

BOOK REVIEW

United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2003—FDI Policies for Development: National and International Perspectives*, United Nations, New York and Geneva, 2003; Sales No. E.03.II.D.8; ISBN 92-1-112580-4; xix plus 303 pages, including bibliography and statistical annex.

The *World Investment Report* and the Nexus between Foreign Investment and Regional Trade Arrangements The *World Investment Report 2003* (hereinafter, the Report) presents the outcome of comprehensive research in the field of foreign direct investment (FDI), with a particular focus on developing countries. The Report provides a valuable and authoritative resource for policy makers, academics, researchers and practitioners¹ The Report was prepared by an interdisciplinary team under the overall direction of Karl P. Sauvant, UNCTAD's Investment Division Director. The Report is presented in a straightforward manner, making it accessible not only to economists but also to a wide variety of readers. This consideration apparently led the Report's authors to separate most of the statistical data (more than 100 pages) from the main text and present it in annexes.

The Report consists of two main parts. Part One provides detailed information on the flows of FDI, together with comprehensive surveys on FDI and transnational corporations (TNCs). Unlike the first part in this year's report, which is similar in structure to those in previous World Investment Reports, Part Two deals with a unique subject. It contains an in-depth analysis of certain key national FDI policies and international investment agreements (IIAs), with a view to emphasizing the development dimension. Particular attention is given to the role of national policies and IAs in attracting FDI to a country, enhancing the benefits accruing to the host State, as well as in preventing relocation of existing investment.

The Preface of the Report, by Kofi A. Annan, Secretary-General of the United Nations, stresses the potential of FDI to create jobs, raise productivity, enhance exports and transfer technology, which makes it "a vital factor in the long-term economic

¹ An additional report in this field is the World Bank's annual *Development Report*. The recent World Bank *Report* (2003) discusses certain subjects that are also dealt with in the UNCTAD Report. Note that another source for FDI information is the *International Direct Investment Statistics Yearbook* prepared by the Organisation for Economic Co-operation and Development; available at: <<http://www.oecd.org>>.

development of the world's developing countries".² Indeed, numerous countries perceive FDI as an engine of development.³ In addition, the Report stresses that experience shows that the best way of attracting and drawing benefits from FDI is not always a *laissez faire* approach (an "open-door" policy) towards FDI. In addition to liberalization measures, attracting FDI requires "stronger locational advantages and more focused efforts at promotion".⁴ Consequently, numerous countries design special policies, including investment incentives, in order to actively attract FDI.

The Preface highlights the key finding of the Report: that global FDI has "declined significantly, from \$1.4 trillion in 2000 to \$650 billion in 2002, raising considerable concerns about prospects for achieving the Millennium Development Goals".⁵ According to the Report, global FDI inflows, already down by over 40 percent in 2001, fell by another 21 percent in 2002.⁶ What should countries do in light of this downturn?

The Report aims to provide some answers to this question.

I. NATIONAL FDI POLICIES AND INTERNATIONAL INVESTMENT AGREEMENTS

What are the factors that explain the decline in world FDI? According to the Report, the main factor was slow economic growth in most parts of the world and dim prospects for recovery, at least in the short term.⁷ Other reasons were falling stock market valuations, lower corporate profitability, slowdown in the pace of corporate restructuring in some industries and the winding-down of privatization in some countries.⁸ The Report notes that the decline in FDI was uneven geographically, sectorally, financially and by mode of entry.⁹

The Report identifies various promotion strategies utilized by countries to attract and retain existing FDI. Besides the use of financial and other incentives, more countries

² See the Report, at p. iii. Additional reasons may explain States' interests in attracting FDI, as for instance bringing in financial resources and in some cases increasing the tax base.

³ Note, however, that some economists contend that FDI does not always play a decisive role in development.

According to Narula and Dunning, it is possible that local firms, as in South Korea, will serve as the main engine of growth; see Rajneesh Narula and John H. Dunning, *Industrial Development, Globalization and Multinational Enterprises: New Realities for Developing Countries*, Oxford Development Studies, Vol. 28, No. 2, 2000.

