forestall the event in the host country (that is, to engage in "advocacy"[10]). If the investor makes a claim under the PRI contract, the home government might well try to recover the value of damages from the host country.[11] In either case, the host government knows that, if it makes a move that is covered by the PRI contract, it knows that it is likely to find that its interlocutor in the relationship has shifted – that is, at some point, the home government will start to play a role in the dispute. If the host government believes that the home government is more of a force to be reckoned with than the investor, then it is less likely to engage in the behaviour (indeed, this deterrence effect could be considered to be one of the main advantages of publicly-provided PRI). Wodehouse (2006) finds that presence of bilateral or multilateral lenders or insurers on a project have significant risk-mitigating effects for investors through the operation of this deterrence effect.

2.3. Contracts, incomplete contracting and transactions costs

The insurance industry is a huge industry covering many types of risk. In order to profitably provide insurance, companies have to: evaluate the risks they face (often they rely on statistical models); create and market insurance products and services that attract clients, that can be offered profitably and that manage the incentive effects of insurance on clients' behavior; and take steps to manage the company's insurance portfolio so as to obtain an appropriate overall combination of risk and return (*e.g.* through portfolio diversification, reinsurance and coinsurance).

Transactions costs refer to the costs incurred when exchanging good and services. Transactions costs in the PRI sector tend to be high relative to other parts of the insurance industry. The reasons for this are:

- *High cost risk evaluation and packaging*. Political risk is "human, subjective, severe and unpredictable".[12] The sources of this risk are multi-faceted (*e.g.* the behavior of governments and other political actors and national and sub-national levels; as well as sectoral and macroeconomic developments). Thus, unlike some other insurance sectors, PRI risk evaluators cannot rely primarily on "statistical" modeling; models need to be supplemented by situation-specific, qualitative analysis.[13] This is an expensive process.
- *High contracting and monitoring costs*. PRI provides cover for what are often complex events unfolding over extended periods of time. Moreover, as noted above, the incentive effects of the insurance are multi-faceted and need to be managed carefully. This means that PRI contracts tend to be detailed and relatively non-standardised. For example, the survey shows that private political risk insurers often provide "bespoke" services (that is, their insurance policies are tailored to each client). Sometimes there is a need to monitor the project closely as the investment project evolves. In some cases, ongoing discussions are required between insured and insurer to clarify the meaning of the PRI contract (and possibly modify the contract) in light of unfolding political events.[14]
- *High cost claims management*. Incomplete contracting refers to the fact that, in most situations, it is impossible to write contracts in advance that are so detailed as to foresee all possible contingencies. In PRI, even with its relatively detailed insurance contracts, this is an important consideration. Disputes often occur as to how the contract applies to a particular political event. These are usually resolved by arbitration or mediation and some public PRI agencies report on their disputes with clients and on how these were resolved.[15] This need for *ex post* dispute resolution has two implications: 1) it raises the cost of administering PRI insurance; and 2) PRI insurance lowers political risk, but involves higher risks (relative to some other types of insurance) related to how the insurance contract will be executed in the event of a claim.

2.4. Missing markets and insurer of last resort

The concept of "missing markets" refers to the fact it is not always possible to form a market price for all possible products and risks. "Missing markets" are often viewed as being a condition that could potentially favor government intervention in markets (because if the government intervenes, it will not be "crowding out" private activity). In PRI markets, high transactions costs mean that many markets will not be able to be served profitably – that is, there will be missing risk markets (*e.g.* for smaller clients whose business might not generate enough revenues to cover the high transactions costs). Although government insurers will not, themselves, be able to avoid the high transactions

costs that characterise the sector, governments may nevertheless choose to provide services to these market segments because they believe that there is some other benefit to be had from doing so.

As will be seen in Section 3, some government providers of PRI deliberately position themselves as "insurers of last resort" – their mission is to complement private markets by serving customers who cannot find private coverage. The survey in Section 3 suggests that the public providers are aware of and promote this aspect of their business – for example, many of them have special services for small businesses and Canada's EDC notes that 90% of its business is conducted with small and medium sized enterprises.

3. Publicly-sponsored investment guarantees and PRI

This section reviews institutional features and business practices of publicly-sponsored investment guarantees and PRI programs. It is based on a sample consisting of the programs of 13 OECD countries (Australia, Austria, Belgium, Canada, France, Germany, Italy, Japan, Korea, Netherlands, Turkey, the United Kingdom, and the United States) and 3 non-OECD countries (China, India and South Africa). Some information is also provided for the Multilateral Investment Guarantee Agency, which is part of the World Bank Group.

The full list of OECD countries providing such services appears in Table A2.1. The list shows that 3 OECD governments do not provide any investment guarantee services (Ireland, Mexico and New Zealand). Annex 1 describes the survey methodology.

3.1. Mission

Why do governments sponsor or provide directly investment guarantees and PRI? One way to answer this question is to look at what governments themselves say in the statutes creating the programs or in published mission statements. Table A2.2 summarises such texts. It shows that governments pursue a variety of objectives with these policies:

- *Enhancing home country economic performance* appears, in one form or another, in all 16 of the mission statements surveyed. Most agencies have home country development (*e.g.* business competitiveness, job creation, economic growth) as their primary objective (*e.g.* Australia, Austria, Canada, Germany, Netherlands, Korea, Japan, Italy, Turkey, India, South Africa, China).
- *Filling gaps in private sector cover*. Three countries (Australia, Japan and the United States) ask their guarantee agencies to "fill the gap" (to use Australia's term) created by incomplete private coverage.[16] These countries deliberately position their agencies as "insurers of last resort" that provide guarantees when private sector coverage is unavailable.
- *Promoting development of host economies*. One agency, US OPIC, originated in the national development agency (US Agency for International Development) and has host country development as its primary mission. Its statutory mission statement asks it to mobilize US "private capital and skills for economic and social development of less developed countries and transition economies." Australia asks its agency to "contribute to the community in Australia and overseas".
- *Realising diplomatic objectives*. Belgium ONDD's mission is to realise Belgium's diplomatic objectives.

3.2. Legal status and governance

The survey reveals four categories of legal status for agencies providing publicly-sponsored investment guarantees and PRI (Table A2.3); 1) government departments funded as part of the annual budget process (Turkey); 2) self-financing government agencies that operate with the full faith and credit of their respective governments (Australia, Belgium, Japan, Korea, the United Kingdom and the United States); 3) public limited companies that are fully state-owned or are limited liability public agencies (Canada, India, Italy and South Africa); 4) private provision of publicly-sponsored PRI (Austria, France, Germany, Netherlands).

3.2.1. Governing bodies

Governing bodies (*e.g.* Board of Directors and Supervisory or Management Boards) provide strategic guidance and oversee the agency's pursuit of its objectives. The survey looks at the composition of the membership of these supervisory bodies for the 7 programs for which directors' background information is available.[17] It shows:

- The Australian agency's Board has nine members, including 3 public officials and 6 non-executive directors (all from business, of which 5 are from the financial sector).
- The Austrian supervisory board has 24 members, including 7 labor representatives, 2 government officials and 15 business representatives (of which 13 are from the financial sector).
- Canada's board has 12 members, including 9 non-executive directors (8 directors from the business sector, including 5 from finance and 1 director with a managerial position in higher education).
- France's COFACE has a board with 21 members, including 16 non-executive directors, of which 14 are from the financial sector (the other 2 are the president of the largest French business federation and a member of the French legislature).
- Netherlands Atradius' Supervisory Board has nine members. All are from the business sector and all have financial backgrounds.
- The 11-person UK ECGD board has 5 executive and 6 non-executive directors (all non-executive directors are from the financial sector).
- The US (OPIC) Board of Directors has 15 members. Seven of these are from the Federal government and 8 from the private sector, including two non-executive directors who have worked in the financial sector and one each from organised labor, small business and cooperatives (thus, 7 from the business sector, of which 2 from the financial sector).

This survey of the membership of the governing bodies of government-sponsored PRI providers shows: 1) representation is heavily weighted toward business and the public sector. Of the total of 97 directors whose backgrounds were examined, 20 are from the public sector and 69 from business. 2) in almost all cases, the public sector directors are executive directors (that is, they work as top managers in the agency itself). Only one public sector director represents a development ministry (the national development agency sits on the board of US OPIC);[18] 3) business representation is heavily weighted toward the financial sector – of the 69 directors coming from the business sector, 54 are from the financial sector. The US and Canadian Boards draw on a somewhat broader range of business experience (*e.g.* from real estate development, apparel, pharmaceuticals, public transport); and 4) among the 8 Directors who do not come from the business or public sectors, representation is mainly from labor unions (which account for 7 of these directors).

3.2.2. Transparency and disclosure

The survey shows that the disclosure practices of providers of publicly-sponsored investment guarantees (Table A2.4) vary greatly.

Almost all investment guarantee programs publish aggregate financial information. Most also publish information about the sectoral and geographic composition of their portfolios. However, beyond this basic level of disclosure, agencies differ greatly in the amount of information they make publicly available. Many agencies publish annual reports (such reports were not found for Italy, Korea, Turkey India, South Africa and China), but the amount and type of information disclosed in these reports varies markedly. Several agencies also make large amounts of information available on-line (*e.g.* environmental impact assessments). Some countries provide detailed information about individual investment guarantee transactions (*e.g.* amount and type of guarantee, location of project, name of client, outcomes of projects, claims paid, and arbitration decisions) while others show no project-specific information.

Overall, then, there is no standard disclosure practice by publicly-sponsored investment guarantee programs and there is little publicly-available information about some programs. The survey also shows that the most standardised disclosure practices occur in the area of environmental impact assessment. This standardisation appears to stem from the work of the OECD Working Party on Export Credits and Credit Guarantees.[19]

Several agencies note that other transparency measures (other than annual reports and continuous web-based disclosure) are relevant for their operations. For example, the United States and the United Kingdom's agencies state that "Freedom of Information" is relevant for them. In addition, many agencies describe reporting and disclosure channels to other parts of government and to the broader budgeting process. For example, the web sites of 5 agencies (Australia, Canada, France, Germany, Italy, United Kingdom and the United States) mention making reports to legislative bodies and some hold consultations with civil society.

3.3. Products, services and prices

The investment guarantee programs covered by this survey provide a wide variety of services. Most of the investment guarantee programs are administered by agencies with broader mandates, including the provision of export credits. This sections looks only at investment guarantee and PRI products.

Risks insured. Table A2.5 shows that the 16 PRI providers surveyed cover very similar sets of political risks. These include: 1) currency inconvertibility and transfer restrictions; 2) confiscation, expropriation, nationalisation; 3) political violence; 4) default on obligations such as loans, arbitral claims, and contracts. One difference that does emerge is coverage of a separate "terrorism" risk, which is explicitly mentioned on the websites of the German, Italian, and US agencies. It is possible that, in many other countries, this risk is subsumed under "political violence" coverage. Some agencies also cover commercial and natural disaster risks (*e.g.* Italy and the Netherlands).

Eligibility. In defining who is eligible for investment guarantees, all countries look at nationality or some other form of close tie to the home country (Table A2.6). All of the agencies surveyed provide cover for their own citizens. Seven PRI providers offer coverage for foreign corporations with domestic presence (Australia, Austria, Belgium, France, Netherlands, Turkey and the United Kingdom). Six provide political risk cover for the

overseas subsidiaries of domestic companies (Belgium, Canada, Germany, Italy, the United Kingdom and the United States). Belgium appears to have the most comprehensive definition: investors are eligible if they are "integrated in the Belgian economic community". In addition, the programs sometimes identify target clients that they attempt to attract by offering special products. The most common target client found is small- or medium-sized enterprise, with 12 of the 13 OECD public PRI providers stating that they have a special mission to serve these clients or offering special products geared to their needs.

Pricing, contract details and subsidies. Although the survey examined carefully the details of the insurance contracts published on websites (*e.g.* in relation to pricing, deductibles, processing and application charges, duration, claims execution, dispute settlement) it is not possible to present this information across countries and across products in a meaningful way. What from this review, however, the available information shows that pricing and related practices vary widely among the agencies in the survey. The programs offer different services, charge different rates, have different deductible and related policies, and have different service charges for processing the contract. This suggests these public programs, because of their differing product and pricing strategies, could introduce competitive distortions in international investment processes.

An interesting aspect of the pricing question concerns whether or not publicly-sponsored PRI involve subsidies. A subsidy in this context would consist of a program that does not return a risk-free rate of return plus a premium for the capital that the taxpayer has put at risk – that is, a non-subsidised program must deliver at least a zero net present value for taxpayers' investment.[20] Providing internationally-comparable estimates of subsidies would be a very costly exercise and this document does not attempt to make such estimates.

However, two national studies shed direct or indirect light on the question of subsidies. A 1996 study by the bank, J.P. Morgan (and commissioned by the US government) evaluates the desirability of a possible privatisation of US OPIC. The study finds that the value of the investment guarantee operation would be reduced if OPIC were to be privatised. This is because the public agency had an exceptional record (relative to the private sector) in claims management (preventing insurable events from happening) and recovery (retrieving the value of insured assets after a claim has been made). If cost structures are very different between the public and private sectors, subsidy calculations would also have to account for these costs differentials (thus, low pricing for public sector products cannot be taken as evidence of a subsidy; it might simply reflect a cost advantage).[21] A 2003 study estimating subsidy level for some of the products offered by UK ECGD, found that a subsidy exists, but that the "subsidy levels constitute a very small proportion of the total value of UK capital goods exports for the relevant sector."[22]

3.4. Project assessment criteria and norms for business conduct

Publicly-sponsored PRI providers use a variety of assessment criteria when deciding which investments qualify for coverage (Table A2.7). They look at: 1) the economic and financial viability of the project; 2) home country impacts (*e.g.* on domestic employment); 3) host country development impact (*e.g.* employment; linkages). In addition, providers of publicly-sponsored PRI communicate to prospective and actual clients the standards of business conduct that they are expected to observe.

3.4.1. Communicating expectations on business conduct

All of the OECD programs except one (as well as MIGA) include among their assessment criteria various combinations of environmental, local community impacts, labor rights and anti-bribery considerations. In this context, they refer to major international instruments in the environmental, labor and anti-corruption fields. Four OECD instruments are frequently cited and promoted by the PRI providers – the Guidelines for Multinational Enterprises (cited by 7 of the 13 OECD countries surveyed); the Recommendation on Common Approaches on Environment and Officially Supported Export Credits (cited by 12); the Convention and/or Recommendation against Bribery of Foreign Public Officials in International Business Transactions (cited by 7) and the Action Statement on Bribery and Officially Supported Export Credits (cited by 5).[23]

PRI providers promote internationally-agreed standards by means of: 1) explanatory texts on websites and manuals written for clients describing the standards of conduct that are expected of them; or 2) contract clauses with related certain performance requirements. For example, Coface's (France) investment guarantee contract contains text and a supporting letter of commitment in which the client acknowledges that his/her rights under the contract will become null and void if the client is found guilty of bribing foreign public officials.

This business practice – communication to clients of expectations as to business conduct in the environmental, labor and anti-corruption field – is one of the main differences between private and public sector business practices in PRI provision (see review of private sector practices in Section 4).

3.4.2. Political risk analysis

Eleven of the 13 OECD-based insurers cite the OECD Arrangement on Officially Supported Export Credits, which creates, *inter alia*, an international co-operation process for country risk analysis[24] that is also relevant for PRI and investment insurance.

Table A2.8 shows that several countries (Austria, Belgium, Germany, Japan, Netherlands, US) publish lists of host countries that communicate country risk assessments. For Australia and Belgium, these lists report on country risk assessments and the assessment exists for developed and developing countries alike. For some countries, these lists define eligibility. Japan has three lists – one consists of host countries that qualify under the Japanese program, a second lists preferred host countries (that is countries that are favored under the program), and a third lists countries where decisions are made on a case-by-case basis. In many cases (Belgium, Germany, Netherlands) the assessment takes into account the existence of "investment protection agreement" (basically a bilateral investment treaty) between the home and host country.

Some publicly-sponsored PRI programs also use commercial country risk ratings or have proprietary country risk analysis programs of their own. France's COFACE and Netherlands Atradius (both of which are private companies) provide broader, in-house risk evaluation and management services and their publicly sponsored services are offered in parallel with these other product lines.

3.5. Monitoring contract compliance and environmental and development impacts

How do publicly-sponsored PRI programs ensure that their clients respect their contractual commitments? How do they monitor the developmental and environmental impacts of the projects they facilitate? Table A2.9 summarises the information on

monitoring practices found on the websites of the 16 publicly-sponsored PRI programs. Monitoring techniques used are as follows:

- *Self monitoring and self reporting*. Many agencies stress that clients are responsible for complying with their contracts. Some seek to help them to do this by providing self-monitoring tools and some ask clients to make self monitoring reports. For example, OPIC operates a self monitoring program in which each investor completes an annual questionnaire/report covering such project impacts as human capacity building, private sector development, developmental infrastructure improvements, macroeconomic and institutional effects and technology and knowledge transfer. It also asks for ongoing project information relevant for understanding environmental and labor management risks. NEXI (Japan) bases its monitoring activity (*e.g.* in relation to environmental and social matters) on information provided by the client. MIGA describes its environmental monitoring procedure as follows: "Compliance will be assured by the applicant's specific and continuing representations and warranties that measures to comply with environmental requirements will be taken and maintained throughout the term of the Contract of Guarantee."
- *Contractual obligation to cooperate with verification*. COFACE's (France) clients have a contractual obligation to cooperate with agency attempts to verify compliance once a problem has been identified, notably by providing documents and authorising "verifications".
- *Monitoring by agency officials* (EFIC, OPIC, MIGA). OPIC also conducts on site inspections. Under its "Site monitoring" program, OPIC randomly selects the projects sites that staff will monitor during a three year period (monitoring involves a one-time site visit). In addition to randomly selected projects, all investments considered to be economically or environmentally sensitive are visited.
- *Complaints facilities/ombudsman* (Australia, Canada, United Kingdom and the United States, South Africa and MIGA). A number of the agencies provide contacts for complaints facilities or ombudsmen. Often these complaints facilities are housed in agency compliance offices and complaints are vetted and, in some cases, followed up on with additional services (audits, mediation).

3.6. Managing relations with host countries

The programs have numerous potential impacts on host societies and host governments. One might expect these impacts to be broadly positive if these programs are successful in promoting productive investment and, therefore, economic development.

However, the programs also influence the way that host governments exercise their sovereign powers in at least two potentially sensitive ways. First, the investment guarantee agency acts on behalf of another sovereign state to influence investment patterns in the host country – this, in itself, might be a source of concern for the host government. Second, the guarantee or insurance service may shift the balance of power between the investor and the home government (since, the home government may intervene through advocacy or recovery if the host government threatens or takes actions that are covered by the home country program). This might also be a source of concern for host countries. The survey looks at how home governments manage these home country-host country issues.

