Investment Agreement of the Americas: Environmental, Economic and Social Perspectives

Center for International Environmental Law
El Instituto del Tercer Mundo
Preamble Center

Printed by: Weadon Printing and Communications, Alexandria, VA

Published by: Center for International Environmental Law

Illustrations: Valeska Maria Populoh

Available from: CIEL - Center for International Environmental Law
1367 Connecticut Ave, N.W., Suite 300
Washington, D.C. 20036-1860, USA
Email: info@ciel.org Web: http://www.ciel.org

Recent Experiences with International Financial Markets: Lessons for the Free Trade Area of the Americas (FTAA)

Preamble Center
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EXECUTIVE SUMMARY

Recent experience with international capital markets suggests that it is not an appropriate time to negotiate a new commercial agreement which would limit signatory countries' abilities to regulate the flow of capital across international boundaries.

But if the investment rules that emerge from negotiations on the Free Trade Area of the Americas (FTAA) are based on investment rules in the North American Free Trade Agreement (NAFTA) and the Multilateral Agreement on Investment (MAI) – as it now appears that they will be – the FTAA would do just that. Provisions in the NAFTA and the MAI on definition of investment, transfers, and national treatment would severely restrain the ability of governments to regulate even short-term speculative capital flows, in order to prevent or manage a financial crisis.

The recent Asian crisis shows the effects which may result from sudden capital outflows. In East Asia, there was a net reversal of private international capital flows to the region of $105 billion-- from a net inflow of $92.8 billion in 1996 to a net outflow of $12.1 billion in 1997. This amounts to about 11 percent of the GDP, before the crisis, of the combined economies of South Korea, Indonesia, Malaysia, Thailand and the Philippines. This is a massive and highly destabilizing reversal of international capital flows, and it does not appear to be the result of changes in the real, underlying economies of the region.

Financial liberalization measures (often adopted under pressure from the OECD, IMF, or Washington) enacted by many Asian countries in the years prior to the 1997 crash bear much of the responsibility for the region's financial crisis. The result, made worse by IMF austerity measures, was a regional depression, increased unemployment and poverty, and increased political and social tensions that may persist for years to come.

In Mexico, most of the capital inflows in the four year period leading up to the peso crisis were comprised of so-called "hot money" – mainly short-term bank lending and portfolio investment. At the end of 1994 there was a shift in investors' sentiment, resulting in large scale capital flight. In 1995, Mexico experienced a net capital outflow of US $15 billion, as compared to a net *inflow* of $31 billion in 1993. The impacts of this reversal on the Mexican economy were severe: the economy contracted sharply, unemployment rose, and poverty rates soared.

Some countries have attempted to protect themselves from the harmful effects and instabilities inherent in a world of increasingly unrestricted capital flows. As recent experiences with capital controls in Chile, Colombia, Malaysia, Hong Kong, Taiwan, and China demonstrate, efforts to limit capital mobility are not inconsistent with orderly and robust economic growth and development. To the contrary, using capital controls can be a highly effective strategy in a country's efforts to return to economic growth after a financial crisis, or to prevent excessive short-term international borrowing, for example, from building up in the first place. However, if the deregulatory model (based on the NAFTA and the MAI)

for international investment is followed, these and other types of controls would be mostly prohibited by the FTAA.

A number of leading economists have entered the debate over global capital flows and the need for more national controls. Along with Columbia's Jagdish Bhagwati, MIT's Paul Krugman and Harvard's Jeffrey Sachs, World Bank Chief Economist Joseph Stiglitz has repeatedly spoken out about the dangers of further capital account liberalization. Moreover, prominent Latin American economists Manuel Agosin and Ricardo Ffrench-Davis have conducted extensive research into the role of capital flows leading up to the Mexican crisis, and the effectiveness of Chile's capital controls. They argue that governments should adopt "speed bumps," reserve requirements, and other types of capital controls to shield their economies from the destabilizing effects of short-term capital flows.