⁴ The Report, at p. 86. According to the Report: "Free markets do not always ensure efficient and equitable outcomes, particularly in developing countries with weak markets and institutions. Hence, the need for policy intervention. The groundwork for making markets work well—sound legal systems, clear and enforceable rules of the game, responsive market institutions, a vibrant domestic enterprise sector and the like—has to be laid down by the host country government." *Id.*

⁵ In September 2000, the General Assembly of the United Nations adopted the Millennium Declaration (Resolution 55/2). The Declaration mainstreams a set of inter-connected, mutually reinforcing development goals into a global agenda: the Millennium Development Goals. For more details, see *Report of the Secretary-General, Implementation of the United Nations Millennium Declaration*, UN Doc. No. A/58/323, 2003; available at: <<http://www.un.org/millenniumgoals>>.

⁶ See the Report, Table I.1. The Report, however, stresses that although there is a decline in FDI flows the global stock of FDI continues to grow, albeit at a slower rate since 2001 (at p. 26) and that the stock of FDI matters more than the flows (at p. 23).

⁷ *Ibid.*, at p. 15.

⁸ *Id.*

⁹ *Ibid.*, at pp. 5–6.

conclude bilateral investment treaties, IIAs and double taxation treaties (DTTs).¹⁰ In addition, recent trade agreements are designed to enhance FDI (this issue will be extensively analyzed in the next section of this review).

At the heart of the Report is the employment of IIAs as a promotional strategy to attract and retain existing FDI.¹¹ Part Two of the Report aims to throw light, from the development perspective, on certain issues that arise in IIAs. Chapter III starts with a survey of key national FDI policies and then advances to the IIA issue. This Chapter presents an in-depth discussion of the growth of IIAs, while differentiating between bilateral, regional and multilateral agreements. The Chapter concludes with an analysis of the key principle features of IIAs at those different levels.

Chapter IV presents the main theme of the Report and lists eight key issues arising from the interaction between national policy-making and international investment rule-making. These issues are:

- (1) how to define investment;
- (2) how to treat the entry of FDI and subsequent operations of foreign affiliates;
- (3) where the dividing line between legitimate policy action and regulatory takings should be drawn;
- (4) what mechanisms should be utilized to settle investment disputes;
- (5) how to use performance requirements;
- (6) how to employ incentives;
- (7) how to encourage the transfer of technology; and
- (8) how to ensure competition, including restraining restrictive business practices operated by TNCs' foreign affiliates.

These eight key issues are of major importance for foreign investors and for countries that shape national FDI policies or negotiate IIAs.¹²

The national treatment principle (the second key issue) includes two constructs: the "right of establishment" and "national treatment" in the post-establishment phase.

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¹⁰The view that the conclusion of DTTs may assist a country to attract FDI was challenged by Dagan, who asserts that the use of DTTs to promote FDI is "a myth"; see Tsilly Dagan, *The Tax Treaties Myth*, New York University Journal of International Law and Politics, Summer 2000, 939–996, at 939. Her argument was demonstrated by Blonigen and Davies from the University of Oregon; see Bruce A. Blonigen and Ronald B. Davies, *Do Bilateral Tax Treaties Promote Foreign Direct Investment?* Working Paper 8834, National Bureau of Economic Research, Washington, D.C., 2002. They suggest that bilateral tax treaties may even reduce foreign investment.

¹¹ UNCTAD has been working on issues related to IIAs for some time, focusing on policy analysis and co-operation; see, for instance, *Progress Report: Work Undertaken within UNCTAD's Work Programme on International Investment Agreements between the 10th Conference of UNCTAD, Bangkok February 2000, and July 2002*, United Nations, New York and Geneva, UN Doc. No. UNCTAD/ITE/MISC.58.

¹² Additional issues are briefly mentioned in the Report, including the most-favored-nation principle, fair and equitable treatment, transparency, extra-territoriality concerns and taxation; see the Report, at p. 99 and the references in note 1.

The Report remarks that most countries that are not Members of the Organisation for Economic Co-operation and Development preserve their right to control FDI admission and establishment in IIAs. The evidence suggests that there may be certain economic reasons for restricting FDI or for liberalizing entry selectively and gradually. Yet, as the Report points out, in the new global order, strong regulations on market-driven resource allocation may deter FDI and create undesirable distortions in the host economy.¹³

“Performance Requirements” constitute an additional key issue of IIAs, and they are often employed as a development tool. Generally, the purpose of such requirements is to induce TNCs to invest more resources in promoting local development (for instance, by requiring them to employ nationals and to promote infant industries and address balance-of-payments problems). Developed countries are generally inclined to associate such requirements with interventionist strategies of the past and question their effectiveness. Developing countries, on the other hand, tend to preserve their right to use performance requirements.¹⁴ The Report states that some studies have found performance requirements to be inefficient and that such measures imposed considerable costs on host countries. The policy advice of the Report is that “[a]s long as governments are aware of the possible costs of performance requirements, they could be left free to weigh their benefits and costs, subject to existing international commitments”.¹⁵ The Report essentially conveys that the use of performance requirements may deter potential foreign investors.