The countries studied use a variety of practices to manage their relations with host countries:

- *Bilateral treaties*. As already noted in the section on evaluation and risk assessment, international investment agreements play a role in the management of these programs (*e.g.* those of Austria, Belgium, Germany, and the Netherlands). US OPIC appears to be the only investment guarantee agency whose relations with host countries are governed by bilateral treaties that are specifically negotiated for this purpose. These treaties cover the rights and responsibilities of both home and host governments in relation to OPIC services. For example, the Mexican-US investment incentive agreement contains *inter alia* the following commitments: OPIC only supports investments permitted by NAFTA or the laws of Mexico; OPIC is not treated as an insurer or a financial organisation under Mexican financial regulation; disputes are to be resolved through negotiation between the two governments and, if these fail, the dispute is to be submitted to an arbitration tribunal in accordance with rules set forth in the treaty.
- *Prior notification*. US OPIC has a policy of systematically informing host governments when it provides guarantees related to projects that are likely to be highly disruptive.
- *Advocacy*. A number of agencies (OPIC, MIGA) mention advocacy. This involves the use of home government diplomatic resources to try to head off potential problems (and associated insurance claims) before they become serious. For example, OPIC describes one episode of advocacy as follows: "OPIC sent a letter to a provincial tax ministry on behalf of a small oil and gas investor, after the local tax ministry assessed property and profits taxes, interest, fines and penalties following an audit. The local arbitration court ruled in the investor's favor, but the tax ministry prevailed in a subsequent appeal. OPIC's letter urged the tax ministry to defer taking any enforcement actions until the investor had the opportunity to have its tax liability fully adjudicated by the court system in the country."
- *Mediation*. MIGA provides mediation services in order to reduce host country/investor tensions and to avoid situations that might lead to a PRI claim. Its website describes these services as follows: "Investment disputes can entail a government being accused of breaching its contract with an investor or expropriating an investor's concession, or an investor being accused of violating its contractual obligations to the host country. Both sides disagree about which is at fault and about how the damaged party should be compensated. MIGA uses its good offices" in these cases to examine areas of responsibility and potential liability, and to help the parties reach an agreement that would settle the dispute to the satisfaction of both sides.
- *Integrating host country concerns into project assessment criteria*. ECGD (United Kingdom) states that "before insurance can be given, ECGD must be satisfied that the investment is acceptable to the host government. Also, the investor will have a continuing responsibility to satisfy all requirements that the host government may lay down in relation to the investment. The ECGD will have no liability for expropriation provoked or instigated by the investor … or from the failure… to comply with local laws and regulations. It is particularly important that the investment should be made and administered in accordance with the customs and sensitivities of the host country."

4. Private PRI providers

The private sector is also active in the provision of political risk insurance. This section provides a selective survey of private PRI providers. The purpose of the section is to document the similarities and differences between private and public insurers in PRI. The section is based on a fact-finding survey of 63 firms. The website of MIGA's "PRI Centre" provides a directory of private political risk insurers that lists 63 insurers with accessible websites. 59 of these companies are insurers, while 4 provide information and management consulting services. The positioning of the companies ranges from small, boutique insurers that specialise in particular sorts of risks to subsidiaries of major global insurers.

A review of these websites reveals the following similarities and differences between public and private insurers:

Same set of political risks covered. The range of risks covered by the private sector is essentially identical to those covered by the publicly-sponsored programs: 1) currency inconvertibility and transfer restrictions; 2) confiscation, expropriation, nationalisation; 3) political violence; 4) default on obligations such as loans, arbitral claims, and contracts.

Detailed private sector contracting. The private insurers also adapts its contracting practices in order to deal with the difficulties of PRI contracting. As noted earlier, the complex nature of political risk means that insurance contracts in the sector have to be detailed. All of the companies that discuss their contracting practices describe contracts that tailored to the needs of client's business situation (many of them stress the "bespoke" – or tailor made – element of the PRI products).

Break-down of activities in the private PRI sector. The breakdown of activities in the sector between brokerage, underwriting, insurance and reinsurance is typical for a private insurance sector. Brokerage and agents constitute what might be through of as the "marketing" arm of the insurance sector. Thirty-two of the 63 companies in the sample identify themselves as insurance brokers (they act as intermediaries between the client and the underwriters and their role is to help the client find a good match between its needs and the available insurance products). This marketing function is absent in publicly sponsored programs, presumably because they can rely on their visibility as sole public providers to attract customers. Twenty three of the 63 companies describe themselves as underwriters. The underwriter accepts the obligation to pay or indemnify the insured – thus, underwriting is the process which defines the terms by which the insured shifts his risk onto the underwriter. Lloyds of London plays an important role in private PRI underwriting – 12 of the 23 underwriters manage "syndicates for Lloyds". In the area of underwriting, the public and private PRI sectors do basically the same thing. Reinsurance is insurance for insurers – it allows insurers to adjust the risk-return profile of their portfolios. Fifty-two of the companies in the sample are in insurance, 25 are in reinsurance and 20 are in both insurance and reinsurance. Reinsurance (along with other risk adjustment techniques such as diversification and coinsurance) are important in the PRI market because, as noted earlier, risks in this market are cross-correlated (thus, insurers are likely to receive many claims all at once). Some public PRI providers also provide reinsurance services and some are clients of private re-insurers.

The prominent role of business expertise and advisory services in the positioning of private PRI providers. The websites of private PRI providers call attention to the value of their information, expertise and advisory services. They position themselves to take advantage of synergies between PRI provision and their political, sectoral and managerial expertise. Twenty-seven

of the companies in the sample provide consulting services and 4 offer political information and forecasting services. Often, expertise is sectoral, geographical and/or by risk category – 28 of the 63 companies have a sectoral dimension to their product lines. Sectors frequently cited include petrochemicals, aviation, maritime transport, construction and electricity. Some companies describe products in highly-specialised sectors such as fine arts and breeding stock. Expertise described on the websites also sometimes involves geographical areas (*e.g.* Indian Ocean or sub-Saharan Africa) or risk categories (*e.g.* war damages).

Advocacy and recovery. Private PRI insurers only rarely cite their capacities for advocacy and recovery as being important competitive strengths. As noted before, advocacy involves intervention with host country political actors with a view to forestalling an event that could result in a PRI claim. As noted above, it an important part of public PRI provision. Only one private PRI insurer mentions that it engages with host country officials in this way. Likewise, only one private PRI insurer mentions that it uses the services of a "recovery" specialist to retrieve the value of insured assets for which a claim has been made. Thus, judging from their websites, private insurers do not attempt to position themselves as having competitive advantage in advocacy and recovery. The study of US OPIC, cited above, by the bank, J.P. Morgan supports the view that OPIC has a strong competitive advantage, relative to private insurers, in both advocacy and recovery.[25]

Communicating expectations on business conduct. Although 28 of the companies surveyed had codes of conduct, none published anything indicating that they seek to promote internationally-agreed standards for business conduct among their clients.[26] In comparing insurance practices in the public and private parts of the PRI market, this appears to be a major difference (Section 3 shows that all but one of the OECD public PRI programs communicate with clients on social, labour, environment, and/or anti-corruption issues).

5. Political risk insurance: a survey of issues

The issues raised by the preceding discussion are:

5.1. *Public* versus *private provision*

Private and public insurance providers have co-existed in the PRI market for many years. A few general questions concerning the co-existence of private and public PRI providers are worth exploring in more detail.

- *Insurer of last resort, market failure and government failure.* Missing markets are commonly cited as being a potentially valid justification for market intervention by governments. The paper suggests that the PRI sector might well be characterised by large gaps in market coverage due to the sector's high transactions costs. These could make it impossible to serve smaller and niche customers profitably. The survey shows that three public PRI providers are mandated to serve as insurers of last resort (that is, they offer PRI cover when it is not available from the private sector). Other agencies may act as *de facto* insurers of last resort even though this is not officially part of their mission. However, it cannot be taken for granted that a market failure justifies government intervention. Offsetting this rationale for intervention are the countervailing risks posed by "government failure". These arise from the scope opened up by public service delivery for creating vested interests, for inappropriate political interventions in market activity (for example, on behalf of favored clients) and from the lack of market incentives for the government officials providing such services.

- *Governments' competitive strengths as PRI insurers*. Publicly-sponsored PRI might be justified on the grounds that, in this sector, governments have unique competitive strengths that can be used to produce welfare-enhancing services at low cost. These strengths would stem primarily from governments' ability to use their diplomatic networks as risk management and asset recovery tools – in this way, governments create economies of scope by using their existing assets to provide services that private sector insurers cannot produce.[27] One example of how this might work can be found in recovery of claims for currency inconvertibility. In a letter to the US General Accounting Office, OPIC's CEO explains: "as part of the government-to-government agreements it negotiates with each country where it operates, OPIC obtains special arrangements for recovering salvage when it pays inconvertibility claims. Under these arrangements, OPIC makes inconvertible local currency available for other US government uses, in exchange for dollars that would have been spent, for example, by a US embassy for its local currency expenses. Through this mechanism, which is not available to private sector insurers, OPIC has been able to obtain excellent salvage on currency inconvertibility claims."[28]
- *Promoting international standards for business conduct*. Another major difference between public and private PRI providers is that publicly-sponsored providers position themselves as platforms for promoting responsible business conduct at the same time investment is being promoted. The survey shows that the private insurance sector is not involved in such promotion. This is in marked contrast to the OECD-based public agencies surveyed, which frequently use and promote relevant international standards (especially environmental standards under the OECD Common Understanding, the OECD Convention against Bribery of Foreign Public Officials and the OECD Guidelines for Multinational Enterprises) and/or monitor clients' observance of these standards.

5.2. Do these programs promote investment for development?

The survey shows that, viewed as a whole, investment guarantee programs do not view their mission as being one of contributing to host country development. As noted earlier, only one (US OPIC) has host country development as its primary mission. The survey also turned up other institutional signs that host country development may not be foremost in the priorities of most investment guarantee organisations:

- *Membership of governing bodies*. The review of membership in the governing bodies of these organisations shows that development concerns are hardly represented. In only one case (US OPIC) is a development ministry official a member of the investment guarantee agency's governing board (and in Germany the development ministry is represented on the inter-ministerial committee that makes major operational decisions). In addition, none of the outside directors in the survey are noted for their development expertise nor is there any direct representation of developing countries (*e.g.* of regional organisations representing countries that are important recipients of projects covered by investment guarantees). The main non-business and non-executive directors are trade union representatives. Thus membership in governing bodies seems to reflect the statutory focus of these agencies on home country economic growth, employment creation and competitiveness goals.
- *PRI applications*. Only 2 application forms for PRI coverage found on line ask for information about the development impacts of the project for which insurance coverage was requested.

- *Performance reporting*. Performance reporting allows agencies to be held accountable for achieving their objectives. As noted earlier, performance reporting practices are highly variable among the 16 programs studied. Some provide information on the sectoral and geographical composition of their portfolios and a few disclose project level information. Some of this information could be used to assess development impacts. However, the general impression left by the survey of the 16 agencies' performance reporting practices is that these are not generally geared to holding the programs accountable for their host country development impacts.

It could be argued that the fact that these investment guarantee programs make possible investments in developing countries that would not otherwise have occurred is, in itself, a development benefit. Thus, one reason that investment guarantee agencies might not build pursuit of host country development into their control and reporting practices is that they take it for granted that their impacts are beneficial for host countries.

However, as pointed out in the OECD Policy Framework for Investment the "benefits of investment do not necessarily accrue automatically or evenly across countries, sectors and local communities. Countries' continuous efforts to strengthen national policies and public institutions, and international co-operation, to create sound investment environments matter most." Because this assumed link between these home country programs and host country development benefits relies so much on the quality of the host country policy environment, there would seem to be strong synergies between investment guarantee programs and the *Policy Framework for Investment* as well as other international co-operation processes for improving policy environments.

5.3. PRI as a second best policy relative to fundamental host country policy reform

The preceding discussion notes a number of problems with investment guarantees and PRI. First, because of high transactions costs, PRI is an expensive insurance product to produce (for both public and private insurers). Moreover, it often only partly succeeds in lowering risk (because, to some extent political risk is replaced by risks associated with claims management). Second, PRI may produce incentive effects in the host country that undercut the impetus for reform and for international investors and host governments to learn to work out their differences through mutual accommodation. Third, the variation in home government policies (three OECD countries have no investment guarantee programs, while many have extensive programs) may distort international investment markets. In addition, these policies could force a kind of "arms race" in investment guarantees, where home countries have no choice but to put in place such policies if they want to meet the competition from other countries' policies.

It is clear from these shortcomings that political risk insurance is a second best policy. A first-best policy involves moving toward investment policy reform and creating sound policy environments in all countries. This will not eliminate political risk – any policy system needs to be able to respond to changing circumstances and these changes are a source of risk for investors affected by regulatory outcomes. However, it will establish predictable and transparent mechanisms for policy change, which both domestic and international investors will find reassuring, and will create credible mechanisms for host country dispute management that take due account of the full range of societal needs (thereby *inter alia* reducing risks of civil unrest). All of this will lower political risk without the expense and uncertainty of PRI contracting.

5.4. Relationship with international investment agreements

The survey highlights the close relationship between PRI and international investment agreements and related institutions. The goals of IIAs and PRI are essentially identical – both seek to promote international investment by lowering political risks. The political events they cover – expropriation, conflict, currency inconvertibility, and breach of host government commitments – are very similar. Risk assessments under many PRI programs often look at the existence of BITs or other agreements (*e.g.* the United States has home-host agreements specifically negotiated for its investment guarantee agency). Some draw on the same international dispute resolution procedures as those specified by international investment agreements.

There are major differences between the two approaches to investment promotion and protection, however. While international investment agreements are treaties between sovereign governments, public PRI are generally based on contracts linking public PRI agencies and private investors. Another difference is that, while many governments are reluctant to include texts on environment, labor, anti-corruption or human rights into their investment agreements, international standards in these areas are promoted by nearly all of the OECD investment guarantee programs in the survey.

Notes

1. These averages are for 2003-2005. World investment guarantee/insurance flows are taken from the Berne Union 2007 Annual Report, which reports on its members' "new business" for "investment insurance". (The Berne Union's members are public and private organisations from the global export credit and investment insurance industry.) World and developing country FDI flows are from Annex B of the 2006 World Investment Report.
2. This definition is modelled on the one provided in a 2005 OECD Development Centre publication that looks at "development guarantees". This monograph defines a guarantee as "Guarantees and insurance against political, contractual/regulatory, credit and foreign exchanges risks." (see Winpenny (2005), page 15.) This monograph looks only at guarantee programs that have development motives.
3. This definition comes from the online glossary of the Political Risk Insurance Centre, a website sponsored by the MIGA *www.pri-center.com/*.
4. List taken from the *OECD Checklist of Criteria to Define Terrorism for the Purpose of Compensation: Recommendation of the Council*. 15 December 2004. See Section 3.1.1. under "Technical Insurability".
5. According to Hamdani *et al.* (2005), "PRI losses exhibit significant volatility from year to year. Not only is there the potential for significant losses associated with political developments in a single country, but events may well be correlated in time across countries."
6. The International Association of Deposit Insurers: *www.iadi.org/Lists/Glossary/DispForm.aspx?ID=21*.
7. Moran (2006) page 84. This text refers to the behaviour of international power companies with investments in Indonesia during the Asian financial crisis.
8. For France, see Article 14, clause 4 of Assurances Investissement: Conditions Générale DMT 101 J; *www.coface.fr*. For the UK, see warning to clients quoted in section 3.6 of this document.
9. See *Policy Competition for Foreign Direct Investment*, OECD Development Centre Studies. This study finds that as "barriers to international investment have fallen over the last two decades the significance of competition for FDI has increased." (Page 10.)
10. US OPIC reports on a number of examples of advocacy at: *www.opic.gov/insurance/projects/profile_advocacy.asp* These include: 1) multiple discussions with the associated city government in an effort to enforce an arbitral award against the local joint venture partner for a fast-food vendor; 2) sending a letter to a provincial tax ministry on behalf of a small oil and gas investor, after the local tax ministry assessed property and profits taxes, interest, fines and penalties following an audit; and 3) sending a letter to a host government following its refusal to recognise an international arbitral award in regards to a dispute that involved a US investor and a local firm.

11. See Section 3 of this document for discussion of advocacy and recovery by home governments.
12. Quote from David James (2004), page 29.
13. On page 35 of David James (2004), James states: "Models can be useful underwriting tools, but not means of controlling aggregate exposure."
14. See for example, the "Findings of Fact" section of the American Arbitration Association's "Findings of Fact, Conclusions of Law and Award". AAA Case No. 50 T 195 00509 02. This section describes discussions between the insured company and OPIC, as both attempted to clarify the meaning of the PRI contract in light of events in the Indian power sector. There were also discussions of modifying the coverage (see for example, paragraph 26 of the Award).
15. MIGA, for example, in its 2006 Operational Overview states: MIGA did not pay any claims in fiscal year 2006, but is actively seeking to resolve three pending claims …. MIGA is also closely monitoring and actively working to resolve the problems of eight other disputes relating to investment guaranteed by the Agency… The Findings of Fact section of American Arbitration Association decision AAA Case No. 50 T195 00509 02 also illustrates how such disputes can arise.
16. The Netherlands asks its publicly-sponsored PRI provider to "complement" the private market.
17. In some cases (*e.g.* Germany), governments have created executive committees (that is, having operational, rather than supervisory, responsibilities) for their investment guarantee programs. These were not included in this survey.
18. In Germany, the inter-ministerial committee that makes decisions on investment guarantee proposals by PWC (the private company charged with running German's investment guarantee program) includes a representative from the German development ministry.
19. See the Revised Council Recommendation on Common Approaches on the Environment and Officially Supported Export Credits. The Recommendation commits member countries to: "Foster transparency, predictability and responsibility in decision-making**,** by encouraging disclosure of relevant environmental information with due regard to any legal stipulations, business confidentiality and other competitive concerns. It also provides guidance on how this should be done."
20. See Schich (1997) for an options-based model of how such risk adjusted pricing can be done for the export credit industry.
21. Stduy cited in Moran (2003) in several places. See, in particular, page 26.
22. See NERA Economic Consulting (2003) page viii.
23. Quite a few other instruments are also used by public PRI providers. For example, the OECD Risk Awareness Tool for Multinational enterprises in Weak Governance Zones is cited by US OPIC.
24. The OECD risk classification of countries is achieved through the application of a methodology comprised of two basic components: 1) the Country Risk Assessment Model (CRAM), which produces a quantitative assessment of country credit risk, based on three groups of risk indicators (the payment experience of the Participants, the financial situation and the economic situation) and 2) the qualitative assessment of the Model results, considered country-by-country to integrate political risk and/or other risk factors not taken (fully) into account by the Model.
25. This J.P. Morgan study is cited in Moran (2003). Moran describes its results as follows: "A study of the potential privatisation of OPIC commissioned from J.P. Morgan concluded that the US government would actually have to offer OPIC's assets at a discount to induce any private corporation to take over its portfolio because the private sector would simply not be able to replicate its deterrent function or reproduce its recovery rates." [Page 4.]
26. One of the companies in the sample is an information and consultancy whose range of services includes consulting in the area of responsible business conduct.
27. A study of OPIC done by the bank J.P. Morgan notes OPIC's "exceptional" performance in claims recovery. The study notes that an eventual privatisation of OPIC would probably lead to a loss in value for the US government because prospective private buyers would factor in a much lower recovery rate. Study described in Moran (2003) page 26.
28. From "Comments from OPIC on page 40 of the US General Accounting Office Report Overseas Investment: Issues Related to the Overseas Private Investment Corporation's Reauthorisation". September 1997.