In short, compelling evidence suggests that it is an inappropriate time to negotiate a treaty that makes it easier for capital to flow uninhibited across national boundaries. But the investment chapter of the proposed Free Trade Area of the Americas (FTAA), if based on the NAFTA/MAI investment model, would accelerate the pace of investment liberalization and capital mobility in the Western Hemisphere. It would restrict the ability of governments to shield themselves from the volatility of global financial markets. At a time when the control of international capital flows is the subject of heightened controversy and debate, the measures currently promoted for inclusion in the FTAA would prohibit most capital controls and similar regulatory measures. Before negotiating any such treaty, we should take stock of the impact of speculative capital flows as well as international capital mobility more generally. It would be unwise and counter-productive to negotiate a treaty that ignores recent experience with deregulated capital flows.

Introduction

The events of the last several years have highlighted the risks and complications of increasing international capital mobility. The role of highly volatile capital flows in precipitating the Mexican peso crisis (1995), and more dramatically the Asian, Russian, and Brazilian financial crises of the last two years, has caused a major shift in the thinking of economists. As recently as two years ago, the majority of the profession believed that increasing liberalization of capital flows, like the opening of economies to freer trade, was inherently beneficial. But today most economists would qualify any such statement considerably, and there has been a broad expansion in the number and types of capital controls that economists would be willing to consider in order to avoid or ameliorate the types of financial crises that we have recently witnessed.

However, policy makers have been slow to adapt to these changes in economic analysis and circumstances. They have continued, for the most part, to pursue through commercial agreements and other venues, measures that would increase the liberalization of capital flows.

The International Monetary Fund asked its executive board in September 1997 to complete an amendment to the IMF's Articles of Agreement that would make liberalization of capital movements one of the mandates of the Fund. The Multilateral Agreement on Investment (MAI), an investment liberalization treaty that was under negotiation at the OECD until

December 1998, would have similarly mandated, through its broad definition of investment and language on transfers, liberalization of signatory countries' capital accounts.[1] The MAI, in turn, was modeled on Chapter 11 of the North American Free Trade Agreement (NAFTA), which contains a broad definition of investment, as well as language on financial transfers which effectively precludes most capital controls. The Free Trade Area of the Americas (FTAA) is the next venue where capital account liberalization will probably be mandated. If, as is anticipated, the investment rules in the FTAA are based on those in the NAFTA and the proposed MAI, the agreement could severely limit the ability of signatory governments to employ capital controls or otherwise protect themselves from the dangers of financial crises and destabilizing capital flows. It is therefore worth examining these investment rules in the light of recent economic events and analysis.

I. How Might the FTAA Encourage Unregulated Capital Mobility?

The FTAA's Negotiating Group on Investment has as its mandate "to establish a fair and transparent legal framework to promote investment through the creation of a stable and predictable environment that protects the investor, his investment and related flows, without creating obstacles to investments from outside the hemisphere."[2] The negotiating group is in the process of drafting the FTAA's investment chapter primarily on the basis of the investment provisions the North American Free Trade Agreement (NAFTA), but it will likely also draw upon the MERCOSUR treaty and the MAI. The Group will also use the recommendations submitted by the Business Forum of the Americas, a coalition of multinational corporations from the United States and South America.

The relevant sections in each of the agreements cited above relating to a nation's ability to impose capital controls are the *definition of investment*, and provisions on *national treatment*, as well as *transfers*. The language in the FTAA on these issues will have the most impact on nations' abilities to regulate capital inflows and outflows.

A. Definition of Investment

Trade agreements and investment liberalization treaties have generally defined investment broadly in recent years. The NAFTA, in article 1139, defines investment to include enterprises, equity and debt securities, loans, income and profits, and real estate or other property, tangible or intangible. The draft MAI defines investment as "every kind of asset owned or controlled, directly or indirectly, by an investor..." This includes property, shares and stocks, claims to money, loans, and intellectual property rights.[3]

These definitions are very broad and include not only Foreign Direct Investment (FDI), but also portfolio investment and other forms of short-term lending. The most volatile kinds of flows included in these

[1]" The MAI Negotiating Text," April 24, 1998.

[2]"Annex to the Joint Declaration of the Fourth Trade Ministerial," 1998.