One of the central issues discussed in the Report, however, is the employment of incentives that aim to attract FDI. Investment incentives are usually financial or fiscal, but there are also other kinds of inducements, such as regulatory concessions including exemptions from environmental and labor laws. Generally, governments use investment incentives to induce investors to establish a presence, to expand an existing business or not to relocate elsewhere. The Report states that the main reason for providing incentives is to correct market failures.¹⁶

Investment incentives, the Report notes, may also be justified on the grounds that the attraction of one or a few “flagship” firms would signal the host State as being an attractive business environment. Regardless of the justifications, governments believe that, all other things being equal, incentives can influence the decisions of TNCs as to where and how much to invest.¹⁷

Although most developing and developed countries use investment incentives, there are various undesirable consequences associated with the granting of incentives. The Report identifies six kinds of such “costs”, such as “offering incentives to TNCs that

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¹³ Ibid., at p. 107.

¹⁴ Ibid., at p. 119.

¹⁵ Ibid., at p. 123.

¹⁶ Ibid., at p. 124.

¹⁷ Ibid., at p. 125.

would have invested anyway, so the incentive is a mere transfer from governments to companies (or, in some circumstances, to the treasuries of the home countries)".¹⁸ The Report then asks if these incentives are worth the costs. The answer appears to be clear: at least among economists (as opposed to politicians) there is an emerging consensus that countries should try to attract FDI not so much by offering incentives but rather by building genuine economic advantages (and offering stable, low and transparent tax rates).¹⁹ According to this view, incentives should not substitute for building competitive and efficient national qualifications. In light of this analysis, it is somewhat surprising that the Report States on this point that "the economic desirability of locational incentives is not clear".²⁰

An additional undesirable consequence of the increasing employment of incentives is that countries seeking to re-route FDI into their territories often find themselves part of "bidding wars", with investors playing off different locations against each other, leading them to offer ever more attractive incentive packages to win the investment.²¹ The Report States that, in the absence of international rules on the use of FDI incentives,²² each country retains the right to offer them. Hence, all or most countries involved are worse off and TNCs benefit from the lack of international coordination in this field. In light of this undesirable state of affairs, a global regime could be initiated to regulate the employment of incentives, with no distinction between developing and developed countries. Yet the Report suggests the controversial solution of a global regime that restricts the use of financial incentives only by developed countries. As to the current countries' position, the Report states: "... there does not seem to be interest among either developed or developing countries to reach an agreement on the use of incentives ..."²³ The issue of international co-operation in the FDI sphere resurfaces and is further elaborated in Chapter v. The basic premise is that tension usually arises between the will to co-operate at the international level through binding sets of laws and the need for governments to discharge their domestic regulatory functions.²⁴ Chapter VI concludes the Report and deals with two broad issues: the nexus between home countries and TNCs; and corporate social responsibility. The latter issue is increasingly addressed in international documents at all levels. However, most of these documents are voluntary and deal with social and environmental issues, leaving economic development issues out of their scope. Contrary to this trend, the Report discusses the possibility of addressing this issue in IIAS.²⁵

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¹⁸ Id.

¹⁹ Id.

²⁰ Ibid., at p. 126.

²¹ Ibid., at p. 124.

²² Note that the World Trade Organization's Agreement on Subsidies and Countervailing Measures (the SCM Agreement) may apply to certain subsidies granted to foreign investors where such measures relate to their activities in trade in goods (the Report, at pp. 126–127); see the SCM Agreement, in 33 I.L.M. 1125, 1994; available at: <http://www.wto.org/english/docs_e/legal_e/24-scm.pdf>.

²³ The Report, at p. 128.

²⁴ Ibid., at p. 145.

²⁵ Ibid., at p. 167.

To conclude this Section, the Report is an extremely valuable document for everyone interested in FDI policy and various aspects of TNC behavior. Still, the Report is very general on numerous issues, and policy makers regularly need more practical advice on the best policies to attract, retain and benefit from FDI.