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ANNEX 1

Methodology

The survey described in this document draws only on publicly available information. It is based on information provided on the websites of investment guarantee agencies and from other official sources (*e.g.* the websites of the World Bank Group and of the Berne Union).

The survey covers national, publicly-sponsored investment guarantee programmes for a sample of OECD and non-OECD countries. The OECD countries selected were chosen to give a balance of geographical coverage. Only websites available in English, French, German or Spanish were considered for eligibility in the sample. The three non-OECD countries in the sample (China, India and South Africa) were chosen because of these countries' importance as global or regional investors.

The survey of private providers of political risk insurance also uses only publicly available information. The sample is the list of private PRI service providers that appears on the MIGA's website, PRI Center (*www.pri-center.com*).

In all cases, the information is that appearing on the relevant websites between April-June 2007.

ANNEX 2

Information Tables for Publicly-Sponsored PRI Providers

Table A2.1. **Institutions providing PRI for OECD Governments**

	Agency: IG Provider	MIGA MEMBER
OECD		
Australia	EFIC – Export Finance and Insurance Corporation (*www.efic.gov.au/)*	Yes
Austria	OEKB – Oesterreichische Kontrollbank AG (*www.oekb.at/control/index.html*)	Yes
Belgium	ONDD – Office National du Ducroire/ Nationale Delcrederedienst (*www.ondd.be*/)	Yes
Canada	EDC – Export Development Canada (*www.edc.ca*/)	Yes
Czech Republic	EGAP – Export Guarantee and Insurance Corporation (*www.egap.cz*/)	Yes
Denmark	EKF – Eksport Kredit Fonden (*www.ekf.dk*/)	Yes
Finland	FINNVERA PLC (*www.finnvera.fi*/)	Yes
France	COFACE – Compagnie Française d'Assurance (*www.coface.com*)	Yes
Germany	PWC – PricewaterhouseCoopers AG (*www.agaportal.de*)	Yes
Greece	ECIO – *Export Credit Insurance Organisation* (*www.oaep.gr*/)	Yes
Hungary	MEHIB – Hungarian Export Credit Insurance (*www.mehib.hu*/)	Yes
Iceland	TRU – Tryggingardeild Utflutnings (*www.nsa.is*)	Yes
Ireland	No information found on any national PRI agency	Yes
Italy	SACE – Servizi Assicurativi del Commercio Estero (*www.sace.it*)	Yes
Japan	NEXI – Nippon Export and Investment Insurance (*www.nexi.go.jp*)	Yes
Korea	KEIC – Korea Export Insurance Corporation (*www.keic.or.kr*)	Yes
Luxembourg	Office du Ducroire Grand Duché de Luxembourg (*www.ducroire.lu*)	Yes
Mexico	No information found on any national PRI agency	Not a member
Netherlands	ATRADIUS Dutch State Business (*atradius.com/nl/dutchstatebusiness*/)	Yes
New Zealand	No information found on any national PRI agency	Application in progress
Norway	GIEK – Garanti-Instituttet for Eksportkreditt (*www.giek.no/default.asp*)	Yes
Poland	KUKE – Export Credit Insurance Corporation Joint Stock Company (*www.kuke.com.pl*/)	Yes
Portugal	COSEC – Companhia de Seguro de Créditos (*www.cosec.pt*)	Yes
Slovak Republic	EXIMBANKA SR – Export-Import Bank of the Slovak Republic (*www.eximbanka.sk*)	Yes
Spain	CESCE – Compañía Española de Seguros de Crédito a la Exportación (*www.cesce.com*)	Yes
Sweden	EKN – Exportkreditnämnden (*www.ekn.se*)	Yes
Switzerland	No information found on any national PRI agency	Yes
Turkey	TURK EXIMBANK (*www.eximbank.gov.tr*/)	Yes
UK	ECGD – The Export Credits Guarantee Department UK (*www.ecgd.gov.uk*/)	Yes
US	OPIC – Overseas Private Investment Corporation (*www.opic.gov*)	Yes
Non-OECD		
China	SINOSURE – China Export and Credit Insurance Corporation (*www.sinosure.com.cn/index.jsp*)	Yes
India	ECGC – Export Credit Guarantee Corporation of India Ltd. (*www.ecgc.in/portal*/)	Yes
South Africa	ECIC – Export Credit Insurance Corporation of South Africa (Pty) Ltd (*www.thedti.gov.za/thedti/ecic.htm*)	Yes
Multilateral		
MIGA (World Bank Group)	MIGA – Multilateral Investment Guarantee Agency (*www.miga.org*)	

Table A2.2. **Mission Statements**

Agency	Promote host country welfare and/or development	Promoting the external competitiveness of home country entities	Fill the market gap – make up for lack of private insurance	Meet international policy objectives	Comments (texts in quotes are from agency websites)
OECD					
OEKB (*Austria*)	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	OeKB's primary objective since 1950 has been the promotion of exports by helping to reduce risks for Austrian companies and protecting them against losses abroad. OeKB supports exporters competing in the world market
EFIC *(Australia)*	Yes	Yes	Yes	Not found in mission statement	EFIC's mission statement says: "We seek to create opportunities for our clients, particularly small to medium enterprises, when the private market lacks capacity or willingness, filling the market gap on a commercial basis to contribute to the community in Australia and overseas."
ONDD *(Belgium)*	Not found in mission statement	Not found in mission statement	Not found in mission statement	Yes	ONDD is an autonomous public institution with a mission "to promote international economic relations."
EDC *(Canada)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	"Our mandate is to support and develop Canada's export trade and Canadian capacity to engage in that trade and to respond to international business opportunities. To fulfil this mandate, we provide trade finance and risk mitigation services to Canadian companies involved in export trade."
COFACE *(France)*	Not found in mission statement	Not found in mission statement	Not found in mission statement	Not found in mission statement	COFACE's mission is to "facilitate exchange between companies everywhere in the world."
SACE *(Italy)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	SACE's "mission is to provide support for the internationalisation if the Italian economy, by insuring and reinsuring political and commercial risks to which Italian operators may be exposed in their international transactions."
PWC *(Germany)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	The German government supports the activities of German companies abroad by means of its foreign trade and investment promotion scheme and in doing so maintains their competitiveness, contributes to job security and promotes exports thus acting as an important growth factor.
NEXI *(Japan)*	Not found in mission statement	Yes	Yes	Not found in mission statement	NEXI's "mission is to assist customers to conduct international business with a sense of security by reducing incidental business risks. NEXI aims to efficiently and effectively conduct insurance business of covering risks which arise in foreign transactions and which are not covered by commercial insurance".
KEIC *(Korea)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	KEIC promotes "the nation's export, overseas investment, and other overseas business activities by providing various types of export-related insurances, overseas investment insurances, and guarantees."

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Table A2.2. **Mission Statements** *(cont.)*

Agency	Promote host country welfare and/or development	Promoting the external competitiveness of home country entities	Fill the market gap – make up for lack of private insurance	Meet international policy objectives	Comments (texts in quotes are from agency websites)
ATRADIUS DSB *(Netherlands)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	Astradius promotes "complementary to the market, Dutch exports and foreign investment by providing credit and investment insurance."
Türk EXIMBANK *(Turkey)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	Türk Eximbank supports foreign trade and Turkish contractors/investors operating overseas through various credit, guarantee and insurance programs.
ECGD *(UK)*	Not found in mission statement	Yes	Not found in mission statement	Yes	ECGD's mission is to "benefit the UK economy by helping exporters of UK goods and services to win business and UK firms to invest overseas by providing guarantees, insurance and reinsurance against loss, taking into account the Government's international policies."
OPIC *(US)*	Yes	Not found in mission statement	Yes	Not found in mission statement	OPIC's "mission is to mobilise and facilitate the participation of United States private capital and skills in the economic and social development of less developed countries and areas, and countries in transition from non market to market outcomes."
Non-OECD					
ECGC *(India)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	ECGC's mission is "To support the Indian Export Industry by providing cost-effective insurance and trade-related services to meet the growing needs of the Indian export market through the optimal utilisation of available resources."
ECIC *(South Africa)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	ECIC "facilitates and encourages South African export trade … To achieve this, the ECIC evaluates export credit and foreign investment risks and provides export credit and foreign investment insurance cover on behalf of government…"
SINOSURE *(China)*	Not found in mission statement	Yes	Not found in mission statement	Not found in mission statement	SINOSURE mission is to protect "Chinese companies from commercial and political risks in export and overseas investments, facilitating the financing of these transactions, improving the competitiveness of Chinese companies in international markets and rendering them strong support overseas."

Table A2.3. **Legal status**

Agency	Legal status	Short Description
OECD		
EFIC *(Australia)*	Part of Ministry	EFIC is part of the Foreign Affairs and Trade portfolio and reports to the Minister for Trade. EFIC's provides finance, guarantees, insurance and bonding facilities to support Australian companies exporting or investing overseas.
OEKB *(Austria)*	Private company	Part of a private financial services group. In the field of export credit and investment insurance, OeKB operates the investment guarantee on behalf of the Republic of Austria.
ONDD *(Belgium)*	Independent agency	Autonomous public institution.
EDC *(Canada)*	Independent agency	EDC is a Canadian Crown Corporation.
COFACE *(France)*	Private company	Owned by Natixis, a private financial services group, COFACE provides credit insurance, information and corporate ratings and receivables management training on behalf of the French government.
PWC AG *(Germany)*	Private company	The German Government appointed a consortium (PricewaterhouseCoopers Aktiengesellschaft (PwC AG) as lead partner with Euler Hermes Kreditversicherungs-AG (Euler Hermes)) to act on its behalf.
SACE *(Italy)*	Public-limited company	All shares are owned by the Ministry of Finance and Economics.
NEXI *(Japan)*	Independent agency	Independent administrative institution referring to the Minister of Economy, Trade and Industry.
KEIC *(Korea)*	Independent agency	KEIC operates under the policy guidance of the Ministry of Commerce, Industry and Energy. KEIC provides export credit insurance to Korean exporters, guarantees to banks that provide export financing and issue bonds for exporters and political risk insurance to new investment overseas.
ATRADIUS DSB *(Netherlands)*	Private company	A fully owned subsidiary of Atradius Group, Atradius Dutch State Business (Atradius DSB) provides medium term export credit and investment insurance services for the account of the Dutch State.
Türk EXIMBANK *(Turkey)*	Independent agency	Turkey's official export credit agency, the Bank currently supports Turkish exporters, contractors and investors through various credit, guarantee and insurance programs. Investment insurance cover may be offered on a case-by-case basis.
ECGD *(UK)*	Part of Ministry	ECGD is a separate department of the UK government, responsible to the Secretary of State for Trade and Industry.
OPIC *(US)*	Independent agency	Independent US government agency. Supports US foreign policy by promoting overseas investment projects with substantial US participation through financing, investment funds and by providing political risk insurance. OPIC is required by statute to give preferential consideration to investments in developing countries with low per capita income. Projects significantly involving US small business and cooperatives are considered a priority.
Non-OECD		
ECGC *(India)*	Independent agency	Established in 1957 by the Government of India, ECGC operates under the control of the Ministry of Commerce.
ECIC *(South Africa)*	Independent limited liability agency	Independent limited liability company with the Government of South Africa, through the Department of Trade and Industry, as the sole shareholder. Provides export credits and foreign investment insurance on behalf of the Government.
SINOSURE *(China)*	Public corporation	Established in 2001 by merging the Export Credit Insurance Departments of PICC (People's Insurance Company of China) and EXIM.

Table A2.4. **Disclosure and reporting**

Agency	Agency-wide reporting			Project-specific reporting			Other remarks
	Annual report?	Financial information for IG programme	Reports to Parliament or other legislative bodies?	Project reports?	Financial	Outcomes	Other information (*e.g.* environmental or social impacts).
OECD							
EFIC *(Australia)*	Yes	Yes	Yes	Yes; the Annual Report discloses information on medium to long term projects (*e.g.* on investor's identity; activity; size and type of transaction, foreign counterparty)	Yes	Not found	"Freedom of information" is noted as a mechanism for information disclosure on agency website.
OEKB *(Austria)*	Yes	Yes	Not found	Yes	Yes, above 10M EUR	Not found	Environmental and social impact assessments of projects above 10M Euros (with consent of client).
ONDD *(Belgium)*	Yes	Yes	Not found	Yes	Not found	Not found	With clients' consent, information on category A projects is made available for public comment. Online listing of projects classified under categories A and B with the project description, the host country, the contracting party, the amount involved (in categories), the environmental category and possibly a hyperlink to the Environmental Impact Assessment of the project.
EDC *(Canada)*	Yes	Yes	Yes	Yes	Not found	Not found	For projects likely to have significant adverse environmental impact: date of signing, host country, investor, principal counterparty, transaction description and size.
COFACE *(France)*	Yes	Yes	Yes	Yes	Not found	Not found	If a transaction is classified as a category A project, information on the environmental impact is made available to the public for at least 30 days before the policy is issued.
PwC *(Germany)*	Yes	Yes	No, except as part of annual budget discussions	Yes, reports on selected cases	Not found	Not found	
SACE *(Italy)*	Yes	Yes	Yes	Not found	Not found	Not found	
NEXI *(Japan)*	Yes	Yes	Not found	Yes	Not found	Monitoring of environmental impacts of sponsored projects	For contracts not yet concluded, the project name, category according to environmental and social impact, reason for categorisation and project location.
KEIC *(Korea)*	Yes	Yes	Not found	Not found	Not found	Not found	
ATRADIUS DSB *(Netherlands)*	Yes	Yes	Not found	Yes	Not found	Not found	If a transaction is classified as a category A project, information on the environmental impact is made available to the public for at least 30 days before the policy is issued.

Table A2.4. **Disclosure and reporting** *(cont.)*

	Agency-wide reporting			Project-specific reporting			Other remarks
Agency	Annual report?	Financial information for IG programme	Reports to Parliament or other legislative bodies?	Project reports?	Financial	Outcomes	Other information (*e.g.* environmental or social impacts).
Türk EXIMBANK *(Turkey)*	Yes	Yes	Not found	Not found	Not found	None found	
ECGD *(UK)*	Yes	Yes	Yes	Yes.	Not found	Not found	If a transaction is classified as a category A project, the information on the environmental impact of it will be made available to the public for at least 30 days before the policy is issued. A list of projects with potentially high social and environmental impacts for which ECGD support has been requested is published (with the consent of the customer). Freedom of information is noted on website as a mechanism for information disclosure.
OPIC *(US)*	Yes	Yes	Yes	Yes	Yes	Yes (*e.g.* claims paid and information about outcomes of arbitration cases)	The Annual Report lists all investment activities sponsored by OPIC. It presents the investor identification, host country, short description of the investment, type of service provided by OPIC and the amount involved. OPIC lists all projects in sectors considered "environmentally sensitive" for a 60-day public comment period. The listing includes the country and industry sector of the projects but not the investor's name. Freedom of information is noted on website as a mechanism for information disclosure. Other transparency mechanisms also apply (*e.g.* reporting on results of OPIC Board meetings).
Non-OECD							
ECGC *(India)*	Not found	Not found	Not found	Not found	Not found	Not found	
ECIC *(South Africa)*	No activities of ECIC described in DTI Annual Report	Not found	Not found	Not found	Not found	Not found	
SINOSURE *(China)*	Yes	Yes	Not found	Not found	Not found	Not found	
Multilateral							
MIGA	Yes	Yes	Not relevant	Yes	Yes	Yes	

Table A2.5. **Political risks covered***

Agency	Currency inconvertibility/ Transfer restrictions	Confiscation, expropriation, nationalisation	Political violence/war	Default on obligations (loans, arbitral claims, contractual, etc.)	Terrorism	Other risks covered
OECD						
EFIC *(Australia)*	Yes	Yes	Yes	Not found	Not found	Cover can also be provided for other political events such as selective discrimination and arbitral award default
OEKB (Austria)		Yes	Yes	Yes	Not found	
ONDD *(Belgium)*	Yes	Yes	Yes	Yes	Not found	
EDC *(Canada)*	Yes	Yes	Yes	Yes	Not found	
COFACE *(France)*	Yes	Yes	Yes		Not found	Changes in host country legislation; denial of justice in countries with which France has no bilateral investment agreement
PWC *(Germany)*	Yes	Yes	Yes	Yes	Yes (included in war risks)	
SACE *(Italy)*	Yes	Yes	Yes	Yes	Yes (including sabotage)	Embargo; force majeure including natural disasters; exchange rate fluctuation due to laws adopted by the host country
ATRADIUS DSB *(Netherlands)*	Yes	Yes	Yes	Yes	Not found	Some commercial risks also covered; force majeure including natural disasters; default on local authorities' obligations
NEXI *(Japan)*	Yes	Yes	Yes	Yes	Not found	Force majeure
KEIC (*Korea*)	Yes	Yes	Yes	Yes	Not found	
Türk EXIMBANK *(Turkey)*					Not found	
ECGD *(UK)*	Yes	Yes	Yes	Yes	Not found	
OPIC *(US)*	Yes	Yes	Yes	Yes	Yes (as a stand-alone policy)	Coverage of project specific risks
Non-OECD						
ECGC *(India)*	Yes	Yes	Yes	Not found	Not found	For Construction Works abroad: Exchange rate fluctuation, failure of the employer to pay the amounts due
ECIC *(South Africa)*	Yes, for works of a capital nature abroad only	Yes	Yes	Yes, for works of a capital nature abroad only	Not found	For works of a capital nature abroad: insolvency
SINOSURE *(China)*	Yes	Yes	Yes	Yes	Not found	

* The risks included in the table are those found on the website of the political risk insurers. In some cases, the risks shown are available only for certain sectors, projects, activities or asset types. In other cases, it can only be purchased on a stand-alone and/or bespoke (tailor-made contract) basis.