[3] "The MAI Negotiating Text," April 24, 1998, Section II.2.

definitions are short-term financial credits to banks and large domestic firms, short-term deposits by non-residents in the domestic financial system and purchases of stocks and bonds by non-residents. These types of transactions are more likely to be for the purpose of taking advantage of interest rate differentials or to get quick capital gains. It is these types of short-term and especially speculative capital flows that are most likely to exacerbate a crisis when they are sharply reversed. *(See Chart 1, Appendix, for a depiction of trends in direct and portfolio investment in developing countries in the Western Hemisphere).* On the other hand, foreign direct investment, which generally includes a controlling interest and often involves the creation of tangible assets such as the construction of factories, is more likely to remain invested for a longer time.[4] When economists argue for the benefits of investment liberalization, it is generally FDI that they rely on to make their case.

Because the definition of investment in the NAFTA and the MAI are broad enough to cover portfolio investment and other forms of short-term lending, the liberalizations and protections of Foreign Direct Investment (FDI) in these agreements will apply equally to speculative portfolio flows. Of particular concern are the provisions liberalizing the transfers of capital relating to investment and the national treatment protections of investment.

B. Transfers

The NAFTA mandates the unrestricted transfer of capital relating to investments including principal, profits, dividends, interest, and capital gains.[5] The investment chapter of the FTAA, based on other treaties and proposed language, may include a broadly worded section on transfers as well, without distinguishing between short-term flows and other forms of investment. If the Business Forum of the Americas' recommendations are adopted, the FTAA may go beyond even existing language on transfers to "design effective measures for free transfer and beyond-border transactions" to ensure that no controls are applied to investment entering or leaving the host country.[6]

C. National Treatment

National treatment – the requirement that foreign investors be treated no less favorably than domestic investors, regardless of the circumstances – is another fundamental principle of investment liberalization treaties; it is a provision of the NAFTA and the proposed MAI. Because of the broad definition of investment, this provision could be used to protect highly mobile foreign capital from the actions taken by national governments in the interest of protecting their economies. National treatment provisions would permit a foreign bank or other investor to argue that it has the same rights as domestic investors and banks under international law.[7]

The recommendations of the 1998

[4] In a statistical survey based on flows to all developing countries, UNCTAD (1998, pp. 13-15) found that during the period 1992-1997, commercial bank loans and portfolio investment had, on average, higher rates of volatility than Foreign Direct Investment.

[5]See NAFTA Article 1109(1).

[6]"Final Recommendations by Workshops of Fourth Business Forum of the Americas," 1998.

[7]Such provisions would not prevent foreign investors from being granted greater rights than domestic firms.

Business Forum of the Americas included broadening the definition of national treatment. The Forum advocated the extension of national treatment to taxation and suggested that the FTAA "extend uniform non-discriminatory national treatment to capital originating from countries *outside the FTAA.*"[Emphasis Added][8] Under such an arrangement, investors from Europe and Asia, for example, would be entitled to the same treatment rights as investors from within the hemisphere. As will be shown in the examples below, national treatment provisions, as applied to portfolio and other short-term investments, risk increasing the vulnerability of national economies to financial turbulence and its harmful economic and social effects.

The provisions on the definition of investment, transfers, and national treatment that the FTAA is likely to include would almost certainly create major obstacles to any government seeking to regulate short-term speculative capital flows, even to prevent or manage a financial crisis.[9] At the same, the potential dangers of short-term capital inflows are well-documented in the recent economic literature on the subject. The crises in Asia and Mexico provide a useful introduction to the story of unchecked capital movements.

II. Capital Mobility and Financial Crises

A. The Role of Capital Flows in the Asian Crisis

Prior to the onset of the Asian financial crisis, there were few mainstream challenges to the maxim that the deregulation of international capital flows was in the best interests of everyone. This principle seemed almost as well established as the theory of comparative advantage with regard to trade, and was able to benefit from a sort of "proof by association" with the latter. This is in spite of the fact that the reasoning of the trade theory does not apply to capital flows,[10] not to mention the very limited usefulness of the theory of comparative advantage itself to any kind of economic development strategy.

The debate over the effects of deregulated international investment intensified when the economies of South Korea, Indonesia, Malaysia, Thailand, and the Philippines, and others in the region

[8]"Final Recommendations by Workshops of Fourth Business Forum of the Americas" 1998, op cit.