II. THE NEXUS BETWEEN FDI AND REGIONAL TRADE ARRANGEMENTS

One of the innovative topics addressed in the Report relates to the inter-relationships between investment and trade agreements. The various links between these spheres are briefly discussed in several parts of the Report, although not in a systematic manner. Thus, for instance, such links are addressed in the sections on performance requirements (including export requirements related to subsidies),²⁶ States' incentives that aim to induce new investors (including those relating to trade in goods),²⁷ and competition policies, which are increasingly contained in RTAs.²⁸ The importance of the nexus between FDI and trade is increasingly evident in modern international economic relations. Recent trends in the international economy blur the distinction between these spheres and challenge scholars and policy makers.²⁹ As elaborated below, the analysis of the inter-relationships between investment and trade may well enrich scholars from both disciplines and bear important implications for policy-making as well as for civil society in general.

The growing awareness of the significance of the interface between FDI and trade led to the adoption of the 1994 World Trade Organization Agreement on Trade-Related Investment Measures as part of the 1994 Uruguay Round Agreements. The WTO General Agreement on Trade in Services (GATS) also regulates some aspects related to FDI, notably with regard to the establishment of "commercial presence" in foreign States.³⁰ In addition, certain fundamental issues involved in the regulation of

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²⁶ See *ibid.*, at pp. 119–121. Such practices are restricted by the SCM Agreement. The WTO Agreement on Trade-Related Investment Measures (the TRIMS Agreement) also prohibits certain performance requirements considered to be trade distorting (e.g. local-content requirements, trade-balancing requirements, restrictions on foreign exchange inflows attributable to an enterprise, and export controls). Note, however, that the effectiveness of the TRIMS Agreement appears to be limited due to procedural reasons and implementation problems; see, for instance, P. Nunnenkamp and M. Pant, *Why the Case for a Multilateral Agreement on Investment is Weak*, Kiel Discussion Papers 400, Institute for World Economics, Kiel, Germany, 2003.

²⁷ The Report, at p. 123. Such incentives may be prohibited by the SCM Agreement.

²⁸ *Ibid.*, at p. 136. See, for example, Chapter 15 of the North American Free Trade Agreement (NAFTA), in 32 I.L.M. 289, 1993.

²⁹ On the relationship between FDI and trade, see, for example, E.M. Graham, *On the Relationship among Foreign Direct Investment and International Trade in the Manufacturing Sector: Empirical Results for the United States and Japan*,

WTO Staff Working Paper RD-96-008, 1996; *The Relationship between Trade and Foreign Direct Investment: A Survey*, Working Party of the Trade Committee, Organisation for Economic Co-operation and Development, TD/TC/WP(2002)14/FINAL, 2002.

³⁰ See Article 1(2) of the GATS, in 33 I.L.M. 1168, 1994; available at: http://www.wto.org/english/docs_e/legal_e/final_e.htm. The negotiations on the regulation of foreign investments in future WTO agreements has generated heated debate between developing and developed States in the current WTO "Doha Round". Various developing countries are strictly opposed to multilateral negotiations on investment. On this debate, see, for example, *Cancon Collapse: Where There's No Will There's No Way*, Bridges Daily Update on the Fifth Ministerial Conference, No. 6, 15 September 2003; *The Wto Under Fire*, *The Economist*, 20 September 2003, p. 29.

FDI resurface in the sphere of international trade.³¹ Notwithstanding the important inter-relationships between investment and trade, it is important to note that certain (and significant) factors differentiate these domains. The differences are prominent, for instance, with regard to the stark asymmetries in FDI patterns (developing *vis-à-vis* developed States) and the more intrusive character of international investment rules (in comparison to most trade rules).³² In general, foreign investments are more tightly regulated by host States than trade in goods.³³

A well-known economic theory that explores the link between trade liberalization and investment flows suggests that developments in these spheres are inversely related. In accordance with the “tariff-jumping argument”, trade liberalization measures that decrease trade costs should reduce FDI³⁴ and, vice versa, setting higher trade barriers is likely to increase investment in the relevant State. The idea is that foreign firms have an incentive to “jump over” the tariff wall, relocate in a foreign territory and thereby escape tariffs and other trade barriers. The latter rationale often underlies States’ *restrictive* import measures that aim to attract more investments. Similarly, this aim is frequently reflected in trade restrictions in RTAs towards third parties. Thus, for example, rules of origin are increasingly employed in RTAs as a strategic instrument to increase regional sourcing and attract FDI.³⁵ The best-known cases in this regard are the European Union’s rules of origin concerning semiconductors and the North American Free Trade Agreement’s (NAFTA) rules regarding color provisions, which proved themselves as effective tools to attract FDI.³⁶