** Includes politically motivated violence: revolutions, rebellions, civil disturbances, war, etc.

Table A2.6. **Eligible clients**

Agency	Domestic Residents		Foreign subsidiaries of domestic companies	Observations
	Nationals	Foreign corporations with domestic presence		
OECD				
OEKB *(Austria)*	Yes	Yes (export oriented, EU member, Austrian origin verified products)	No	
EFIC *(Australia)*	Yes	Yes	No	EFIC states that eligibility "criteria are product specific, and include EFIC being satisfied that all parties in a transaction are acceptable and capable of fulfilling their respective obligations."
ONDD *(Belgium)*	Yes	Yes	Yes	Clients are those who are integrated in the Belgium economic community.
EDC *(Canada)*	Yes		Yes	
COFACE *(France)*	Yes	Yes	No	
PWC *(Germany)*	Yes	No	Yes[a]	Endowment capital for foreign branches of German companies. There must be an explicit German interest in the realisation of the project abroad.
SACE *(Italy)*	Yes	No	Yes	
NEXI *(Japan)*	Yes	No	No	
KEIC *(Korea)*	Yes	No	No	
ATRADIUS DSB *(Netherlands)*	Yes	Yes	No	
Türk EXIMBANK (*Turkey*)	Yes	Yes	No	
ECDG *(UK)*	Yes	Yes	Yes	"All companies and persons carrying on business in the UK are in principle eligible for insurance, provided that the investment is identifiable as of UK origin in the host country. This also applies where the investment is made via an overseas subsidiary. Cover can be considered where an eligible UK investor channels an investment through a non-UK intermediary provided that the investor has a sufficient degree of control over the intermediary."
OPIC *(USA)*	Yes	No[a]	Yes[b]	Company must be "beneficially owned" by US citizens.
Non-OECD				
ECGC *(India)*	Yes	No	No	Target clients are referred to as Indian investors and contractors.
ECIC *(South Africa)*	Yes	No	No	Target clients are defined as South African entities.
SINOSURE *(China)*	Yes	No	No	Enterprises and financial institutions registered and having its principal place of business in Mainland China, excluding those controlled by Hong Kong, Macau and Taiwan enterprises, institutions and citizens.

Notes: The term "domestic residents" refers to entities operating in the domestic/home market of the country that is providing PRI. "Subsidiaries of domestic residents" refers to affiliates of domestic residents, either national or foreign.

Table A2.7. **Assessment criteria and conditions**

Agency/Criteria	Economic Evaluation			Environmental Impact	Social Impact	Labour Rights	Bribery
	Economic and financial viability	Home country impact	Host country development impact				
OECD							
EFIC *(Australia)*	Yes	Yes	Not found	Yes	Yes	Yes	
OEKB *(Austria)*	Yes	Yes	Not found	Yes	Yes	Not found	Yes
ONDD *(Belgium)*	Not found	Yes	Not found	Yes	Yes	Not found	Not found
EDC *(Canada)*		Yes	Not found	Yes	Not found	Not found	Yes
COFACE *(France)*	Yes	Yes	Yes	Yes	Not found	Not found	Yes
PwC (*Germany)*	Yes	Yes	Yes	Yes	Not found	Not found	Not found
SACE *(Italy)*	Not found	Yes	Not found	Yes	Not found	Not found	Not found
KEIC (*Korea*)	Not found	Not found	Not found	Not found	Not found	Not found	Not found
NEXI *(Japan)*	Yes	Not found	Not found	Yes	Yes	Not found	Not found
ATRADIUS DSB *(Netherlands)*	Not found	Not found	Not found	Yes	Yes	Yes	Yes
Türk Eximbank *(Turkey)*	Not found	Not found	Not found	Not found	Not found	Not found	Not found
ECGD *(UK)*	Not found	Yes	Not found	Yes	Yes	Not found	Yes
OPIC *(USA)*	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Non-OECD							
ECGC *(India)*	Not found	Not found	Not found	Not found	Not found	Not found	Not found
ECIC *(South Africa)*	Not found	Not found	Not found	Not found	Not found	Not found	Not found
SINOSURE *(China)*	Not found	Not found	Not found	Not found	Not found	Not found	Not found

Notes: This table describes criteria used by agencies to evaluate investment projects overseas and also conditions or criteria used to refuse sponsorship ("Off-limit" or prohibitive criteria. If clients are asked to sign forms regarding environmental, labour and/or anti-bribery, this is treated as a condition for providing insurance cover. The column heading "Social impact" refers to the agency taking into account the consequences of the investment to local communities. It is often a prohibitive criterion – for example, projects that require major displacement of local populations are not eligible for coverage. "Labour rights" refers to the observance of international labour rights (*e.g.* ILO) by the investor.

Table A2.8. **Political risk assessment practices**

Agency	List of eligible countries	Investment protection treaties or agreements relevant	International ratings used	Notes
EFIC *(Australia)*	Yes	Not found	Not found	
OEKB *(Austria)*	Yes	Not found	Not found	
ONDD *(Belgium)*	Yes	Yes	Not found	
EDC *(Canada)*	Not found	Not found	Yes	To qualify, "overseas investments must be beneficial to Canada and comply with EDC's Code of Business Ethics including commitment to the environment and anti-corruption." The website contains country-by-country political and economic analysis for many countries.
COFACE *(France)*	Not found	Not found	COFACE has a proprietary risk evaluation system	
PwC *(Germany)*	Yes	Yes	Not found	Sector specific contracts.
SACE *(Italy)*	Not found	Not found	Yes	
KEIC *(Korea)*	Not found	Not found	Not found	
NEXI *(Japan)*	Yes	No reference found	Yes	Japan has several lists denoting the status of the host country under the programme: one is of countries that are not eligible; a second were limited insurance coverage is available and a third for which a review must be conducted due to NEXIs limited underwriting experience. Other countries are eligible.
ATRADIUS DSB *(Netherlands)*	Yes	Yes	Atradius has a proprietary risk evaluation system	
Türk EXIMBANK *(Turkey)*	Not found	Not found	Not found	
ECGD *(UK)*	Not found	Not found	Not found	The ECGD application forms ask for detailed information about relations with host governments. It also notes that the existence of an adequate arbitration agreement between the investor and the host government will viewed with favour as the application is considered.
OPIC *(USA)*	Yes	Yes	Not found	The website shows, for most eligible countries, special bilateral "Investment Incentive Agreements" that govern OPIC-host government relations.
Non-OECD				
ECGC *(India)*	Not found	Not found	Not found	
ECIC *(South Africa)*	Not found	Not found	Not found	
SINOSURE *(China)*	Not found	Not found	Not found	

Table A2.9. **Monitoring of outcomes/client compliance with contractual obligations**

Agency	Complaints facility or Ombudsman	Contract compliance monitoring by agency staff	Notes
OECD			
OEKB *(Austria)*	Not found	Yes	Screening is used to identify environmentally sensitive projects or projects located in or near sensitive areas which would require further review. The decision on the kind of further review is based on the applicant's statement in the application form and other information received from the applicant.
EFIC *(Australia)*	Not found	Yes	For Category A and B projects having contract conditions relating to environmental and social impacts, EFIC monitors such conditions for the duration of the contract.
EDC (*Canada)*	Yes	Yes	A compliance audit can be conducted by EDC's internal auditors or an external third party to verify whether or not EDC is complying with its policies, procedures and guidelines. This audit takes place separate from the complaint process.
ONDD *(Belgium)*	Not found	Not found	
COFACE *(France)*	Not found	Yes	COFACE requires clients to facilitate its right of control by supplying documents and authorising inspections to allow COFACE to verify the client's compliance with his obligations.
PWC *(Germany)*	Not found	Yes	Not specifically mentioned, but PWC generally monitors and accompanies investors.
SACE *(Italy)*	Not found	Not found	
NEXI *(Japan)*	Not found	Not found	If environmental reviews indicate a need for monitoring, NEXI undertakes monitoring based on regular self-reports submitted by the client. The timing of self-reporting depends on various factors (sector, location, project-specific characteristics). Items required monitoring shall be decided according to the sector and nature of the project, with reference to a list of terms described in Appendix 3 ("Items Requiring Monitoring") of NEXI's "Guidelines on Environmental and Social Considerations in Tade Insurance". Examples include: 1) matters indicated by local environmental authorities; 2) anti-pollution measures concerning air and water quality; 3) consideration for rare species during construction work; 4) social aspects, including progress in resettlement plans.
KEIC *(Korea)*	Not found	Not found	
ATRADIUS DSB *(Netherlands)*	Not found	Not found	
Türk EXIMBANK *(Turkey)*	Not found	Not found	
ECGD (*UK)*	Yes	Not found	ECGD's website proposes several options for filing complaints, including contacting the ombudsman located in the Parliamentary Commission for Administration.
OPIC *(USA)*	Yes	Yes	OPIC is required by statute to monitor the actual effects of projects assisted by the agency. OPIC monitors the actual economic impact of every project until the conclusion of the investment. Specifically, the projects are evaluated for their effects on the host country economies and employment, their environmental impact, and conformance with internationally recognised worker rights standards; Two procedures are in place: 1) the "Site Monitoring" Program by which OPIC randomly selects the projects that staff will monitor (via a one-time on site visit) during a 3 year period. In addition to random visits, all investments considered to be economically or environmentally sensitive are also visited; 2) OPIC operates a "Self-Monitoring" Program by which each investor completes an annual questionnaire reporting on the project's developmental impact.
Non-OECD			
ECGC *(India)*	Not found	Not found	
ECIC *(South Africa)*	Not found	Yes	The ECIC website directs readers to the South African Department of Trade and industries "Fraud Hotline."
SINOSURE *(China)*	Not found	Not found	

Table A2.9. **Monitoring of outcomes/client compliance with contractual obligations** *(cont.)*

Agency	Complaints facility or Ombudsman	Contract compliance monitoring by agency staff	Notes
Multilateral			
MIGA	Yes	Yes	To mitigate against the risk of loss in the case of investment disputes, investors are required to notify MIGA as early as possible of difficulties with a host government that might give rise to a claim of loss under the guarantee. In the environmental and social fields… Compliance will be assured by the applicant's specific and continuing representations and warranties that measures to comply with environmental requirements will be taken and maintained throughout the term of the Contract of Guarantee. Failure to do so may result either in contract cancellation or denial of a claim. MIGA may from time-to-time request warranties from the guarantee holder that the project remains in compliance with the terms and conditions of the contract. For all Category A projects, the guarantee holder is required to submit at MIGA's request an environmental monitoring report confirming compliance with local environmental laws and regulations, and demonstrating compliance with the Environmental Action Plan. MIGA may also carry out monitoring visits, request specific data, or carry out other measures as necessary to verify information. Frequency of site visits will depend on environmental and social complexity of the project. Evidence that a project is not in compliance are grounds for canceling coverage or denying a claim.

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The Benefits of Financial Sector Liberalisation for Least Developed Countries: A Case Study of Ethiopia

by

Kozo Kiyota, Barbara Peitsch, Robert M. Stern*

This paper focuses on issues of financial sector liberalisation in Ethiopia, with reference in particular to the Ethiopian banking sector. Ethiopia is a country that has not been studied extensively because of its isolation and comparative lack of data. Through newly obtained panel data from all commercial banks (privately held and state-owned), we have identified two factors that may constrain Ethiopia's financial development. One is the closed nature of the Ethiopian financial sector in which there are no foreign banks, a non-competitive market structure, and strong capital controls in place. The other is the dominant role of state owned banks. Our observations and analysis of bank performance suggest that the Ethiopian economy would benefit from financial sector liberalisation, especially from the entry of foreign banks and the associated privatisation of state owned banks. A more general policy lesson is that financial sector liberalisation holds potential development benefits for countries at all stages of economic development, not just countries that are more advanced.

* Kozo Kiyota, Yokohama National University and University of Michigan, Ann Arbor; Barbara Peitsch, University of Michigan, Dearborn; and Robert M. Stern, University of Michigan, Ann Arbor. Correspondence should be addressed to *rmstern@umich.edu*.
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1. Introduction

Ethiopia appears unique compared to its East African neighbors (namely Kenya, Tanzania, and Uganda) and many other developing countries in that it has not yet opened its banking sector to foreign participation.[1] The Ethiopian banking sector remains isolated from the impact of globalisation. Although Ethiopian policy makers understand the potential importance of financial liberalisation,[2] it is widely believed that liberalisation may result in loss of control over the economy and may not be economically beneficial.[3]

While Ethiopia's financial sector has not been studied to any great extent, the benefits of financial sector liberalisation for developing countries have been widely investigated, with conclusions suggesting that there may be significant positive effects involved. For example, Demirgüç-Kunt, Levine, and Min (1998) investigated the effects of foreign bank presence in 80 countries between 1988 and 1995. They found that liberalising restrictions on foreign bank entry accelerated the efficiency of the domestic banking sector, and thereby contributed to long-run economic growth. Mattoo, Rathindran, and Subramanian (2006) examined the effects of financial liberalisation on per-capita GNP growth in 59 countries between 1990 and 1999 and found that openness in financial services had positive and significant effects on economic growth.

Similarly, a number of studies have examined whether the level of development of financial intermediation and the degree of state ownership of banks were determinants of economic growth. Thus, for example, Levine, Loayza, and Beck (2000) examined the effects of financial intermediation on economic growth in 74 countries from 1960 to 1995 and found that greater financial intermediation development had a significantly positive impact on economic growth. La Porta, Lopez-de-Silanes, and Shleifer (2002) examined the ownership structure of banks in 92 countries and found that higher government ownership of banks resulted in lower per-capita GDP growth from 1960 to 1995, even when initial financial intermediation development had a positive and significant effect. They also found that higher government ownership of banks was associated with slower subsequent financial sector development and lower productivity growth. It is noteworthy that, because of data constraints, these studies did not include Ethiopia.[4]

What distinguishes our paper is that we take a close look at the Ethiopian banking sector to consider whether Ethiopia would benefit from allowing foreign participation. Our contribution is threefold. First, we utilise Ethiopian bank-level data to analyse the performance of state-owned *vis-à-vis* privately-held banks. Second, we identify the stakeholder opposition to financial sector liberalisation. Finally, we address the potential benefits and qualifications to liberalisation for the Ethiopian economy.

In what follows, Section 2 provides background information on the Ethiopian economy and financial sector development. Section 3 compares Ethiopia's key economic, social, and financial indicators with those of other East and Sub-Saharan African (SSA) countries. Section 4 examines the performance of state-owned and private banks in Ethiopia. Section 5 outlines

the stakeholder opposition to financial sector liberalisation, and Section 6 considers the potential benefits and qualifications to liberalisation. Section 7 concludes.

2. Historical background: Ethiopian economy and financial sector

Ethiopia has some notable historical differences compared to other countries in the region. Although occupied by the Italians for a short time in the 1930s, Ethiopia does not share the colonial legacy of its neighbors. Its population (now nearly 80 million) has historically been, and continues to be, almost evenly divided between Coptic Christians and Muslims, with a very small Jewish population still located in the Northwest of the country. The Ethiopian economy has been state controlled through a series of industrial development plans since the Imperial Government of Haile Selassie. It was managed as a Soviet-style centrally planned economy under a socialist government from 1976-1991. The post-1991 government led a transition to a more market-based system, and subsequent governments have introduced further reforms. Although state control has been reduced and domestic and foreign (private) investment promoted, the state still plays a dominant role in the economy today.

Ethiopia's financial sector remains closed and is much less developed than its neighbors. Ethiopia has no capital market and very limited informal investing in shares of private companies. A series of financial sector reforms has been introduced since 1994, when private banks were allowed to be re-established. But the three large state-owned banks continue to dominate the market in terms of capital, deposits and assets. The current government is committed to alleviating poverty through private- sector development and through integrating Ethiopia into the global economy. However, the government does not at this time seem prepared to privatise large state-owned enterprises (or banks), allow for private ownership of land, or open the financial sector to foreign participation and competition.

3. How Is Ethiopia different from other African countries?

As noted, Ethiopia has a unique economic and social/historical background, but it is not clear how it is different from other African countries. To address this question, this section compares key economic, social, and financial indicators for Ethiopia with those of other African countries.

Table 1 summarises the key indicators for four East African countries (Ethiopia, Kenya, Tanzania, and Uganda) and Sub-Saharan Africa (SSA) as a whole. Ethiopia has similar economic and social features compared to many other African countries, including historically low per capita GDP growth rates, an underdeveloped infrastructure, and a legal system based on English law. But Ethiopia also has some differences from other African countries. In 2005, per capita GDP was 140.6 US dollars, the lowest level in East Africa. Agricultural dependency and rural population are 46.3 and 84.0%, respectively, both of which are among the highest in East Africa. Life expectancy is 42.7 years, the lowest in the region. Only 22.0% of the population has access to clean drinking water, which is the lowest in SSA. These characteristics clearly show that Ethiopia is one of the least developed countries in East Africa and among SSA countries.

Table 1 also includes key financial indicators. Following Levine *et al.* (2000), we utilise three financial intermediation variables. The first indicator is liquid liabilities, which is defined as M3 (currency plus demand and interest-bearing liabilities of banks and non-bank financial institutions) as a percentage of GDP. According to Levine *et al.*, this is a

Table 1. **Key economic and social indicators for Ethiopia and other African countries**

	Ethiopia	Kenya	Tanzania	Uganda	Sub-Sahara Africa	Rank of Ethiopia in East Africa	Rank of Ethiopia in SSA
Economic and Social Indicators							
GDP (2005, US$ millions)	10.018	15.151	12,646	7.786	9,286	4/4	41/45
Per capita GDP (2005)	140.6	442.3	329.9	270.2	898.7	4/4	41/45
Per capita GDP growth (annual average, 1995-2005)	0.9	–0.1	1.6	3.0	0.5	3/4	17/45
Agriculture dependency (% of GDP, 2005)	46.3	27.9	46.2	32.2	28.2	1/4	6/43
Rural population (% of total population, 2005)	84.0	79.3	75.8	87.4	62.6	2/4	3/47
Life expectancy (years, 2005)	42.7	49.0	46.3	50.0	48.7	4/4	34/46
GINI index (average, 1990-2005)	35.0	50.0	34.2	45.7	47.3	3/4	28/30
Infrastructure							
Paved roads (% of total roads, 2003 or 2004)	19.1	14.1	8.6	23.0	24.2	2/4	10/24
Improved water source (% of population with access, 2004)	22.0	61.0	62.0	60.0	65.0	4/4	47/47
Financial Indicators							
Liquid liabilities (%, 2004)	44.6	39.2	21.2	19.7	29.8	1/4	4/27
Commercial-central bank (%, 2004)	50.4	90.0	87.5	50.0	67.2	3/4	33/40
Private credit (%, 2004)	19.1	24.5	7.5	6.1	17.1	2/4	5/27
Gross domestic saving (% of GDP, 2005)	3.6	9.3	9.7	7.1	9.2	4/4	29/42
Financial liberalization index (10-100, 2007)	20.0	50.0	50.0	70.0	48.2	4/4	38/38
Dailami's financial openness index: 1.12 (closed) – 1.93 (free) (1997)	1.12	n.a.	n.a.	n.a.	1.44	n.a.	17/17
Bank concentration (%, 2004)	87.9	58.9	67.2	62.6	80.7	1/4	5/10

Note: For the list of Sub-Saharan African countries, see Table A1. For definitions of the indicators and sources, see Table A.1.2.

typical measure of "financial depth" and thus of the overall size of the financial sector. The second indicator, commercial-central bank, is defined as commercial bank assets as a share of commercial bank plus central bank assets. This measure captures how the economy's savings are allocated to commercial banks. The third indicator is private credit, defined as credit extended to the private sector as a ratio to GDP. Levine *et al*. (2000) emphasise the key importance of private credit.