[9]The draft text of the MAI (24 April 1998) contains exceptions to the MAI's "Transfers" sections, so that a country may "delay or prevent a transfer through equitable, *non-discriminatory* and good faith application of measures" in order to "protect the rights of creditors," ensure compliance with laws and regulations on trading and dealing in securities, futures, and derivatives, and on recording and reporting transfers, and in connection with criminal offences. The exception concludes with the caveat that "such measures and their application shall not be used as a means of avoiding the Contracting Party's commitments or obligations under the Agreement." (Chapter IV, 4.1-4.6) These exceptions, therefore, would not permit a country to regulate short-term capital inflows, or enact capital controls in a time of crisis. (See also Sforza 1998.)

[10]See Bhagwati 1998.

were hit by a financial crisis that subsequently developed into a regional depression. Although the policies of the IMF helped transform the financial crisis into a crisis of the underlying real economy, even pro-globalization economists have noted that the financial liberalization of these countries was a major proximate cause, if not the major cause, of the onset of the crisis. Jagdish Bhagwati, one of the world's leading international economists and the Economic Policy Adviser to the Director-General of the GATT (1991-93) has noted that "the Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as Asian economies loosened up their capital account controls and enabled their banks and firms to borrow abroad. . . it has become apparent that crises attendant on capital mobility cannot be ignored."[11]

What was so striking about this case is that it was truly "the intrinsic instability in international lending"[12] that pushed these countries to the abyss. Most important was a net reversal of private international capital flows to the region of $105 billion-- from a net inflow of $92.8 billion in 1996 to a net outflow of $12.1 billion in 1997. This amounts to about 11 percent of the GDP, before the crisis, of the combined economies of South Korea, Indonesia, Malaysia, Thailand and the Philippines.[13] This is a massive and highly destabilizing reversal of international capital flows, and it does not appear to be related to the workings of the real, underlying economies of the region.[14]

Financial liberalization measures enacted by many Asian countries in the years prior to the 1997 crash bear much of the responsibility for the inability of governments to control the massive net reversal of capital flows out of the region in 1997. For example, the Korean government began to relax its control over financial flows in the early 1990s. In order for South Korea to join the OECD in 1996, it had to liberalize its financial sector even further.[15] The deregulation of financial transfers provided for in NAFTA and the proposed MAI would, most importantly, 1) increase the ability of affected economies to rapidly acquire accumulations of short-term debt and 2) remove from national authorities the ability to enact capital controls when the resulting panic sets in.

Other explanations of the onset of the Asian crisis, especially the media sound bites about "crony capitalism" or "inefficient" industrial organization do not have much evidence to back them up. Indeed, when people, including some economists, refer to the Korean economic system as "inefficient" it is not clear what they mean. The most obvious economic meaning would be that resources were allocated inefficiently, so that the economy (and therefore living standards) did not grow in accordance with its full potential. The South Korean economy grew at a *per capita* rate of 7.2% over the last thirty years, one of the highest rates of economic growth in the history of the world. It is certainly possible that it could have grown even faster, but no one has presented an economic argument as to how this might have been accomplished.

All this is not to say that there were no problems accumulating in these five

[11]Ibid, p. 8.

[12]Radelet and Sachs 1998, p. 4.

[13]Ibid.

[14]See Mark Weisbrot 1999, for a more extensive discussion of this point.

[15]See Ha-Joon Chang, 1998.

Asian countries. There was a build up in domestic bank lending in all of the countries except Indonesia, where firms increased their borrowing directly from foreign banks. Real exchange rates did appreciate noticeably – about 12% for South Korea and 25% for the other four countries – as large international capital flows poured in. But other countries have had much larger real appreciations without the kind of currency collapse that these countries underwent. And it should be stressed that these weaknesses as well as the current account deficits were very much tied to the liberalization of capital flows that took place in the preceding years.

Radelet and Sachs[16] have also examined the effect of international shocks, such as the devaluation of the Chinese yuan in 1994, the increased competition from Mexico, and the overcapacity in particular industries such as semiconductors. The combined effect of these influences does not appear to account for what happened.

It is therefore difficult to escape the conclusion that the instability caused by recent international financial liberalization bears the primary responsibility for the onset of the crisis. The reversal of capital flows amounting to eleven percent of the regional GDP was a result of "herd" behavior, with foreign and domestic investors alike stampeding for the exits for fear of being caught with greatly depreciated local currency and assets.