A different relationship between FDI and trade emerges from recent State practice in the international economic system. The *complementary* nature of policies in these two spheres is noticeable in modern RTAs. As the Report notes, there is a growing trend to

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³¹ Thus, for instance, the controversial issue of environmental regulation arises both in international trade and foreign investment; see Thomas Wälde and Abba Kolo, *Environmental Regulation, Investment Protection and “Regulatory Taking” in International Law*, 50 *International and Comparative Quarterly* 811, 2001. Generally, the tension in the sphere of FDI between host States’ interest to co-operate at the international level through binding rules and their interest to discharge their domestic regulatory function in a flexible manner resurfaces also with regard to international trade agreements. The scope of States’ regulatory discretion has been debated in the WTO system, and particularly with regard to the interpretation of Articles III and XX of the General Agreement on Tariffs and Trade; see the Report, at pp. 145 *et seq.*

³² See, for example, the Report, at p. 95.

³³ In general, international factor movements tend to raise more political difficulties than international trade; see Paul R. Krugman and Maurice Obstfeld, *International Economics: Theory and Policy*, 6th edition, Addison Wesley, Boston, 2003, p. 160.

³⁴ See, for example, Michael J. Trebilcock and Robert Howse, *The Regulation of International Trade*, 2nd edition, Routledge, London, 1999, pp. 340–342; Massimo Motta, *Multinational Firms and the Tariff-jumping Argument: A Game Theoretic Analysis with Some Unconventional Conclusions*, *European Economic Review*, Vol. 36, 1992, pp. 1557–1571; M. Blomström and A. Kokko, *Regional Integration and Foreign Direct Investment: A Conceptual Framework and Three Cases*, World Bank Policy Research Working Paper 1750, Washington, D.C., 1997; B. Blonigen, *In Search of Substitution between Foreign Production and Exports*, *Journal of International Economics*, Vol. 53, 2001, pp. 81–104. Note, however, that the question as to whether trade and FDI are complementary or substitutive has been a long-standing research question in international economics; on this issue, see *The Relationship between Trade and Foreign Direct Investment*, *supra*, footnote 29.

³⁵ Moshe Hirsch, *International Trade Law, Political Economy and Rules of Origin: A Plea for a Reform of the WTO Regime on Rules of Origin*, 36 *J.W.T.* 2, 2000, p. 171, at pp. 177 *et seq.*

³⁶ *Ibid.*, at pp. 180–181 and the references included therein. On the principal factors that explain which regional settings are more susceptible to such strategic use of rules of origin, see at pp. 179–180.

conclude treaties that regulate both investment and trade issues.³⁷ These comprehensive regional arrangements aim to enhance the flow of both investment and trade within the region.³⁸ The prominent examples of such convergence on the bilateral level are the 2002 Japan–Singapore Agreement for a New -Age Economic Partnership³⁹ and the recent free trade agreement between Chile and the United States.⁴⁰ On the regional level, the most prominent examples are the NAFTA⁴¹ and the current draft of the Free Trade Area of the Americas (FTAA).⁴²

A. Regional Trade Arrangements as an Instrument to Promote Foreign Investments

Ethier's innovative model casts new light on the inter-relationship between FDI and trade and broadens our understanding of the role of trade agreements in investment regimes. The model focuses on the second wave of RTAs (started in mid-1980), which marks a qualitative change compared with the first generation of such arrangements (and is often labeled as "the new regionalism").⁴³

Ethier's seminal article, *The New Regionalism*,⁴⁴ elucidates the distinctive features of the new wave of RTAs and highlights the function of the recent trade agreements as a tool of development strategy. The central argument is based on his account of the six characteristics of the new regionalism:

(1) typically, the new regionalism involves one or more small countries linking up with a larger country;

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³⁷ "Indeed, most regional free trade agreements today are also free investment agreements, at least in principle."

The Report, at p. 91. See also at pp. 23 and 25.

³⁸ Ibid., at pp. 91–92.

³⁹ Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership (JSEPA); available at the Website of the Ministry of Foreign Affairs of Japan at: <<http://www.mofa.go.jp/region/asia-paci/singapore/jsepa.html>>. Chapter 8 of the JSEPA deals with investment. On this Agreement, see Ramkishan S. Rajan and Rahul Sen, *The Japan–Singapore "New Age" Economic Partnership Agreement: Background, Motivation and Implications*; available at: <<http://www.adelaide.edu.au/cies/0208.pdf>>. See also the Report, at pp. 89–90.