As previously noted, Levine *et al*. (2000) found a strong positive relationship between the development of financial intermediation and economic growth. Based on Ethiopia's poor economic and social indicators, one may expect Ethiopian financial intermediation to perform poorly. However, this is not borne out by all the financial intermediation indicators noted in Table 1. That is, in 2004, credit issued to the private sector in Ethiopia was 19.1% of GDP (the 2nd highest in East Africa and the 5th in SSA), and liquid liabilities were 44.6% of GDP (the largest in East Africa and the fourth in SSA).

However, on closer inspection, with respect to private credit to GDP, Ethiopia's GDP is relatively low, so this does not necessarily mean then that intermediation is stronger in Ethiopia on this dimension. Note also that Ethiopia's gross domestic saving rate is only 3.6%, the lowest in East Africa. This implies that much of the population does not have ready access to banking services, and it may also be the case that the infrastructure for banking in rural areas is especially poor. It should also be noted that liquid liabilities (i.e., M3) can be increased by worker remittances rather than domestic saving. Hence, the credit issued and liquidity indicators noted may not reflect depth in Ethiopia's financial system.

It is further worth noting that the financial liberalisation index, which measures banking security and independence from government control, on a scale of 10 to 100 (100 being the most liberal), is only 20 for Ethiopia (the lowest in SSA). This indicates that

the Ethiopian financial sector is highly controlled by the government, a finding that is consistent with Dailami (2000), who ranked Ethiopia as the most closed country in the 96 countries for 1997 covered in his study.

Moreover, bank concentration, defined as the asset share of the three largest banks, is 87.9% in Ethiopia, which is the highest in East Africa. Indeed, the Ethiopian banking sector is dominated by one large state-owned bank, the Commercial Bank of Ethiopia (CBE). Table 2 presents the assets of Ethiopian banks for 1998-2006.[5] In 2004, there were three state-owned banks and six private banks. The asset share of the CBE was 66.3%, while the share of all three state-owned banks was nearly 80%. These results clearly indicate the dominant state control of the Ethiopian banking sector.

The foregoing observations have important implications. As discussed above, Demirgüç-Kunt *et al.* (1998) and Mattoo *et al.* (2006) found a positive relationship between financial sector openness and economic growth. Mattoo *et al.* emphasised that the key elements of financial openness are domestic market competition, foreign ownership, and limited capital controls, all of which are lacking in Ethiopia. That is, high bank concentration indicates a lack of competition in Ethiopia's banking sector. Foreign banks are not permitted to enter the market in any form, and the Ethiopian Government maintains strong control over international capital movements.

Table 2. **Assets of Ethiopian banks, 1998-2006**

Value (Millions of ETB)	1998	1999	2000	2001	2002	2003	2004	2005	2006
State-owned banks	19 732	19 936	23 417	25 035	25 673	27 697	33 113	35 001	37 646
Commercial Bank of Ethiopia	17 503	17 434	19 828	21 489	22 146	24 200	27 975	33 169	35 849
Development Bank of Ethiopia	2 229	2 502	2 615	2 578	2 569	2 555	4 081	n a	n a
Construction and Business Bank	n a	n a	974	968	958	942	1 057	1 832	1 797
Private banks	1 354	2 040	3 157	4 036	5 234	6 968	9 093	12 253	16 443
Dashen Bank	511	674	865	1 100	1 486	1 991	2 677	3 420	4 546
Awash International Bank	452	536	759	907	1 112	1 401	1 770	2 226	2 954
Bank of Abyssinia	206	388	718	896	1 142	1 333	1 585	2 057	2 834
Wegagen Bank	185	366	514	583	646	889	1 140	1 616	2 259
United Bank	n.a.	76	143	214	314	469	674	1 073	1 599
Cooperative Bank of Oromia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	129	224
Nib International Bank	n.a.	n.a.	158	336	534	885	1 247	1 732	2 027
Total	21 086	21 976	26 574	29 071	30 907	34 665	42 206	47 254	54 089
Share (%)	1998	1999	2000	2001	2002	2003	2004	2005	2006
State-owned banks	93.6	90.7	88.1	86.1	83.1	79.9	78.5	74.1	69.6
Commercial Bank of Ethiopia	83.0	79.3	74.6	73.9	71.7	69.8	66.3	70.2	66.3
Development Bank of Ethiopia	10.6	11.4	9.8	8.9	8.3	7.4	9.7	n.a.	n.a.
Construction and Business Bank	n.a.	n.a.	3.7	3.3	3.1	2.7	2.5	3.9	3.3
Private banks	6.4	9.3	11.9	13.9	16.9	20.1	21.5	25.9	30.4
Dashen Bank	2.4	3.1	3.3	3.8	4.8	5.7	6.3	7.2	8.4
Awash International Bank	2.1	2.4	2.9	3.1	3.6	4.0	4.2	4.7	5.5
Bank of Abyssinia	1.0	1.8	2.7	3.1	3.7	3.8	3.8	4.4	5.2
Wegagen Bank	0.9	1.7	1.9	2.0	2.1	2.6	2.7	3.4	4.2
United Bank	n.a.	0.3	0.5	0.7	1.0	1.4	1.6	2.3	3.0
Cooperative Bank of Oromia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.3	0.4
Nib International Bank	n.a.	n.a.	0.6	1.2	1.7	2.6	3.0	3.7	3.7

Note: n.a. (not available).
Source: Annual Reports of the individual banks.

We may also note the study by Beck *et al.* (2004), who concluded that increases in bank concentration were an obstacle to obtaining finance. They found that the constraining effects of bank concentration were exacerbated by more restrictions on bank activities, more government interference in the banking sector, and a larger share of government-owned banks. By the same token, these constraining effects were dampened by the presence of a large share of foreign banks. It would appear therefore that the highly closed nature of the in Ethiopian financial sector would serve to negate the positive effects that would otherwise come from greater financial intermediation.

4. State-owned *versus* private banks

Several studies such as La Porta *et al.* (2002) have found that the performance of private banks is typically better than state-owned banks. The previous section suggests that the large asset share of state-owned banks may be a factor that inhibits growth. This section examines whether state-owned banks underperform relative to private banks.

Table 3 presents the total assets and return on assets (ROA) of Ethiopian state-owned and private banks from 1998 to 2006. It can be seen that the share of assets of private banks grew from 6.4% in 1998 to 30.4% in 2006. This in turn implies that the share of state-owned banks significantly declined. Note, however, that the values of total assets increased from 1998 to 2006 for both state-owned and private banks. This suggests that the Ethiopian banking sector has grown rapidly. The growth of private banks has been much faster than state-owned banks, although more than two-thirds of assets are still held by state-owned banks.[6] It is also evident that private banks show generally better performance than state-owned banks. In seven out of nine years, private banks had higher ROA than state-owned banks. Note, however, that the ROA of the private banks did not improve for the last three years, 2004-06.

Table 3. **Total assets and return on assets (ROA) for state-owned and private banks, 1998-2006**

	Total assets				ROA	
	Value (millions of Birr)		Share (%)		State-owned	Private
	State-owned	Private	State-owned	Private		
1998	19 732	1 354	93.6	6.4	0.015	0.005
1999	19 936	2040	90.7	9.3	0.007	0.016
2000	23 417	3 157	88.1	11.9	0.011	0.014
2001	25 035	4 036	86.1	13.9	0.005	0.020
2002	25 673	5 234	83.1	16.9	–0.004	0.012
2003	27 697	6 968	79.9	20.1	–0.002	0.011
2004	33 113	9 093	78.5	21.5	0.005	0.021
2005	35 001	12 253	74.1	25.9	0.013	0.021
2006	37 646	16 443	69.6	30.4	0.027	0.022

Notes:
1. Total assets are sum of assets for state-owned and private banks.
2. NOA is average for public and private banks.
Source: Annual Reports of the individual banks.

Table 4 shows the interest-rate spreads between state-owned and private banks. Three findings stand out from this table. First, these spreads increased from 1998 to 2006 for both state-owned and private banks, though it should be noted that since 2003, interest rate spreads of private banks have declined, suggesting that competition has increased.

Table 4. **Interest-rate spreads between state-owned and private banks, 1998-2006**

	Interest rate spread		Lending rate		Deposit rate	
	State-owned	Private	State-owned	Private	State-owned	Private
1998	4.5	5.0	10.5	11.0	6.0	6.0
1999	4.5	5.0	10.5	11.0	6.0	6.0
2000	4.5	5.3	10.5	11.3	6.0	6.0
2001	4.5	5.4	10.5	11.4	6.0	6.0
2002	5.0	6.4	8.0	9.4	3.0	3.0
2003	5.0	6.5	8.0	9.5	3.0	3.0
2004	5.0	6.4	8.0	9.4	3.0	3.0
2005	5.0	6.0	8.0	9.0	3.0	3.0
2006	5.0	6.0	8.0	9.0	3.0	3.0

Note: Figures are average for state-owned and private banks.
Source: Annual Reports of the individual banks.

Second, private banks have higher interest-rate spreads than state-owned banks. Third, the deposit rate is the same for state-owned and private banks, implying that the differences in interest-rate spreads reflect differences in lending rates between banks. It may be noted that with the new entry of private banks, lending rates have consistently decreased since 2002. Deposit rates were still fixed by the National Bank of Ethiopia through 2005, and were therefore the same for state-owned and private banks. Although the entry of new banks contributed to the decline in the lending rate, it did not contribute to the decline in the interest-rate spreads. Combined with the fact that there are only 10 banks in Ethiopia, the results suggest accordingly that the banking sector reflects a non-competitive market structure, especially among private banks, although the market share of private banks is still small.

Next, we examine quantitatively the performance of state-owned and private banks, controlling for other factors such as market share. The model is similar to the one used in Berger, Clarke, Cull, Klapper, and Udell (2005). The left-hand-side variables are bank-performance variables (y_{it}). The right-hand-side variable is a dummy variable (D_{it}) that takes the value one for state-owned banks and zero for private banks. Other control variables (Z_{it}) such as the scale of banks are also included in the regression. The regression equation is written as follows:

$$y_{it} = \alpha_0 + \alpha_1 D_{it} + \alpha_2 Z_{it} + \eta_i + \varepsilon_{it}, \qquad (1)$$

where η_i is a bank-specific random factor and ε_{it} is an error term. Unobserved bank heterogeneity is controlled for by the bank-specific random factor.

For our purposes, we focus on bank performance that includes: (1) the cost divided by total assets; (2) return on assets (ROA), defined as interest and non-interest expenses divided by total assets; (3) and the interest-rate spread, defined as lending rates minus deposit rates. Following Berger *et al.* (2005), we use market share and the scale of last year's assets as control variables. Market share is defined as the share of assets while last year's assets are included taking natural logs.

Table 5 indicates the regression results of equation (1) for the performance variables. Three findings are evident. First, the costs of state-owned banks are significantly higher (1.6 percentage points) than those of private banks. Second, the ROA of state-owned banks is 1.7 percentage points lower than private banks. These findings imply that state-owned banks

Table 5. **Differences in performance of state-owned and private banks**

	Cost-asset ratio	ROA	Interest rate spread
State-owned bank dummy	0.016*	–0.017*	–0.015***
	[0.009]	[0.009]	[0.005]
Market share	0.004	–0.002	–0.001
	[0.005]	[0.005]	[0.003]
Lag of log of assets	–0.008***	0.005**	0.003**
	[0.002]	[0.002]	[0.001]
Constant	0.104***	–0.013	0.040***
	[0.014]	[0.014]	[0.009]
R-squared	0.224	0.189	0.207
N	66	66	62

Notes:
1. Random-effect model is used for the estimation.
2. ***, **, and * indicate statistically significant at 1%, 5%, and 10% levels, respectively.
3. Standard errors are in brackets.

Source: Annual Reports of the individual banks.

are less efficient than private banks. Third, the interest spread is 1.5 percentage points smaller for state-owned banks than private banks.

The inefficiency of state-owned banks in Ethiopia is consistent with the findings for other countries (La Porta *et al.*, 2002). There is reason to believe that the inefficiency of state-owned banks may offset the positive effects of financial intermediation. Indeed, several studies have found positive effects of bank privatisation in developing countries.[7] As a part of financial sector liberalisation, the privatisation of state-owned banks may be another important issue to consider in promoting competition in the banking sector.[8]

5. Ethiopian government concerns and opposition to liberalisation

Given the evidence from the literature and our analysis discussed above of the importance of greater openness and foreign participation in enhancing financial intermediation and economic growth, it may be surprising that the Ethiopian government remains so strongly opposed to financial sector liberalisation. It appears that the Prime Minister, his economic advisors, and the Cabinet of Ministers are particularly concerned about the potential impact of foreign bank entry on the development of the domestic banking sector, access to and the allocation of credit, domestic savings mobilisation, the country's capital account, and the ability of the central bank to supervise foreign banks and the new products and services that they introduce into the market.[9]

Ethiopia's Prime Minister, Meles Zenawi (2007), has expressed his personal views on financial sector reform and development in Africa in a partially completed manuscript entitled, *African Development: Dead Ends and New Beginnings*. His views on the past failures of financial reforms and the design of new reforms are of interest. In Section 17.2 of his Chapter 17, "Outcome of Economic Reform", he holds financial sector reforms responsible for the high incidence of non-performing loans and excess liquidity in many African countries. He attributes this failure to the pervasive lack of information in guiding bank operations (bank inability to assess credit), and the lack of demand for credit from private sector borrowers that has led to excess liquidity. He notes also that there have been high interest-rate spreads, high real rates of interest, and pervasive rent-seeking. Excess liquidity reflected the failure of banks to effectively mobilise savings and promote lending. In the case of Ethiopia, the Prime Minister and his government, as key stakeholders, have

five main concerns, many of which are shared by other stakeholders, including the leadership of the private banks and the Ethiopian Bankers' Association:

- The government believes that the development of a viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and better reputations. They argue that the Ethiopian financial sector is too young and inexperienced to compete (the infant industry argument).
- Ethiopian government officials also believe that entry by foreign banks will further skew credit allocation towards large-scale industrial, real estate and service enterprises (including trade) and away from agriculture, small-scale and cottage/micro enterprises (sectors which are the priorities for the government's development strategy). They contend that foreign banks will concentrate lending in major urban centers using foreign funds, contributing little towards the development of rural banking. Furthermore, they contend that foreign banks will "cherry pick" the best companies and sectors.
- Domestic savings mobilisation has been identified as an area of concern to Ethiopian officials, who have suggested that foreign banks would lend in their home or other foreign currencies and would not be interested in mobilising domestic savings.
- There is concern that foreign banks may serve as conduits for the inward and outward flows of capital (*e.g.,* through capital and money-market transactions; credit operations; personal capital movements; etc.). This may cause foreign exchange and/or liquidity shortages, with potentially adverse effects on the country's capital account. The concern becomes more pronounced in view of the limited regulatory capacity of the central bank.
- Finally, it is strongly believed that the authorities will be unable at present to regulate and supervise foreign banks effectively.

6. Potential benefits and qualifications to liberalisation

While the Ethiopian government's concerns about financial liberalisation are understandable, there is nonetheless a compelling case that can be made in our view to pursue liberalisation. The following are some of the important potential benefits that may be realised from liberalisation and some qualifications to be taken into account:[10]

- Financial liberalisation may have positive effects on the efficiency of the banking sector in the host market. This is because domestic banks are forced to compete with more efficient foreign banks and because skills and technology levels improve.[11]
- The entry of foreign banks through financial liberalisation may improve bank supervision through regulatory spillover. According to Goldberg (2007, p. 10): "The entry of foreign banks in emerging markets that are healthier than domestic banks implicitly allows a country to import stronger prudential regulation and increase the soundness of the local banking sector."[12]
- The entry of foreign banks may also contribute to financial stability in host countries. This is because the cross-border flows are generally more volatile than locally generated claims by foreign branches and subsidiaries.
- As a part of financial sector liberalisation, the privatisation of state-owned banks may be an important option to further enhance the efficiency of the banking sector. As discussed in Section 4, numerous studies have confirmed that state-owned banks are less efficient than private banks and that privatisation generally has positive effects on bank performance.

- The entry of foreign banks may have positive effects on employment and wages. While studies of manufacturing industries have confirmed that FDI generally had positive effects on employment and wages in host countries, since banks play an important role in financial intermediation, the effects of FDI for financial services on employment may be greater and broader than those of FDI for manufacturing sectors.[13]

By the same token, financial services liberalisation carries certain economic risks and uncertainties, some of which are consistent with the stakeholders' concerns noted above:

- Financial liberalisation may cause financial fragility rather than financial stability. For example, Demirgüç-Kunt and Detragiache (2001) examined the relationship between banking crises and financial liberalisation (defined as interest rate liberalisation) for 53 countries between 1980 and 1995. They found that banking crises were more likely to occur in countries whose financial system was liberalised. This is especially true in developing countries where the institutional environment is weak.[14]
- In their survey article, Prasad, Rogoff, Wei, and Kose (2007) suggest that the positive relationship between financial liberalisation and economic growth was rather weak in the case of developing countries. But they found that financial liberalisation could be beneficial under the right circumstances such as high quality of governance.
- Mishkin (2007) has noted that if financial liberalisation is not managed properly, it can lead to potentially highly disruptive financial crises. This was borne out in Tornell, Westermann, and Martínez (2003), who found that liberalisation led to a higher incidence of crises. However, they also found that there was more rapid economic growth in countries in which there were severe credit market imperfections.
- Foreign banks may not address directly issues of poverty alleviation and the access of low-income and rural-based savers and borrowers to financial services. Although financial liberalisation itself may have positive effects on economic growth, only wealthy people may gain from financial development. However, according to Mishkin (2007, p. 263): "In countries with better financial development, the income of the poorest fifth of the population actually grows faster than average GDP per capita." This is because financial development enables the poor to access credit more easily.

It is evident from the preceding discussion that there may be significant economic benefits to be derived from financial sector liberalisation, in particular from the entry of foreign banks and the privatisation of state-owned banks. However, attention needs to be paid to the possible detrimental effects that may occur in the case of developing countries like Ethiopia. The question then is how the Ethiopian authorities should address issues of financial liberalisation.

In undertaking liberalisation, it may be important to give particular attention to the mode of entry and time frame so that the Ethiopian banking sector can enhance the quality of governance and develop its institutional framework, thereby providing insurance against financial crises. For example, government officials may choose to limit the degree of foreign ownership for a specified period of time in an effort to help domestic firms to prepare for future competition and enhance the quality of governance. Similarly, adjustment measures and regulatory monitoring of foreign bank branches, subsidiaries, and greenfield investments are essential in permitting foreign financial FDI.

It is also important for the Ethiopian economy to expand banking in rural areas through financial liberalisation. It might be possible here to establish a specialised rural financial institution that would then take over rural lending activities from the state-

owned banks through a privatisation process.[15] Ethiopia can improve the environment for economic growth if it develops policies that promote successful financial development and financial liberalisation, instead of adamantly resisting liberalisation.[16]

7. Concluding remarks

In our discussion, we noted especially the closed nature of Ethiopia's banking system in which there is no foreign participation, evidence of a non-competitive market structure, and strong capital controls. We also had occasion to examine the performance of Ethiopia's state-owned and private banks, noting that state-owned banks were comparatively inefficient relative to private banks. The combination of the closed characteristics of Ethiopia's banking sector and its non-competitive market structure serves to weaken the link between financial intermediation and economic growth, the importance of which is borne out extensively in the literature.