The logic of such panics is fairly straightforward. In the Asian crisis, it began with the fall of the Thai currency, then soon spread to other countries. With a high level of short-term international debt, a depreciation of the domestic currency increases the cost of debt service. Everyone needs more domestic currency to get the same amount of dollars for debt service, and the selling of domestic currency to get those dollars or other "hard" currencies drives the domestic currency down further. It does not take much to set off a panic, especially if the central bank does not have a high level of foreign currency reserves relative to the short term debt. These reserves shrink further as more and more investors convert their domestic currency and domestic assets into dollars. Foreign lenders refuse to renew their short-term loans (or, as in South Korea, are able to even call them in early), and the downward spiral continues.

Other economists have found that the inherent instability of international financial markets was a major cause of previous financial crises, including Mexico's in 1994.[17] And Radelet and Sachs' statistical analysis of recent crises in emerging markets found that the most important predictor of crisis was the ratio of short-term international debt to the country's foreign exchange reserves.[18] In other words, these countries became vulnerable to panic-induced capital outflows, as well as runs on their currency, because of a build-up of short-term international borrowing.

This build-up of short-term international borrowing was thus a direct result of the financial liberalization that took place in the years preceding the crisis. In South Korea, for example, this included the removal of a number of restrictions on foreign ownership of domestic stocks and

[16]Radelet and Sachs 1998, op cit.

[17]See, e.g., Guillermo Calvo and Enrique Mendoza, 1995, page 235.

[18]The authors used a probit model based on data for 22 emerging markets, during the years 1994-97.

bonds, residents' ownership of foreign assets, and overseas borrowing by domestic financial and non-financial institutions.[19] Korea's foreign debt nearly tripled from $44 billion in 1993 to $120 billion in September 1997. This was not a very large debt burden for an economy of Korea's size, but the short-term percentage was dangerously high at 67.9% by mid-1997.[20] For comparison, the average ratio of short-term to total debt for non-OPEC less developed countries at the time of the 1980s debt crisis (1980-82) was twenty percent.[21]

Financial liberalizations in the other countries led to similar vulnerabilities. Thailand created the Bangkok International Banking Facility in 1992, which greatly expanded both the number and scope of financial institutions that could borrow and lend in international markets. Indonesian non-financial corporations borrowed directly from foreign capital markets, piling up $39.7 billion of short-term debt by mid 1997, eighty-seven percent of which was short-term.[22] On the eve of the crisis the five countries had a combined debt to foreign banks of $274 billion, with about sixty-four percent in short-term obligations.

In sum, it is clear that international financial liberalization played a significant role in bringing about the Asian financial crisis, from which the region has yet to recover. We now turn to the Mexican peso crisis, and recent experience with international capital flows in the Americas.

B. The Mexican Peso Crisis and Latin America's Experience with Liberalized Capital Flows

Latin American nations have become accustomed – for better or for worse – to the boom-and bust cycles that have come to exist in a world of growing transnational capital flows. In the 1970s and early 1980s, many countries in the region received large inflows of foreign capital. At the same time, countries in the region undertook liberalization of their financial sectors and relaxed or eliminated foreign exchange regulations. The inflows dried up in the 1980s as the debt crisis discouraged lending to the region. After the debt crisis subsided, however, Latin America again received large capital inflows beginning in 1991. In the 1990s, foreign capital inflows have reached between 5 and 10 percent of GDP in Argentina, Brazil, Chile, and Mexico.

During the periods when capital inflows were plentiful (from 1976-1981 and 1991-94), macroeconomic imbalances emerged towards the ends of the cycles. Throughout both periods, currencies appreciated and current account deficits grew in many countries. As a result, some of these countries became very vulnerable to the actions of external creditors. The creditors in turn became sensitive to even the slightest bit of "bad news."[23]

This was the case in the lead-up to Mexico's financial crisis in December 1994. Access to external capital grew very quickly in the early 1990s – in 1991, 1992, and 1993 annual net capital inflows represented more than 8% of Mexico's GDP.[24] These large capital inflows supported an overvalued

[19]Chang, Park, Gyue 1998.

[20]Radelet and Sachs 1998, op cit.