⁴⁰ Signed in December 2002. Chapter 10 of this Agreement deals with the issue of investment. On this free

trade agreement, see United States Trade Representative, *Chile Free Trade Agreement*, available at:

<http://www.ustr.gov/new/fta/Chile/chapter_summaries.htm>.

⁴¹ See Chapter 11 of the NAFTA, *supra*, footnote 28. On the investment rules of the NAFTA, see

Maximo Romero Jimenez, *NAFTA Chapter 11: Considerations of NAFTA Chapter 11*, 2 *Chicago Journal of International Law* 243, 2001; Charles N. Brower and L.A. Steven, *Who Then Should Judge? Developing the International Rule of Law under NAFTA Chapter 11, and the Doctrine of Indirect Expropriation*, 2 *Chicago Journal of International Law* 193, 2001.

⁴² The draft of the FTAA is available on the official FTAA Website at: <<http://www.ftaa-alca.org>>. Note that the

participating countries have yet to agree on the language in the investment chapter of the FTAA draft; see the Report, at p. 92. In fact, the NAFTA's investment provisions (Chapter 11) are at the core of the proposed FTAA. On the negotiation of the investment rules, see Roberto Echandi, *Bringing Investment to the Aegis of the Multilateral Trading System: Steps Taken in the Context of the FTAA Negotiating Group on Investment*, in Marco Bronckers and Reinhard Quick (eds.), *New Directions in International Economic Law, Essays in Honour of John H. Jackson*, Kluwer Law

International, 2001.

⁴³ A notable change represented by the new regionalism is the conversion of the U.S. position towards trade regionalism. As to developing States, while the first wave of RTAs was characterized by import substitution policies, the new generation of RTAs shifted to outward-looking policies (frequently based on export promotion) on the part of these States; see Moshe Hirsch, *Regional Trade Arrangements as a Development Strategy: Political Economy and the Role of International Trade Law*, paper submitted to the Conference on "Inter-relationships: International Economic Law and Developing Countries", The American Society of International Law, Interest Group on International Economic Law, 4–6 October 2002, Washington, D.C., and the references included therein.

⁴⁴ Wilfred J. Ethier, *The New Regionalism*, 108 *Economic Journal* 449, 1998.

- (2) the small countries have recently made, or are making, significant unilateral reforms;
- (3) the degree of trade liberalization provided for in the agreements is generally modest;
- (4) the obligations regarding liberalization apply primarily to the small countries;
- (5) the regional arrangements often involve “deep” integration and the member States are committed to harmonize other economic policies; and
- (6) the participating States are typically neighbors.⁴⁵

Based upon this characterization, Ethier argues that the new regionalism should be viewed as a means by which new or small countries compete among themselves for FDI. The numerous States that undertake economic reforms consider the capacity to attract FDI as the key to successful entry into the multilateral trading system. Still, the risk of future reversion to non-liberal policies undermines the long-term credibility of these reforms. Conclusion of an RTA with a large developed State adds a credible enforcement mechanism and constitutes an external commitment to continued long-term reform policies.⁴⁶ These facts explain why reforming States are interested in establishing RTAs even though typically they only receive minor concessions from their partners (compared with the situation prior to the conclusion of the agreement).⁴⁷ Ethier states that his model chiefly applies to Third World and former Communist States but may also be applied, with some modifications, to small industrialized States.⁴⁸ The risks presented to foreign investors that are underlined by Ethier are also echoed in the Report:

“Few developing country governments have shown the capacity to blend FDI with institutional, infrastructure and industrial policies. Their interventionist policies have tended to be rigid, prone to ‘hijacking’ by vested interests and open to rent seeking with little improvements in efficiency or skills.”⁴⁹

The NAFTA is the prime example of Ethier’s model. Mexico was primarily motivated to accede to this RTA so as to attract FDI,⁵⁰ and recent empirical studies confirm that this goal has been largely realized.⁵¹ Likewise, the desire to attract FDI played an important role in the negotiations between Chile and the United States towards the establishment of their free trade agreement.⁵²

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⁴⁵ Ibid., at 1150–1152.

⁴⁶ Ibid., at 1155–1160.

⁴⁷ Ibid., at 1159.

⁴⁸ Id.

⁴⁹ The Report, at p. 106.