The question thus arises as to whether and how the Ethiopian authorities should address issues of financial liberalisation. Interviews conducted with stakeholders revealed widespread opposition to liberalisation on a number of grounds. Some of this opposition is understandable in an economy that has been closed to foreign participation for several decades. But, in our view, there is a compelling case that can be made for liberalisation and the significant benefits that it may induce. In pursuing liberalisation, the stakeholders' concerns need to be acknowledged and addressed with reference especially to improvement of financial regulation and oversight. Finally, there are broader considerations that need to be taken into account, given that Ethiopia is among the poorest countries in SSA. These broader considerations involve questions of the overall strategy of economic development and how to improve the incomes and living standards especially of the rural poor. Financial liberalisation is not a panacea for Ethiopia's broader economic problems. But it may nonetheless serve to ameliorate these problems by improving the efficiency of the banking system and providing the basis for greater financial intermediation and economic growth.

Notes

1. While we focus on the banking sector, much of our analysis can be applied to Ethiopia's insurance and micro-finance activities, which are relatively small compared to banking.
2. We interpret financial liberalisation to include various forms of foreign participation in the financial sector as will be noted below, as well as privatisation of state-owned banks.
3. The official skepticism towards financial liberalisation was manifested in a series of interviews that the authors conducted during February to April 2007 in the context of a consultancy about undertaking financial liberalisation as a part of Ethiopia's application for WTO accession.
4. However, there have been a few studies of selected financial issues that have included Ethiopia in the country cross-section observations. These include: Beck, Demirgüç-Kunt, and Maksimovic (2004), Crowley (2007), and Djankov, McLiesh, and Shleifer (2007). IMF (2006) addresses key macroeconomic issues in Ethiopia, but provides only limited information on the financial sector.
5. The Ethiopian banking data used in this section come from the published annual reports of the individual banks.
6. It should be noted that in absolute terms, the assets of state-owned banks grew by more than the assets of privately held banks, ETB 18 billions, compared to ETB 15 billions, respectively over the same time period.
7. For example, Beck, Cull, and Jerome (2005) for Nigeria, Bonin, Hasan, and Wachtel (2005) for Bulgaria, the Czech Republic, Croatia, Hungary, Poland and Romania, and Omran (2007) for Egypt.

8. Mattoo *et al.* (2006) have pointed out the importance of the introduction of foreign ownership and domestic competition at the same time: "privatising or introducing foreign ownership without introducing competition (or establishing a separate regulator), would simply transfer monopoly rents from the government to the private monopolist."
9. These concerns were raised by government officials, senior bankers and representatives of the bankers' association in Ethiopia in February-April 2007 during interviews with the authors, who were preparing a study on the economic impact of WTO accession on Ethiopia's financial sector.
10. We assume, in discussing these benefits, that foreign entry will be subject to national treatment. For a comprehensive survey on the effects of financial FDI in developing countries, see Goldberg (2007).
11. For example, Claessens, Demirgüç-Kunt, and Huizinga (2001) examined 7.900 banks in 80 countries for 1988-1995 and found that foreign entry reduced the profitability of domestic banks but improved the efficiency of the banking sector.
12. Crystal, Dages, and Goldberg (2001) found that the entry of foreign banks had positive effects on the overall soundness of local banking systems partly because foreign banks screened and treated problem loans more aggressively.
13. The effects may be different between greenfield investments and mergers and acquisitions (M&A). According to Goldberg (2007), greenfield investment is expected to have positive effects on employment while the effects of M&A are less transparent.
14. However, we should note that there are various types of financial liberalisation. In Demirgüç-Kunt and Detragiache (2001), the negative effect of financial liberalisation comes from the liberalisation of interest rates, rather than from the entry of foreign banks.
15. Other countries, such as Indonesia and Kenya, have fostered specialised financial institutions to deal with rural lending. For more information, see Mwega (2002, Ch. 10), Robinson (1997, p. 24), and World Bank (1999).
16. Our view is closely related to the point made by Mishkin (2007, p. 287): "Bad policies are the reason that financial development does not occur and why financial globalisation often leads to harmful financial crises. Instead of rejecting financial globalisation, we can greatly improve the environment for economic growth if we develop policies that promote successful financial development and financial globalisation."

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RESEARCH NOTES AND ANNOUNCEMENTS

OECD Global Forum on International Investment VII: Synthesis of Proceedings*

Best practices in promoting investment for development: pursuing a common agenda

Overview

The OECD Global Forum on International Investment (GFI) is an annual event organised by the OECD Investment Committee since 2001.[1] The objective of the GFI is to serve as a focal point where policy-makers and other interested stakeholders from across the globe can come together to engage in peer learning and dialogue on emerging issues facing the international investment policy community.

The overarching theme of GFI-7 was "Best practices in promoting investment for development". The relationship between investment and development was also a key theme of the 2007 G-8 Summit, which called upon "UNCTAD and the OECD to jointly engage industrialized countries, emerging economies and developing countries in the development of best practices for creating an institutional environment conducive to increased foreign investment and sustainable development." In response to this call, GFI-7 was organised for the first time in close co-operation with UNCTAD. Key outcomes from GFI-7 were presented by OECD Deputy Secretary General Amano at UNCTAD XII in Accra, Ghana, on 20-25 April 2008.

GFI-7 took place over two days on 27-28 March 2008. The event opened and closed with plenary sessions, separated by 13 parallel sessions dealing with a broad range of investment-related topics. The opening plenary was organised as a "Davos style" discussion at ministerial level. Reflecting the inherently horizontal nature of international investment issues, the chairs of nine different official OECD bodies and members of the Secretariat

* GFI-7 was the first to be held at OECD headquarters in Paris, France. Previous GFIs took place in Mexico (2001), China (2002), South Africa (2003), India (2004), Brazil (2005), and Turkey (2006). Bangladesh, Benin, Cambodia, Mauritania, Niger, Uganda, Yemen, and Zambia.

from nine different directorates played active roles in all of these sessions. In addition, a special closed-door session of the newly formed GFI Advisory Expert Group (AEG) was held after the close of the Forum, comprised of leading academics and practitioners in the field of international investment and members of the Investment Committee and Secretariat. The purpose of the AEG meeting was to discuss possible themes and begin planning for GFI-8. Social and networking events held during the GFI included a high-level lunch hosted by the OECD Secretary General and a reception at the close of the first day hosted by the French Government.

GFI-7 was attended by the Secretaries General of the OECD and UNCTAD, the Prime Minister of Peru, Ministers from Morocco, Uganda, Costa Rica, India, the Chairman of Egypt's General Authority for Investment and Free Zones, and over 400 participants representing 73 economies, the private sector, labour unions, non-governmental organisations, and academia. The regional breakdown of non-Member participants was as follows: 14 African economies, 8 Middle-Eastern economies, 7 Latin American economies, 5 East and South East European economies, 5 East Asian economies, and 4 Central Asian economies. Eight representatives from Least Developed Countries received financial support from UNCTAD to participate.[2]

A new feature introduced for GFI-7 was a call for papers issued 6 months before the event through several prominent networks dealing with international investment issues, including the Academy of International Business, UNESCAP's Asia-Pacific Research and Training Network on Trade (ARTNeT), the World Association of Investment Promotion Agencies (WAIPA), and the FDI network within the Development Gateway. In response to this call, the Secretariat received over 40 written submissions which were considered to be of high enough quality and relevance to be included as background documentation in the programme.

All background documents are available on the conference website *www.oecd.org/investment/GFI-7*.

The remainder of this document provides a synthesis of the discussions, organized on a session by session basis.

DAY 1 – 27 MARCH 2008

Opening plenary	Welcome and introductory presentations
10:00-10:30	• **Mr. Angel Gurría**, Secretary General, OECD • **Dr. Supachai Panitchpakdi**, Secretary General, UNCTAD • **Mr. Jorge del Castillo**, Prime Minister, Peru In his opening statement, Mr. del Castillo used Peru as an example of how a sound policy framework for investment can support strong economic growth and development. The key features of such a policy framework he identified included: openness, transparency, national treatment, sound labour and environmental policies, a well managed privatization programme, efforts to fight corruption, the promotion of responsible business conduct, efforts to cut red tape, and an active programme of international co-operation. In their respective opening statements, Secretaries General Supachai and Gurría echoed the importance of many of the same policy ingredients for a healthy investment environment, providing a sense of convergence and shared understanding on what policy makers need to do to achieve results. Many of these same elements feature in the work of the two organisations, such as UNCTAD's Investment Policy Reviews and the OECD's Policy Framework for Investment, and Mr. del Castillo credited Peru's co-operation with the OECD and UNCTAD with having influenced many of Peru's reforms. The economic benefits of these policies for Peru have included high rates of economic growth, the development of a modern infrastructure, a stable macro-economic environment, rising productivity, and the broadening and deepening of economic activity into services and international manufacturing value-chains. At the same time, Mr. del Castillo made clear in his examples that the benefits of a sound policy framework for investment do not realize themselves overnight. An underlying message was the importance of consistency and predictability over time, with significant results being achieved often over many years of persistent policy reform. Furthermore, he also emphasized the continuous nature of this process and challenges that remain, including the need to better spread the benefits of economic growth through society and the need to balance industrial development with measures to protect the country's rich environment and biodiversity. Secretaries General Supachai and Gurría also acknowledged that, despite much progress, many challenges remain. Secretary General Supachai, for example, pointed out that many of the least developed countries have yet to benefit sufficiently from the boom in FDI. Secretary General Gurría cited the threat of protectionism and the need for very significant increases in investment in areas such as water and energy. Both agreed on the need for further international co-operation and for leveraging the experience gained in complementary activities. For example, Dr. Supachai highlighted the desirability of reflecting the experience gained by the many countries using the Policy Framework for Investment in UNCTAD Investment Policy Reviews. All three opening presentations are available in their entirety on the GFI-7 website at: *www.oecd.org/investment/gfi-7*.

DAY 1 – 27 MARCH 2008

High level roundtable	**The political economy of investment policy reform: Maintaining the momentum of investment globalisation**
10:30-13:00	**High-level roundtable participants:** • **Mr. Nizar Baraka**, Minister for Economic and General Affairs, Morocco • **Mr. Jorge Del Castillo**, Prime Minister, Peru • **Mr. Angel Gurría**, Secretary General, OECD • **Dr. Semakula Kiwanuka**, Minister for Investment, Uganda • **Mr. Marco Vinicio Ruiz**, Minister of Trade, Costa Rica • **Mr. Ajay Shankar**, Secretary to the Government of India, Ministry of Commerce and Industry, India • **Dr. Supachai Panitchpakdi**, Secretary General, UNCTAD • **Dr. Ziad Bahaa El Din**, Chairman of Board of Trustees, General Authority for Investment and Free Zones (GAFI), Egypt **Moderator:** • **Mr. Axel Threlfall**, Partner, ECD Insight, London, United Kingdom This high-level roundtable explored the current challenges faced by decision-makers as they seek to improve their investment climates and promote more and better investment for development. In particular, it examined the political economy of investment policy reform and how leaders have made the case to their various constituencies for the benefits of more open, transparent, and non-discriminatory policy frameworks for investment. Among the questions addressed during the discussion: • What is the government's strategy to ensure that its policy reforms for a better investment climate continue to enjoy broad support? • What role can international co-operation and "peer pressure" play in sustaining government efforts to improve the investment climate? Will international support be important for the recognition and success of investment policy reforms? • What will be the most challenging future issues for your country for attracting and maximizing the development benefits of international investment? What are the most challenging global issues facing the international investment policy community? Several key interrelated themes emerged during this high-level discussion. The panel showed consensus on the desirability of pursuing broad-based strategies of policy reform that support both domestic and foreign investors and that recognise the crucial role of human resource development efforts, sound trade policies, developing essential infrastructure, and solid frameworks for both public and corporate governance. However, it was also acknowledged that for many countries, especially the least developed countries, severe capacity constraints mitigate against such an ambitious reform agenda. A related point touched upon by most of the panellists concerned the need to develop linkages between foreign and domestic investors in order to maximise the development benefits of foreign investment. Within this context, several participants noted a change over time, from policy frameworks that were specifically intended to benefit and thereby attract foreign investors to policy frameworks that are "blind" to nationality. One speaker indicated that his country has been considering the elimination of any remaining legal and regulatory distinctions between foreign and domestic investors precisely because such distinctions are not seen to be serving the objective of attracting more and better investment for development. At the same time, the participants still recognised that different investors will have different priorities (*e.g.* access to financing for SMEs) and that policy makers can make a difference by being sensitive to these needs. Several of the panellists identified another important advantage of developing policy frameworks that address the needs of domestic and foreign investors equally, namely to ensure broader domestic support for investment policy reforms. All of the panellists agreed that domestic support and the perceived legitimacy of reforms were as much about the process as the content, especially the need for continuous dialogue between the government and various stakeholders. Within this context, transparency was also identified as essential in fostering trust. A critical point of agreement among all the panellists, despite significant differences between the countries represented, was the recognition that ultimate responsibility for improving the investment climate resided with governments and that countries need to "look in the mirror… and be tough" on themselves. Secretary General Gurría identified the OECD's Policy Framework for Investment (PFI) as the sort of tool specifically designed to help countries "look in the mirror". Several of the panellists discussed the benefits they associated with the PFI. These included: 1) the positive process of dialogue which PFI-based exercises naturally tend to support (*e.g.* between different ministries, between the government and international organisations); 2) the benefits of building policy reforms around a framework that is underpinned by broadly accepted principles (as opposed to frameworks, for example, that are the outcome of bilateral negotiating dynamics); and 3) the deeper approach of the PFI (contrasted with, for example, complementary ranking and benchmarking exercises).

DAY 1 – 27 MARCH 2008

Parallel sessions	Developing the PFI user's toolkit
15:00-17:30	The PFI User's Toolkit is being developed by the OECD to provide practical policy guidance to governments who are using the PFI to increase private sector investment. The Toolkit explains how and why governments can benefit from using the PFI, and makes clear the consequences for investment of existing government policies, laws and regulations. The Toolkit aims to help PFI users analyze where progress is most advanced as well as where the most significant investment bottlenecks remain, thus highlighting priority areas for reform. ***Working group 1.1: Investment policy*** **Chair: Mr. Manfred Schekulin**, Chair, OECD Investment Committee **Speakers:** • **Mr. Pierre Poret**, Head, OECD Investment Division: Background on the PFI and the User's Toolkit • **Mr. Ross Herbert**, South African Institute of International Affairs: Presentation of the draft chapter on investment policy • **Mr. Ho Quang Minh**, Director, External Economic Relations, Vietnam • **Mr. Roy Nixon**, Director, Treasury Department of Australia, and convenor of APEC Investment Expert Group • **Mr. James Zhan**, Officer-in-Charge, Division on Investment and Enterprise, UNCTAD **Discussants:** • **Dr. Ziad Bahaa El Din**, Chairman of Board of Trustees, General Authority for Investment and Free Zones (GAFI) EGYPT • **Mr. Mahmoud Anis Bettaieb**, Bettaieb Law Firm, Tunisia • **Mr. Joseph Battat**, Lead Investment Policy Officer, Investment Climate Department, FIAS – Multi-donor Investment Climate Advisory Service of the World Bank Group • **Professor Christian Bellak**, Department of Economics, University of Economics Vienna • **Professor Philippe Gugler**, Dean, Faculty of Economics and Social Sciences, University of Fribourg • **Dr. Karl P. Sauvant**, Executive Director, Columbia Program on International Investment, Columbia Law School and The Earth Institute, Columbia University A broad range of issues concerning the improvement of investment climates emerged during this session, several of which would clearly have implications not only for the PFI User's Toolkit but also for an eventual revision of the PFI itself. Several participants addressed the apparent gap between what is "in the books" and what is actually happening in practice. A main reason for this gap concerns the capacity of countries, especially the least developed countries, to implement policies effectively. In this respect, a suggestion repeated several times was to orient the PFI more towards the needs of these countries by, *inter alia* , developing a "PFI light", making the guidance for using the PFI more modular and concrete (to facilitate very specific, cost effective policy initiatives), and to provide more guidance on local applications of the PFI (as opposed to ambitious national-level programmes). Another theme that repeated itself in the discussion concerned the importance of the process of dialogue and inquiry fostered and encouraged by the PFI. Several different dimensions of this were identified, including: • The dialogue between different government ministries required by the PFI's horizontal approach; • The dialogue encouraged between the OECD, UNCTAD, and the World Bank, to ensure synergies between their complementary instruments and approaches to help countries improve their investment climates, with the PFI being identified as a useful first diagnostic step to ensure that subsequent capacity building efforts are well targeting and prioritised; • Dialogue between regional partners involved in peer learning and capacity building exercises (such as in the context of APEC and NEPAD); and • Dialogue between the providers of official development assistance and recipients. Another general point to emerge was the need to better "cross-reference" the different elements of the PFI and to perhaps use the PFI User's Toolkit to guide policy makers to other sections of the PFI that they might choose to prioritise. This point was implicit in comments by participants on the need for more guidance on issues such as responsible business conduct and human resource development (topics which have their own chapters in the PFI). Finally, some of the discussion indicated a need to explain more clearly in the PFI User's Toolkit that the PFI is intended as a way to help countries conduct structured self-evaluations that will allow them to maximise the development benefits of their own policy choices through a better informed policy formulation process. Within this context, it also became clear that the focus of the PFI on domestic investment (80% of the questions in the PFI concern domestic investment) also needs to be further emphasised and better explained.

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Parallel sessions	Developing the PFI user's toolkit
15:00-17:30	***Working group 1.2: Trade policy*** **Chair: Mr. Robert McDougall**, Chair, OECD Working Party of the Trade Committee **Speakers:** • **Mr. Michael Gestrin**, Senior Economist, OECD Investment Division: Background on the Policy Framework for Investment • **Mr. Dale Andrew**, Head, Trade Policy Linkages and Services Division: Background on the trade chapter of the PFI • **Mr. Sébatien Miroudot,** Trade Policy Analyst, Trade Policy Linkages and Services Division: Commentary on the draft trade chapter of the PFI User's Toolkit **Discussants:** • **Mr. Yann Duval**, Trade Policy Section, Trade and Investment Division, United Nations ESCAP, Bankok, Thailand • **Ms. Karen Ellis**, Research Fellow, Overseas Development Institute, UK Policies relating to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies, by facilitating integration into global supply chains, and by boosting productivity and rates of return on investment. The focus of this session was the draft trade chapter of the PFI User's Toolkit and practical issues that trade policy makers can take into account in order maximize the contribution of trade policy to a healthy investment environment. The key theme to emerge from the presentations and discussion during this session related to the critical need for more information and analysis on the impact of various trade policies for the investment environment and economic development more generally. This issue was shown to have different dimensions. First, given the economic and social heterogeneity of countries, it is very difficult to identify "off the shelf" good practices for trade policy-makers to follow. This is especially the case as trade policy has evolved beyond its focus on "at the border" issues to address more complex regulatory issues that follow international business value chains deep into an economy. One of the reasons for this shift has been the growing recognition of the importance of services in both trade and for economic development, with many services providing basic needs. The general view was that much more empirical and analytical work is required to help inform trade policy-makers in an environment in which trade policy and "behind the border" regulatory issues cannot be treated as if they were unrelated. Several participants commented on the apparent disconnect and even incoherence between the processes associated with trade policy (e.g. negotiations in Geneva or for regional trade agreements) and the complex domestic regulatory challenges being confronted by other ministries "back home". The panel also touched upon a topic that was the focus of the morning high-level roundtable: the need for more and better data and analysis to inform trade policy-making is inextricably linked to the role of different stakeholders in the trade policy process and achieving broad political support for trade policy reforms. As long as the motives and logic of trade policy reforms are not clearly spelled out, these will be difficult to sustain, especially if they necessitate painful adjustments, as when a particular sector of the economy is faced with increased international competition. Therefore, the challenge for governments of basing trade-policy on a better understanding of its development impact could be supported through a more inclusive process involving more consultation of various stakeholders. A more inclusive approach however isn't without challenges, including the choice of stakeholders to include in surveys and consultations and how to institutionalise these channels of communication into the trade policy making process.

