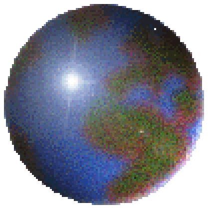

Mode 3

Almaty, May 2012

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What defines FDI?

- Direct investment is when the investment is large enough to give an investor a *controlling and long-term interest* in the acquired company.
- *Motivation* is the factor that differentiates direct investment from cross-border portfolio investment.
- Portfolio investors focus on income from the ownership of shares and other securities without expecting to play a controlling or influencing role in the management of the assets underlying their investments.
- Thus the demarcation between portfolio and direct investment is based on the criteria of <u>control</u>.

'Direct Investment'

- IMF Benchmark definition of FDI (1977)

' ...an investment that is made to *acquire* a *lasting interest* in an enterprise operating in *an economy other than that of the investor*, the investor's purpose being to have an *effective voice in the management* of the enterprise... '

What defines control?

- Direct investment is considered evident when the direct investor owns at least 10 per cent of the voting power of FDI-invested enterprise.
- Mere equity ownership may not be enough.
- Ability to ensure *effective management control*, even from a distance.

Types of FDI

- FDI is classified on the basis of the mode of entry of the foreign investor:
  - ***Greenfield***: establishing a completely new business establishment;
  - ***Brownfield***: adding to productive capacity where some fixed capital already exists;
  - ***Mergers and acquisitions***: control obtained by acquisition or merging of an existing local company.
    - Note the differing impacts on competition

Motivations for FDI

- Resource seeking
- Efficiency seeking
- Market seeking
- Innovation seeking

FDI in goods vs. FDI in services

- In manufacturing, the segmentation of production process: splitting labor intensive part and less labor intensive part of production process in different countries.
  - low tradability in services makes such segmentation difficult.
- Services affiliates,
  - a lower propensity to engage in intra-firm trade than manufacturing affiliates (again because of problem with respect to splitting up),
  - more skill and capital intensive (precisely for the same reason) than manufacturing affiliates.

FDI in goods vs. FDI in services

- Few empirical studies exist on the determinants of FDI into services.
- The determinants of service FDI:
  - Market size/ local customer base
  - Home-country business presence
  - Host government policies
  - Local customer base
  - Cultural distance
  - Competitive advantages
  - Tradability of services
  - Global oligopolistic reaction
  - Industry concentration
  - Growth of the firm size

Rationale for restrictions

- Restrictions as protection from competition for emergent service industries.
- Restrictions are required on the entry to, or scale of, services which could impose external costs, e.g., in air transport or energy distribution.
- It is necessary to prevent foreign participation in “essential” service industries, e.g., banks and other financial institutions, if independence in monetary and credit policies is to be guaranteed.
- Unrestricted competition may be pernicious in services characterized by high fixed costs and fluctuating demand such as transport and communication
  - these service provisions may cater to only the most lucrative market segments.
- Retaliation may also lead to restrictions as country’s own enterprises are subject to similar restrictions in other countries.

The evolving legal architecture for international investment is one of multi-layered governance

- **National level**
  - Specific laws applicable to foreign investment
- **Bilateral level**
  - Bilateral Investment Treaties (BITs)
- **Regional / Preferential level**
  - Chapters on Investment in Economic Integration Agreements (EIAs)
- **Multilateral level**
  - Applicable rules in WTO Agreements
  - Other institutions and instruments (double taxation treaties)

Multilateral level

- There is as yet no multilateral agreement on investment, but rather a patchwork of rules and instruments (hard and soft law)
- Failed attempts to bring investment into a multilateral setting
  - Havana Charter (1948)
  - Uruguay Round (1987)
  - MAI (1998): from the WII, to MIA to MAI…
  - WTO/DDA/Singapore Issues (2002)
- Applicable rules on WTO Agreements
  - GATS, TRIMs, DSU [TRIPs, ASCM]
- Other relevant investment-related institutions
  - International Centre for the Settlement of Investment Disputes (ICSID)
  - Multilateral Investment Guarantee Agency (MIGA/World Bank)
  - Arbitration Centres (ICC, Stockholm Chamber of Commerce)
  - Other World Bank agencies (IFC,FIAS)
  - UN Global Compact
  - OECD Guidelines on Multinational Enterprises
  - OECD Convention on Bribery and Corruption
  - OECD Guidelines on Corporate Social responsibility
  - OAS Anti-bribery convention

GATS and Foreign Investment

- Bilateral Investment Treaties (BITs) that establish disciplines for investment in goods and services.
- No such horizontal investment disciplines have so far been established under the WTO.
- WTO Members discarded the establishment of a multilateral investment agreement from the DDA's work programme as part of the July 2004 General Council Decision.

GATS and Foreign Investment

- GATS:
  - multilateral agreement that covers investment in services,
  - NOT
  - an agreement on investment per se in the spirit of the failed Multilateral Agreement on Investment (MAI).

GATS Definition of Commercial Presence

- "commercial presence" means any type of business or professional establishment, including through

  (i) the constitution, acquisition or maintenance of a juridical person, or

  (ii) the creation or maintenance of a branch or a representative office,

  within the territory of a Member for the purpose of supplying a service (GATS Article XXVIII)

GATS Definition of Commercial Presence

- A juridical person is:

  (i) "owned" by persons of a Member if more than 50 per cent of the equity interest in it is beneficially owned by persons of that Member;

  (ii) "controlled" by persons of a Member if such persons have the power to name a majority of its directors or otherwise to legally direct its actions;

  (iii) "affiliated" with another person when it controls, or is controlled by, that other person; or when it and the other person are both controlled by the same person

Kazakhstan example

- Company may be 100% owned and controlled by foreigners and considered a national person
- According to Kazakhstan, 100% owned and controlled bank such as Citibank is considered a Kazak bank
- According to the GATS, Citibank is a U.S. origin bank
- What happens if the Kazak government imposes capital requirements on U.S. origin banks?
  - Citibank needs to resort to the WTO Dispute Settlement System, or
  - Citibank needs to resort to local courts in Kazakhstan?
  - Could it do both?
- Is the GATS definition of juridical person less liberal than a big chunk of the world?

GATS Definition of Commercial Presence

- This definition covers foreign direct investment in services only where the investor of the other party holds more than 50 per cent of the equity interest or exercises control over the invested enterprise.

- The definition of commercial presence extends to "the creation or maintenance of a branch or a representative office".

Thank you