⁵⁰ Stephan Haggard, *Developing Nations and the Politics of Global Integration*, The Brookings Institution, Washington, D.C., 1995, p. 94.

⁵¹ As Walkrich shows, investments from the other NAFTA Member States have been significantly increased following the establishment of the Agreement; Andres Walkrich, *The “New Regionalism” and Foreign Direct Investment: The Case of Mexico*, manuscript, SSRN Library, October 2001, pp. 1 and 3–5.

⁵² *Chile Economy: Going It Alone*, The Economist, 4 January 2003.

Ethier's model introduced several innovative features into the analysis of RTAs. First, and perhaps most important, Ethier places the subject of investment at the heart of the new RTA system. He views RTAs as tools for promoting FDI to developing States. Thus, the level of trade liberalization measures included in such RTAs is not the decisive criterion for appraising their effectiveness. Likewise, the measurement of intra-regional trade following the implementation of the RTA, which is the predominant test employed by international economists to assess the effectiveness of RTAs,⁵³ should not be the major criterion to be applied in such appraisals. In accordance with Ethier's argument, the key motivation for developing States to participate in the new RTAs is to attract investments. Consequently, the volume of FDI inflows should constitute the main test for evaluating the success or failure of the new generation of RTAs. Furthermore, the major role of RTAs in this model is to enhance the credibility of economic reforms pursued by developing States. RTAs are employed in this construction as a signaling device to reveal essential information to foreign investors. The role of information flow in trade relationships has already been studied by economists who explored the role of preferential arrangements in the global trading system.⁵⁴ Ethier's thesis differs from past studies by focusing on signals that are conveyed to private investors (rather than States) and whose content is a commitment to long-term outward-oriented policies.

While Ethier's model sheds new light on the inter-relationships among FDI, RTAs and economic development, it is clear that his scheme should not be considered as either an exclusive path or as exhaustive list of conditions for investment inflow.⁵⁵ Other factors, such as the size of the RTA markets⁵⁶ and the existence of adequate infrastructure as well as of skilled labor,⁵⁷ are also of prime importance for attracting foreign investments. In addition, the rapid industrialization process undertaken in several States in Eastern Asia demonstrates that successful RTAs do not always constitute a prerequisite to economic development.⁵⁸ The Report surveys the mixed results of studies that explored the impact

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⁵³ On the "the de-Melo and Panagariya test" for RTAs, see, for example, Debraj Ray, *Development Economics*, Princeton University Press, Princeton, New Jersey, 1998, pp. 742–746.

⁵⁴ See Josh Ederington and Phillip Mccalman, *Signaling in Trade Agreements*, manuscript, SSRN Library, 2000, pp. 1, 3 and 15.

⁵⁵ In addition, motivations other than attracting FDI may also play significant roles in States' decisions to join RTAs; see, for example, John Whalley, *Why Do Countries Seek Regional Trade Agreements?* NBER Working Paper Series, Working Paper No. 5552, National Bureau of Economic Research, Washington, D.C., 1996.

⁵⁶ On the size of the market as an obstacle to investments and development in the Central American Common Market, see Miroslav N. Jovanovic, *International Economic Integration: Limits and Prospects*, 2nd edition, Routledge, London and New York, 1998, pp. 329–331.

⁵⁷ On the lack of adequate infrastructure and skilled labor as obstacles to successful regional initiatives and development in the West African Economic Union, see Peter Robson, *The Economics of International Integration*, 4th edition, Routledge, London and New York, 1998, p. 284. On the importance of these factors in Latin America, see Jovanovic, *ibid.*, at p. 328.

⁵⁸ The RTA in this region—the Association of South-East Asian Nations (ASEAN)—is considered by experts to play an "insignificant" role in the "leap forward" of the new industrialized States; Jovanovic, *ibid.*, at pp. 338–339. See also Chris Dixon, *Regional Integration in South East Asia*, in Jean Grugel and Wil Hout (eds.), *Regionalism across the North–South Divide*, Routledge, London, 1999, 115, at 132. On ASEAN, see also Robson, *supra*, footnote 57, at pp. 293–295; Jovanovic, *ibid.*, at pp. 336–339.