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Parallel sessions	Developing the PFI user's toolkit
15:00-17:30	***Working group 1.3: Competition policy*** **Chair: Mr. Frédéric Jenny**, Chair, OECD Competition Committee **Speakers:** • **Mr. Jonathan Coppel**, Senior Economist, Investment Division: Background on the PFI and the User's Toolkit • **Mr. Vivek Ghosal**: Presentation of a preliminary draft chapter on competition policy **Discussants:** • **Mr. Rijit Sengupta**, Centre Coordinator and Deputy Head, CUTS Centre for Competition, Investment and Economic Regulation (CUTS CCIER) • **Mr. Nick Godfrey**, Economic Adviser, Investment Climate/Financial Sector Team, Growth and Investment Group, Policy and Research Division, Department for International Development (DFID), UK The presentations and discussions identified the comprehensive approach to the investment climate adopted by the PFI as one of its main strengths. At the same time, a number of participants noted the difficulty of drawing general lessons from one country's practices, as each system reflects the specific circumstances of the country. In all cases however, the strength of the governance of the competition agency was identified as a key issue. The session presenters and participants offered a number of practical suggestions for improving the draft competition chapter of the PFI User's Toolkit. These included: i) emphasising to potential users that the PFI relates to both foreign and domestic investment; ii) explaining the relationship between competition policy and investor decisions; and iii) noting explicitly that the Toolkit is addressed to governments, especially governments from lower to upper middle income countries. The session also identified many additional resources that could be cited in the Toolkit, including, for example, the OECD Competition Assessment Toolkit and the UK Department for International Development's "Competition Assessment Framework".

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15:00-17:30	Developing the PFI user's toolkit

Working group 1.4: Tax policy

Chair:

- **Mr. Christian Valenduc**, Chair, Working Party No. 2, Committee on Fiscal Affairs

Speakers:

- **Mr. W. Steven Clark**, Head, Horizontal Programmes Unit, OECD Centre for Tax Policy and Administration: Presentation of the draft tax chapter of the PFI User's Toolkit
- **Ms. Marie-France Houde**, Senior Economist, OECD Investment Division: Background on the PFI and the User's Toolkit

Discussants:

- **Mr. Hugh J. Ault**, Special Advisor, OECD Centre for Tax Policy and Administration, and Professor of Law, Faculty of Law, Boston College Law School
- **Mr. Sebastian James**, Business Taxation, FIAS, World Bank Group
- **Mr. Alan Carter**, Senior Economist, International Business Taxation, Her Majesty's Revenue and Customs (HMRC)

To fulfil their functions, all governments require taxation revenue. However, the level of the tax burden and the design of tax policy, including how it is administered, directly influence business costs and returns on investment. Sound tax policy enables governments to achieve public policy objectives while also supporting a favourable investment environment.

A good part of the discussion focussed on the interface between the tax system and SMEs, including some illustrative examples of disappointing experience with certain SME tax incentives implemented in the UK, involving unintended effects including unintended tax planning opportunities. Within this context, important design issues (including avoiding tax holidays, the use of targeted rate cuts *versus* accelerated depreciation, and grandfathering provisions) were also addressed. One presentation underscored the importance of tax expenditure reporting and cost-benefit assessment of incentives.

On the other hand, it was also noted that tax compliance costs tend to be more burdensome for SMEs due to a large fixed cost component. Various approaches to reducing SME tax compliance costs were noted. The benefits of can include improved competitiveness for SMEs, and reduced informal activity supporting good governance, access to finance, and an expanded tax base.

The discussion also focused on the role of tax treaties. This is an area addressed in the PFI but which might require greater elaboration in the PFI User's Toolkit and any subsequent revision of the PFI itself. Tax treaties encourage investment and economic development through different channels. Host country considerations and trade-offs in negotiating tax treaties were discussed, as well as the benefits of conducting an assessments of a country's tax treaty network.

Several additional points were raised during the discussion, including special difficulties in implementing tax policies in less developed countries, and challenges facing policy makers in targeting special tax incentive relief to instances of market failure.

DAY 2 – 28 MARCH 2008

08:00-10:00	Breakfast sessions

Breakfast session 1: **New frontiers in investment promotion**
Sponsored by the World Association of Investment Promotion Agencies
Chair: Mr. Kai Hammerich, President, World Association of Investment Promotion Agencies
Discussants:

- **Professor Gayle Allard**, Professor of Economic Environment and Country Analysis, Chair, Department of Economics, Instituto de Empresa, Madrid, Spain
- **Professor Christian Bellak**, Department of Economics, University of Economics Vienna
- **Dr. Douglas van den Berghe**, Partner, Investment Consulting Associates
- **Professor Axele Giroud**, Senior Lecturer in International Business, Manchester Business School, United Kingdom
- **Dr. Mary Keeling**, Managing Consultant, Global Centre for Economic Development Research, IBM Institute for Business Value
- **Professor Choong Yong Ahn**, Foreign Investment Ombudsman, Korea Trade-Investment Promotion Agency
- **Ms. Patricia de Lima Favaretto**, Associate Market Analyst, Market Analysis Section, International Trade Centre (ITC)
- **Professor Maria Birsan**, Babes-Bolyai University, Cluj-Napoca, Romania
- **Dr. Stephan Dreyhaupt**, Head of Investment Information Services, NIGA, World Bank, Washington D.C., United States

In addition to the "state of the art" in today's investment promotion community, this session considered examples of innovative approaches that could become tomorrow's new "best practice".

It has become clear to most governments in recent years that investment promotion and facilitation measures can make a difference. Multinational enterprises are sometimes slow to spot profitable investment opportunities and often hesitate before using local suppliers. But successful promotion is expensive and resources need to be used wisely. Some IPA roles are more useful than others, depending on the stage of development of the host economy and the existing stock of FDI in that country. Investment promotion should complement, not compensate, for a poor investment climate. Without a suitable enabling environment, promotion might even be counterproductive. Similarly, underfunded IPAs might also make matters worse since an ineffectual IPA reflects badly on the overall investment climate in the eyes of investors. Successful IPAs are characterised by private sector participation on the board and strong political support. One-stop shops are not effective, if they do not help to simplify regulations and mandate a rapid response to investor requests from each relevant ministry.

The positive impact of an IPA may be indirect: through its role in helping to shape policy. The IPA is often the government interlocutor with investors and through its function as a one-stop shop is intimately aware of the complexity of local regulations. There is evidence that the more resources devoted to policy advocacy, the greater the inflows of investment. Agencies in poorer countries should consider also concentrating their efforts on satisfying existing investors than on spending money on expensive advertising campaigns and missions to potential home countries. An existing investor's recommendation is often the best promotional tool.

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08:00-10:00	Breakfast sessions

Breakfast session 2: **The Columbia Emerging Market Global Players Project**
Sponsored by the Columbia Program on International Investment, Columbia Law School and The Earth Institute, Columbia University
Chair: Dr. Karl P. Sauvant, Executive Director, Columbia Program on International Investment, Columbia Law School and The Earth Institute, Columbia University
Discussants:

- **Mr. Alvaro Cyrino**, Professor and Researcher, Center on International Business, Fundação Dom Cabral, Brazil
- **Mr. Alexander Mansilya-Kruz**, Research Department , Moscow School of Management SKOLKOVO, Russia
- **Dr. Marjan Svetlicic**, Faculty of Social Sciences, Slovenia
- **Mr. Andrea Goldstein**, Deputy Director, Heiligendamm Dialogue Process
- **Dr. Persephone Economou**, Consultant, MIGA, World Bank

Outward foreign direct investment (FDI) from emerging markets reached over $200 billion in 2006 – some four times world FDI flows 25 years ago. This session examined some of the forces driving the rise of emerging market multinationals and, in particular, some of the challenges facing them, based on work done in the framework of the Emerging Market Global Players Project (EMGP).

Two key issues emerged from the discussion. The first concerned a lag between the relatively rapid emergence of a number of developing countries as outward investors and government policy in these countries addressed at outward investment. It was noted that whereas all developed countries have policy frameworks dealing with outward investment (covering such things as double taxation and the provision of political risk insurance), almost all of the "new" outward investors have lagged behind in this regard. This raises two questions. First, do these countries need to become more active in the formulation and implementation of policy frameworks to deal with outward investment? Second, if the answer to the first question is yes, how should this new policy area be developed and what should it cover? A related issue raised in the discussion that would doubtless hold relevance in any attempt to answer these questions concerned the important role played by state-owned enterprises in many of the countries that are emerging outward investors.

Another important issue concerned human resource constraints for firms based in emerging markets and the extent to which these constraints might limit future growth and internationalisation. The two areas of international business mentioned where this might be the case concerned the highly technical field of international mergers and acquisitions and the more general management requirements for running internationally integrated production networks. This was identified as another area where a policy response might be called for, including the development of business schools in these markets that are equipped to produce the new human resources and skills required by firms that are expanding into international markets.

DAY 2 – 28 MARCH 2008

08:00-10:00 **Breakfast sessions**

***Breakfast session 3*: Measuring the business climate**

Chair: Mr. Rainer Geiger, Deputy Director, OECD Directorate for Financial and Enterprise Affairs

Discussants:

- **Mr. Alexander Boehmer**, Head of MENA-OECD Investment Programme, OECD Private Sector Development Division: BCDS and the SME Policy Index
- **Mr. Sean Dougherty**, Senior Economist, OECD Economics Department: *Going for Growth* and the Structural Policy Indicators
- **Mr. Peter Kusek**, Investment Policy and Promotion Specialist, FIAS, World Bank Group
- **Ms. Blanka Kalinova**, Senior Economist, OECD Investment Division: The OECD FDI Regulatory Restrictiveness Index
- **Mrs. Zoubida Allaoua**, Sector Manager, Finance and Private Sector Development Social and Economic Development Group, Middle East and North Africa Region, World Bank

An attractive business climate and a vibrant private sector are fundamental to economic growth and employment. However the extent to which a business climate is attractive in any particular country depends on many factors, including political stability, market size, macroeconomic policy and structural policies at the microeconomic level in areas such as investment, trade, tax, competition, labour policy, financial sector, corporate governance, and anti-corruption. The quality of infrastructure and human capital development is also essential. This session addressed a number of key questions concerning business climate metrics, including:

- What is the purpose of measuring the business climate?
- Which aspects of the business climate should be measured?
- How can measurements of the business climate be integrated into a comprehensive tool?

Four methodologies were presented and discussed:

- The OECD Business Climate Development Strategy (BCDS);
- The OECD Going for Growth Indicators;
- The World Bank FIAS FDI Indicators project; and
- The OECD FDI Regulatory Restrictiveness Indicators.

One of the major benefits of benchmarking and of measuring the business climate is to provide policymakers with the maximum information possible to be able to design business climate reforms to stimulate growth and foster employment. As in other sessions, co-operation between intergovernmental organisations was identified as being desirable, especially since the international organisations are the main sources of business climate metrics. Co-operation and coordination become all the more important in this area given the limited capacities in developing and emerging economies to respond. Business climate reforms are complex and challenging in their implementation, as unique country specific characteristics need to be considered, social issues need to be taken into account, and broad capacity building within countries' institutions will often be required.

The OECD's Business Climate Development Strategy (BCDS) is a systematic whole-of-government approach building on the Policy Framework for Investment which aims to support governments in selecting reform priorities and to assist them with reform design and implementation. The BCDS uses a four-step-methodology which 1) ranks country performance on five levels, 2) synthesises existing evaluations of the business climate policies, 3) takes stock of existing business climate reform projects and 4) defines policy priorities. The BCDS will be implemented in a number of countries in the Middle East and North Africa (MENA) throughout 2008/09.

The OECD's Going for Growth Indicators consists in a regular cross-country structural surveillance of OECD member countries. Going for Growth aims at fostering growth performance and convergence among OECD economies. The assessment is based on a set of around 50 quantitative indicators which measure the performance of countries in different policy areas affecting product market and labour market policies, and draw on expertise of a number of OECD directorates. Five structural policy recommendations are issued for each country; three of them are based on the indicator-based assessment, and two on further OECD country expertise. Every two years recommendations are issued; follow-up research on their impact is conducted every other year.

The FIAS (World Bank) FDI Indicators project is an extension of the Cost of Doing Business Indicators. This set of indicators benchmark country performance concerning the ease of opening and conducting a formal business, both with regard to formal statutory restrictions and regulatory and administrative barriers in practice. The target is to identify, stimulate and advise investment policy reforms. Most of the indicators are measured using a hypothetical investment project case applicable to all countries. Data is collected through a questionnaire which is filled out by private sector intermediaries (*e.g.* investment lawyers), *i.e.* from an investor's point of view, as well as by government agencies for validation purposes. The first report on this project is scheduled to be published in 2009. The hope is that the FDI Indicators will create a momentum for reform similar to what has already been achieved through the Doing Business Indicators.

The OECD's FDI Regulatory Restrictiveness Index measures the deviation of the treatment of foreign investors from national treatment based on the legal and regulatory framework of a country. It maps the formal ownership, screening, approval and other limitations to foreign investment to a quantitative indicator ranging from 0 meaning completely open to 1 meaning closed. The index covers nine service sectors. It has been applied to the 30 OECD member countries, the 10 countries adhering to the OECD Declaration on International Investment, and five other major emerging economies. The FDI Regulatory Restrictiveness Index is used in OECD Economic Surveys and has helped to focus attention on particular policy areas requiring attention. In some cases reforms have been implemented as a result.

DAY 2 – 28 MARCH 2008

08:00-10:00	Breakfast sessions
	Breakfast session 4: **The IISD Model International Agreement on Investment for Sustainable Development and stocktaking of investment incentives** **Sponsored by the International Institute for Sustainable Development** **Chair: Mr. Howard Mann**, Senior International Law Advisor, International Institute for Sustainable Development, Canada **Discussants:** • **Dr. Walid Ben Hamida**, Maître de Conférences, Université d'Evry Val-d'Essonne et Sciences Po Paris • **Ms. Anna Joubin-Bret**, Senior Legal Advisor, Division on Investment and Enterprise, UNCTAD • **Professor Philippe SandsQC**, Professor of Law, University College London, and Barrister, Matrix Chambers • **Professor Kenneth P. Thomas**, Department of Political Science, University of Missouri, United States This breakfast session reviewed the IISD Model International Agreement on Investment for Sustainable Development, which was launched in April 2005, in terms of elements that have become regular features in the landscape of international investment agreements, as well as elements that have not. The IISD Model Agreement was developed to accomplish two things. Providing language alternatives on key issues and subjects in investment negotiations was one goal. But the more important goal was to set an agenda for a new direction in international investment agreements.

DAY 2 – 28 MARCH 2008

Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	**Session 2.1: International investment and innovation** **Co-Chairs:** • **Professor Yves Doz**, Timken Chaired Professor of Global Technology and Innovation, INSEAD, France • **Mr. Naohiro Tsutsumi**, OECD Investment Committee Vice-chair **Discussants:** • **Professor Xiaolan Fu**, Director of the Sanjaya Lall Programme for Technology and Management for Development, University of Oxford, United Kingdom • **Professor Jean-Louis Mucchielli**, l'Université de Paris 1, France • **Professor Johannes Stephan and Mr. Björn Jindra**, Halle Institute for Economic Research, Germany • **Dr. Liviu Voinea**, Director, Group of Applied Economics, Bucharest, Romania • **Mr. Thomas Hatzichronoglou**, OECD Directorate for Science, Technology and Industry • **Professor José Guimón**, Adjunct Professor, Universidad Autónoma de Madrid • **Professor Lucia Piscitello**, DIG, Politecnico di Milano, Italy This session addressed the interface between international investment and innovation, including key questions such as: • From a development perspective, what are the framework conditions under which multinational enterprises' activities positively impact on the innovation capacities of local enterprises and host countries? • What are the recent trends with respect to the growing internationalization of intellectual assets through MNE investment decisions? • How do non-discriminatory and transparent investment policies and investment agreements support government innovation strategies? The ongoing shift towards a knowledge-based and technology-driven economy has brought to the fore the issue of how knowledge is created, acquired and disseminated, bearing on countries' economic performance and also raising issues of protecting "strategic assets". This has placed increased attention on international investment, since this is one of the main channels for the acquisition and diffusion of technological and managerial know-how. One of the main reasons for R&D in overseas affiliates of business enterprises is to adapt products and technologies developed in the home country of the parent firm to local market conditions ("home base exploiting" or adaptive R&D). Indeed, a traditional role of FDI is to serve as a conduit for the exploitation of intellectual assets developed in multinational firms' home countries. This panel also focused attention on a more recent phenomenon, namely the growing role of foreign R&D as a way for firms to develop new technologies overseas and to serve as a conduit for technology sourcing in host countries. Affiliate R&D in this case aims to benefit from access to local R&D resources and technological and scientific developments in clusters of universities, major competitors and suppliers. Two policy dimensions of this type of technology sourcing in host countries were emphasized in the discussion. One was the impact this has had on the investment promotion and facilitation strategies of countries. These now place more attention on the specific services and facilities required by R&D-oriented investors. In addition, these investors require greater emphasis on "aftercare" given the evolutionary nature of R&D-oriented investment. The second policy dimension that was given considerable attention concerned the role and appropriateness of providing financial incentives specifically to attract high-technology investments. A general consensus was that, while many governments will continue to try to lure high-technology investors with incentives, ultimately it is the government's ability to foster centres of excellence and innovation in the economy more generally that will play the greatest role in attracting research-intensive investment.

DAY 2 – 28 MARCH 2008

Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	**Session 2.2: The policy framework for investment: the social and environmental dimensions** **Co-chairs:** • **Ambassador Elisabeth Dahlin**, Swedish Partnership for Global Responsibility, Ministry of Foreign Affairs, Sweden • **Mrs. Veronique Deli**, Chair, OECD Working Party on Global and Structural Policies **Speakers:** • **Mr. Lorenzo Cotula**, Senior Researcher – Law and Sustainable Development, International Institute for Environment and Development, London, United Kingdom • **Mr. Mark Kantor**, Washington, D.C. • **Mr. Julius Langendorff**, Deputy Head of the Environmental Agreements and Trade Unit in the European Commission's Directorate-General for Environment and Co-chair, OECD Joint Working Party on Trade and Environment • **Professor Philippe Sands** QC, Professor of Law, University College London, and Barrister, Matrix Chambers • **Ms. Andrea Shemberg**, Legal Advisor to the UN Special Representative to the Secretary General for Business and Human Rights • **Mr. Robert Volterra**, Partner, Latham and Watkins, London, United Kingdom **Discussants** • **Mr. Reiner Hoffmann**, Deputy General Secretary of the European Trade Union Confederation • **Mr. Jochen Krimphoff**, Senior Manager EU Services, PricewaterhouseCoopers France, Développement Durable and Corporate Social Responsibility • **Dr. Jörg Weber**, Chief, International Arrangements Section, Division on Investment and Enterprise, UNCTAD This session was devoted to the analysis of the interrelation between the economic dimension and the social and environmental dimensions of current investment disciplines, including international investment agreements as well as contracts between states and foreign investors. The lack of significant interactions between these two spheres is due to the current legal framework on foreign investment drawing upon the structure of the international legal order as it emerged after the second-world-war, in which one set of rules did not intersect with other sets of rules. This is reflected in the legal disciplines provided for under international investment agreements which have been conceived almost exclusively in terms of protection of foreign investments and investors against host states. The same could be said for long-term investment contracts which usually provide for risk-mitigation tools to protect foreign investments from such sovereign risks as nationalization, expropriation, the obsolescing bargain or the imposition of new requirements. Concern has been expressed with regard to the risk, as made evident by the recent claim brought against South Africa, for the state to find itself caught in the dilemma of incurring international responsibility for failure to fulfil international obligations *vis-à-vis* foreign investors under investment treaties while implementing social reforms or adopting environmental measures. The same imbalance is also reflected in long-term contracts between host states and foreign investors with stabilisation clauses which would allow investors to claim exemption from or compensation for social or environmental regulatory changes during the whole investment's life time. As far as investment treaties are concerned, the crucial issue is how and to what extent it is admissible to take into account norms of law that arise outside the foreign investment field in interpreting and applying investment treaties. In the context of contracts between states and foreign investors the question is whether stabilisation clauses have an impact on the state's ability to adopt new social and environmental legislations. From the very outset, the "all or nothing" or "the zero-sum game" approach has been rejected as clearly not helpful in solving the problems at stake. The protection of the rights of foreign investors should not be seen in isolation and should not trump other societal or environmental objectives. It has been acknowledged that the whole debate is essentially about striking a balance between competing but equally legitimate objectives. Viable options to ensure the adoption of a more integrated approach have been explored in the context of both international investment treaties and agreements between host states and foreign investors. Caution has also been recommended against the risk of using social and environmental norms as disguised forms of protectionist measures to limit the economic development of host countries. The first available option is the incorporation of environmental and social provisions in the text of international investment treaties. While little reference is provided in relatively few of the bilateral investment treaties (mostly in the preamble), further developments are to be found in EU and US Free Trade Agreements. A 2008 OECD Investment Committee survey documents the various ways environmental, labour and anti-corruption provisions have been incorporated in international investment agreements. The 2007 OECD work on Environment and Free Trade Agreements provides examples of the progressive integration of social and environmental issues in the negotiation mandate of the "new generation" of EU Free Trade Agreements, Association Agreements and Partnership and Co-operation Agreements. In June 2006 the European Council made explicit reference to trade and investment as a tool to achieve global sustainable development. Since then, these broad orientations have been translated in more detailed negotiating mandates adopted by EU member states. The European Commission has also endorsed a Sustainability Impact Assessment (SIA) study of the Economic Partnership Agreements (EPAs) between the EU and the African, Caribbean and Pacific (ACP) countries advising on the potential positive and negative economic, environmental and social impacts of different EPAs negotiations to increase not only the quantity but also the quality of foreign investments, prevent or mitigate any negative consequences and enhance positive ones. The environmental chapter in the recent Cariforum-EC Partnership Agreement contain specific investment-related provisions to up-hold protection and ensure that foreign direct investment is not encouraged by lowering domestic environmental, labour or occupational health and safety legislation and standards. Significant changes with respect to the language and enforceability of obligations related to labour rights and the environment have also been introduced in new USFTAs such as the US-Peru Trade Promotion Agreement, as a result of the "bipartisan trade compromise" between the US Republican Administration and Democratic leaders in Congress agreed in June 2007.

DAY 2 – 28 MARCH 2008

Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	As highlighted in the 2008 OECD survey on environmental, labour and anti-corruption issues under investment agreements, the degree and extent of integration of social and environmental standards vary significantly. First, while unequivocal and obligatory language is related to investors' protection obligations ("shall"), the language used for states' commitments related to environmental and social standards is often less prescriptive (shall strive/encourage/ may/should not). Then, if truly obligatory language is used, substantial commitments may vary a lot, ranging from the requirement to enforce environmental and labour national legislation to compliance with international standards listed in the body of the agreement. Finally, dispute resolution mechanisms and available remedies for non-compliance are also far from being uniform. The existing gap in the field of international investment law is unlikely to be bridged in the near future by a comprehensive multilateral investment agreement. Alternative mechanisms already exist to achieve the same outcome, though. The way forward has already been pointed by reference to other international instruments and jurisprudence, namely article 31(3)(c) of the Vienna Convention and the WTO Appellate Body line of case-law. Since the 1998 Shrimp Turtles case, great strides have already been made in the trade context to accommodate competing objectives by adopting a holistic approach to the international legal order. There are no theoretical hurdles which would prevent to take into account norms arising outside investment treaties, while adjudicating investment disputes. But this has only rarely happened in the context of investment disputes. The real issue is ultimately about allocating costs and risks. It has been suggested that legitimate social and environmental objectives should be taken into account in the determination of the amount of compensation which foreign investors are entitled to in case of breach of an investment treaty obligation. If social and environmental concerns are not taken into account in determining the amount of compensation in investment treaty disputes, there is the risk of creating a mechanism of disincentives for states to pursue other legitimate objectives. The same dynamic is reproduced in investment agreements between states and foreign investors. A recent study has shown that stabilisation clauses in agreements signed by non-OECD countries provide extensive coverage for any new social or environmental legislation. The Policy Framework for Investment recommends that when stabilisation clauses are used, governments need to balance their usefulness against the risk of circumscribing host governments' right to regulate. Stabilisation clauses can insulate investors from the application of new social and environmental regulations over the life of an investment project or require that foreign investors be compensated for compliance with such new laws. If a state has to compensate foreign investors to enact new legislations, it will have a disincentive to raise social and environmental standards. Ad hoc exemptions may also be problematic when a single investment project counts for a significant share of the national economy. The adoption of a more holistic approach in the interpretation and application of international investment agreements and better practices identified in OECD host government agreements were indicated as the way forward to achieve a better balance. OECD countries and other participants considered the OECD as a well placed forum to carry out further work on the relationship between the right to regulate and the relevance of non-investment treaty obligations in the adjudication of investment disputes as well as on the interplay between the right to regulate, stabilisation clauses under state contracts and umbrella clauses under international investment agreements. They looked forward to further work by the Investment Committee and its partners in these areas.

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Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	**Session 2.3: The policy challenges of involving private investment in key primary sectors: the water and energy sectors in focus** **Chair:** • **Mrs. Monica Scatasta**, Coordinator, OECD horizontal water programme • **Mr. Vernon MacKay**, Chair, OECD Investment Committee's Working Party **Discussants:** • **Mr. Jack Moss**, AquaFed – The International Federation of Private Water Operators, United Kingdom • **H.E. Professor Semakula Kiwanuka**, Minister of Investment, Uganda • **Ms. Anna Joubin-Bret**, Senior Legal Advisor, Division on Investment and Enterprise, UNCTAD This session focused on the policy challenges of involving private investment in infrastructure sectors and addressed key questions, such as: • What are the key factors that are holding back (public and private, including foreign) investment in the water/sanitation infrastructure and the energy sector? • What are the main conditions required to enhance the enabling institutional and regulatory environment to ensure a beneficial participation of the private sector in *i)* the water/sanitation and *ii)* the energy infrastructure sectors? • What lessons can be drawn from the initial experience with the sectoral applications of the Policy Framework for Investment (PFI) and the OECD Principles for Private Sector Participation in Infrastructure in the context of energy and water/sanitation infrastructure? Vital for national and world wealth and social development, the energy and water infrastructure sectors face considerable investment challenges with respect to the amount of required funds and of the policy and regulatory issues raised. Over a billion people have no access to drinking water and 2.6 billion lack basic sanitation. Just halving the proportion of people without access to drinking water and sanitation by 2015 would require investments of some US$30 billion per year, double of the current level. Likewise, the International Energy Agency estimates the rise of the world's primary energy needs at 55% between 2005 and 2030 (1.8% per year) and the subsequent investment in supply infrastructure to meet projected global demand at $22 trillion. Although public investment involvement has been traditionally strong in the energy sector and water infrastructure, public funds have largely fallen short of the tremendous needs. Consequently, many countries have sought the involvement of the private sector to meet these needs and/or to improve the fundamentals of the sectors so that more financing may materialize. Infrastructure sectors (especially the two sectors in focus, but also transport) share several characteristics: tremendous investment needs, but also a number of constraints that act as deterrents to private investor such as high initial investment, long payback periods and important regulatory risk. As documented in the UNCTAD presentation, infrastructure cases represent 40 per cent of pending investor-state dispute settlements cases arising under investment treaties. The water and sanitation sector combines these difficulties with being a life essential good. The aim of the ongoing OECD Water Programme is to address some of the challenges that ensuring sustainable financing for water and sanitation raises. In particular, it involves providing some guidance to governments and their partners on how to improve the use of economic incentives – especially prices – for better water resource management and more efficient service provision. It also involves identifying the key elements for an optimal involvement of the private sector. In this context, two OECD frameworks – the Policy Framework for Investment and the Principles for Private Sector Participation in Infrastructure – have been developed to provide guidance on the main policy issues and options for efficient infrastructure investment. In water and energy, the private sector's involvement crucially hinges on a transparent and predictable legal and regulatory framework and coherence among critical policy areas such as corporate and public governance, tax and competition policy. Secure and stable revenue stream remains critical to sustainable water and sanitation projects. And in many cases, long-term direct government involvement remains necessary, especially in the neglected sanitation field. In the case of Russia, high world energy prices have not yet proved sufficient to attract needed investment. Protected property rights, transparent tax regime and administration and sound competition policy remain basic requirements for making the energy sector attractive to private as well as public investors. Both the water and energy sectors are politically sensitive. For this reason, respecting the multi-stakeholder dimension of the partnership that involves the consumers, the communities and different layers of government and diverse private actors, is critical. This involves a common understanding by all actors of their respective roles and responsibilities.

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Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	**Session 2.4: Policy coherence for development: New approaches** **Co-Chairs:** • **Mr. Eckhard Deutscher**, Chair, OECD Development Assistance Committee • **Mr. Wes Scholz**, OECD Investment Committee Vice-chair **Discussants:** • **Dr. Amar K.J.R. Nayak**, Xavier Institute of Management, Bhubaneswar, India • **Professor Arun Kumar Jain**, Dieter Schwarz Visiting Chair Professor of International Management and Corporate Governance, Heilbronn Business School, Germany • **Professor Barbara Peitsch**, University of Michigan, Dearborn, United States • **Ms. Emily Sims**, Senior Specialist, ILO Programme on Multinational Enterprises and Social Policy, Geneva, Switzerland • **Professor Daya Shanker**, Bowater School of Management and Marketing, Deakin University, Melbourne, Australia This session considered issues associated with new, innovative approaches for promoting investment for development and addressed key questions, such as: • In what ways has ODA been put to use to help countries improve their investment environments? • What other innovative approaches are being put into use for improving investment climates and boosting investment for development? • How can developed countries improve the coherence of their various policies with their stated development assistance objectives? • What progress has been made with respect to the achievement of the Monterrey Consensus objectives on the mobilisation of domestic and international financial resources for development? In addressing these questions, the discussion highlighted 5 clear themes. The first of these relates to the need for a more systematic cooperation between development and investment communities to promote coherence and comprehensive approaches for investment in developing countries. Mutually supportive policies are feasible and necessary, although business goals do not always coincide with the public policy goals. Coherence entails integrating old systems to new; rural to urban and local to global challenges. Growth and sustainability of enterprises is coupled with promotion of decent work. It was generally agreed by the participants that this aspect of policy coherence is not sufficiently understood. A second theme concerned the importance of transparency, trust and rule of law both at the recipient country and by investors in support of a healthy investment climate. The Indian experience was held up as an example of how integrating the business goals to the country's economic goals makes investments profitable in the long term. Local ownership and constructive social dialogue are important factors to success. A third theme concerned the importance of moving towards a knowledge based economy – versus commodity export. Combining best available management practices with public financial support can help avoid the "commodities trap", but there are no easy solutions, in particular for post-conflict countries in Africa. The global markets and increasing competition for energy and minerals pose new challenges for poor countries, small firms and donor behavior. Special economic zones generate profit and knowledge, but need to consider the benefits of broader social dialogue in the long term. The importance of innovative partnerships was a fourth theme touched upon during this session. Business schools in developing countries could play an intermediary to strengthen dialogue between private and public sectors – as they do in developed countries. Reinforcing scholarship programmes, student exchange and distant learning (ICT) are small but important incentives for the young talent in developing countries. Finally, donors need to improve their coordination and recognise – also in practice – the role of the private sector as a partner in development. Well-targeted development assistance can play a catalytic role in creating an enabling environment for private sector investments in developing countries. Many donors have limited and some even diminishing aid to the enabling environment. Aid should continue to focus on the creation of a business climate that attracts private foreign capital for investments in partner countries. Aid can help supporting policy and institutional reform and capacity development. Declining aid to policy and infrastructure is partly due to the results based approach that focuses aid on "job creation" or to "high profile" sectors such as HIV/AIDS. Support not only for primary but also tertiary education would help business environment.

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Parallel sessions	The investment climate in broader perspective: Systemic global issues
10:30-12:30	**Session 2.5: The revised Benchmark Definition (BMD): Adapting FDI data to the new realities of the global economy** **Chair:** • **Mr. Roger De Boeck**, Vice-chair, OECD Investment Committee's Working Group on International Investment Statistics, **Speakers:** • **Mr. Paul Mahoney**, Chair, OECD Investment Committee's Working Group on International Investment Statistics (Australia) • **Mr. Obie Whichard**, Associate Director for International Economics, Bureau of Economic Analysis, United States • **Mr. Pierre Sola**, Principal Economist/Statistician, European Central Bank **Discussants:** • **Mr. Christian Lajule**, Chief, International Investment Position, Statistics Canada • **Mr. Gerrit van den Dool**, Senior Economist/FDI Manager, de Nederlandsche Bank, Netherlands • **Mr. Thomas Hatzichronoglou**, Senior Economist, OECD Directorate for Science, Technology and Industry. • **Dr. Anne Miroux**, Head, Investment Analysis Branch, Division on Investment and Enterprise, UNCTAD In 2004 the OECD started to examine how international statistical standards with respect to FDI needed to be updated and improved. Four years later, this discussion has culminated in the OECD Benchmark Definition of Foreign Direct Investment, 4th (BMD4). BMD4 is the new international standard to measure FDI. It also provides elements of clarification to users of statistics and attempts to describe the relationship between FDI financial flows and stocks and the activities of direct investment enterprises controlled by non-residents (statistics more generally referred to as the statistics on the Activities of MNEs). This session addressed some of the key features of the BMD4 as well as future challenges for FDI statistics, including: • How will BMD4 help to improve analytical work on FDI and globalisation? What are the remaining challenges? • What are the possibilities for improving crucial data for policy making without increasing the burden? Are there other series that we currently measure that have become obsolete for policy purposes in the context of globally exposed economies? • What is the importance of consistency between FDI data and data on the activities of MNEs? How, in the context of increasing globalisation, can the various data sources available be used to provide insights not only into the economic aspects of FDI in the economies concerned but also its social impact? One of the most significant improvements brought in by the new Benchmark Definition concerns capital in transit. Multinational enterprises (MNE) increasingly set up complex international structures to manage their financing. In many cases they use the services of so-called Special Purpose Entities or SPEs (e.g. holding companies, shell companies, brass-plate companies, and financing subsidiaries). The transactions that flow through these entities distort FDI statistics in three ways: • by overstating inward and outward FDI for the country hosting SPEs; • by overstating overall FDI through double counting; and • by confusing the ultimate origins and destinations of FDI. The example of Luxembourg's FDI statistics demonstrates well how economic analysis can be hampered when the data do not distinguish between capital in transit and genuine FDI. Luxembourg already applies the new recommendations of the Benchmark Definition to segregate capital in transit through SPEs, enabling an accurate examination of the role of FDI in the economy. If it did not, Luxembourg's FDI figures would be highly distorted. For example, in 2006 96% of inflows passed through SPEs, such that without the distinction between capital in transit and genuine FDI, Luxembourg's reported FDI inflows would be overstated by a factor of almost 30 and would add over US$100 billion of virtual FDI to global FDI statistics. Other countries where SPEs are resident are also expected to provide the same breakdowns, although in most other countries the importance of SPEs is less significant than in the present example. Preliminary calculations suggest that FDI flows measured under the new Benchmark Definition could be as much as three times lower than flows measured under traditional methods
14:00-15:00	**Chair: Mr. Manfred Schekulin, Chair, OECD Investment Committee** **Panelists:** • **Mr. Jorge del Castillo**, Prime Minister, Peru • **Madame Qiu Lixin**, Deputy Director-General, Foreign Investment Administration, Ministry of Commerce, People's Republic of China • **Dr. Karl P. Sauvant**, Executive Director, Columbia Program on International Investment, Columbia Law School – Earth Institute • **Mr. John Evans**, Secretary General, Trade Union Advisory Committee to the OECD • **Mr. Tadahiro Asami**, Secretary General, Business Industry Advisory Committee to the OECD Like the opening plenary session, the closing plenary was characterised by a certain convergence in the views expressed, despite the quite different perspectives represented. The themes that repeated themselves in the presentations included the idea that the international policy framework for investment is evolving quite rapidly in response to a range of global challenges and structural changes, a shared view that good policy frameworks for investment "start at home", the critical role of governments in establishing healthy investment environments, and, related to this last point, the important role of international co-operation. However, the discussion also underscored a broad consensus that the international investment policy community faces a number of serious challenges. These include the need for more inclusive dialogue reflecting the changing structure of international investment patterns (*e.g.* the emergence of some developing countries as important new outward investors), challenges to the rule of law in international investment relations and growing strains on existing dispute settlement systems, and concerns over growing protectionism.

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