of RTAs on FDI in Asia.⁵⁹ Overall, it is clear that “the soundness of the national economy policy and macroeconomic stability has always played an important role in attracting FDI, rather than a country’s participation in the regional integration scheme.”⁶⁰ Ethier’s model assigns a crucial role to the establishment of an RTA with a large developed State because embodying reform measures in an international treaty “with a big country (often the dominant trading partner) adds a credible enforcement mechanism”.⁶¹ In the absence of an RTA with a developed State, alternative means to attain this aim should be explored. In certain cases, enforcement organs of certain international institutions may complement RTAs among developing States. Thus, for instance, international economic organizations that operate effective supervisory operations (such as the WTO’s Dispute Settlement Body) may establish a new organ to monitor and sanction violations of RTAs formed by developing States. Such “combined regimes” may increase the credibility of developing States’ reforms and attract FDI inflows to these regional markets.⁶²

B. *FDI Blocks and Investment Diversion*

One of the most important FDI patterns analyzed in the Report relates to the emergence of “mega FDI blocks”. This term refers to the concentration of FDI within the Triad (the European Union, Japan and the United States) that accounts for around 80 percent of the world outward stock and 50–60 percent of the world’s inward stock. Clusters of non-Triad countries have strong FDI links to the Triad countries. As noted above, these blocks somewhat overlap with existing RTAs.⁶³ This FDI concentration generates significant gains to the members of these blocks, and particularly to developing States. As this trend intensifies, the ensuing discriminatory impacts are likely to attract the attention of more scholars and policy makers.

The concentration of FDI in several blocks and the accompanying benefits that are generated to their members indicate that some losses are incurred to non-member States. In parallel to the well-known Vinerian theory on customs unions that emphasizes the detrimental impacts of “trade diversion”,⁶⁴ it becomes clear that FDI blocks are also

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⁵⁹The Report, at p. 47.

⁶⁰Jovanovic, *supra*, footnote 56, at p. 339. Similarly, the Report, at p. 85, states that “[n]ational policies are key for attracting FDI, increasing benefits from it and assuaging the concerns about it.”

⁶¹Ethier, *supra*, footnote 44, at 1155.

⁶²On such possible technique to enhance the credibility of developing States’ reforms *vis-a-vis* foreign investors, see, in detail, Hirsch, *supra*, footnote 43.

⁶³The Report, at pp. 23–26.

⁶⁴In accordance with the Vinerian model, “trade diversion” takes place when imported low-cost products from non-member States are replaced by higher-cost goods that are imported from a member State of the preferential arrangement. This situation entails a less efficient allocation of resources, as a country switches its source of import to a less efficient producing country, leading to welfare imperfection. The Vinerian model, formulated by Jacob Viner, is a general model of custom unions; see Jacob Viner, *The Custom Union Issue*, Carnegie Endowment for International Peace, New York, 1950, at 3; Krugman and Obstfeld, *supra*, footnote 33, at pp. 243–247; Jaime de Melo, Arvind Panagariya, and Dani Rodrik, *The New Regionalism: A Country Perspective*, in Jaime de Melo and Arvind Panagariya (eds.), *New Dimensions in Regional Integration*, Cambridge University Press, Cambridge, U.K., 1993, 159, at 161–163; Robson, *supra*, footnote 57, at pp. 19–20.

discriminatory. Thus, States outside of the blocks are harmed by investment diversion.⁶⁵ Third parties' anxieties are likely to intensify the pressure to establish international disciplines to harness the formation of new regional investments blocks (or the expansion of existing ones). Such concerns may increase in the future, particularly in regions that are characterized by a high level of investment competition or during periods of FDI decline.

In light of the well-known Article XXIV of the General Agreement on Tariffs and Trade (GATT) and Article V of the GATS that restrict the establishment and operations of RTAs,⁶⁶ equivalent rules may aim to curb the discriminatory impacts of FDI blocks. Although the existing GATT/WTO mechanisms on RTAs are likely to serve as a starting point for the shaping of parallel rules in the FDI domain, the distinctive characteristics of the latter sphere indicate that the resulting regulatory framework in the investment domain will not be the same.

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⁶⁵ On this issue, see Richard E. Baldwin, Rikard Forslid and Jan I. Haaland, *Investment Creation and Diversion in Europe*, *The World Economy*, Vol. 19, No. 6, 1996, pp. 635–659. See also the Report, at p. 94.

⁶⁶ On these provisions and the regulation of RTAs in the GATT and the GATS, see Trebilcock and Howse, *supra*, footnote 34, at pp. 128–134; John H. Jackson, William J. Davey, and Alan O. Sykes, *International Economic Relations*, 4th edition, West Publishing Co., Eagan, Minnesota, 2002, pp. 447–465.

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