[21]Chang, Park, Gyue 1998, op cit.

[22]Bank for International Settlements data cited in Radelet and Sachs 1998, op cit.

[23]See Ricardo Ffrench-Davis 1998, p.17-18.

[24]Agosin and Ffrench-Davis 1996, op cit, p. 5.

peso as well as chronic current account deficits. These factors combined to make the economy very vulnerable to external shocks.

Most of the capital inflows to Mexico in the four year period leading up to the crisis were comprised of so-called "hot money" – mainly short-term bank lending and portfolio investment. In 1993, portfolio inflows alone amounted to 7.7% of GDP, with FDI inflows amounting to just 1.4% of GDP (See table 1). In the four-year period leading up to the crisis, Mexico's net external debt grew by US $92 billion, of which only US $24 billion was Foreign Direct Investment (FDI).[25]

Mexico was especially hard hit by the inflow of short-term capital in the 1990s because of its *laissez-faire* approach to capital inflows. Beginning in the mid-1980s, Mexico's capital account was dramatically liberalized. Before 1988, foreign portfolio investment had been strictly regulated.[26] After 1988, due to the lifting of capital account restrictions, there was a surge in foreign portfolio investment. The liberalization was part of a larger effort to liberalize the economy (including trade liberalization, privatization of state-owned enterprises, and removal of restrictions on foreign ownership). Many of these policy changes were required in order for Mexico to accede to the GATT, become a member of the OECD, and join the NAFTA, all of which Mexico did in the early 1990s.[27]

The crisis was precipitated in 1994 largely as a result of the U.S. Federal Reserve's doubling of short-term interest rates in the U.S. from February 1994 to February 1995, which caused Mexico's bond market to become relatively less attractive to investors. Investors grew even more wary when the Zapatista uprising in Chiapas and the assassination of leading presidential candidate Luis Donaldo Colosio suggested political instability. The result: market sentiment changed, and both foreign and domestic financial capital stampeded for the exits.

The reversal of capital flows was drastic. In 1995, Mexico experienced a net capital outflow of US $15 billion, as compared to a net inflow of $31 billion in 1993. In just the fourth quarter of 1994, there was a net outflow of $5.5 billion of portfolio investment, and Mexico was facing a $17.7 billion (4.2% of GDP) balance of payments deficit at the end of the year. Foreign exchange reserves fell from $24.9 to $6.1 billion, and the Mexican peso collapsed, losing a third of its value in the last 10 days of 1994, and half of its value by the end of 1995.[28]

The impacts on the Mexican economy were drastic, although they were certainly exacerbated by the IMF austerity policies – including enormous interest rate hikes and budget cuts – that followed. The economy contracted by 6.6% in 1995 and investment dropped 30%. As interest rates soared, companies (especially small businesses) failed, debt burdens became unpayable and layoffs ensued.

[25]Ffrench-Davis 1998, op cit, p. 24.

[26]Agosin and Ffrench-Davis 1996, p. 23.

[27]See Nora Lustig 1998, for a discussion of trade and investment liberalization undertaken by Mexico in the 1980s and 1990s.

[28]Blecker (1996); IMF International Financial Statistics

By mid-1995 official unemployment had doubled as compared to two years earlier. From 1994 to 1995, there was a 20% increase in the proportion of people living in extreme poverty.[29]

Economic growth resumed in 1996, but much of the crisis-induced decline in living standards persisted or worsened for the bulk of the population. By 1997 poverty levels had barely come down. Real wages for manufacturing workers plummeted by 39% from 1994-1997,[30] even as manufacturing employment grew.

As in the Asian economic crisis, it is difficult to separate the effects of the financial liberalization, the ensuing crisis and currency collapse, and the IMF austerity policies.[31] Some observers have laid the blame on major policy errors, in particular the maintaining of an over-valued currency for the years prior to the crisis.[32] Others, such as Robert Blecker have made a strong case that there are fundamental contradictions in the whole growth and development model pursued by Mexican governments since the early 1980s, not only in their exchange rate policies, but in macroeconomic and other policies which thwarted its attempt to harness foreign trade and investment as the engine of economic growth (Blecker 1996).

Nonetheless it is clear that the Mexico's financial liberalization played a key role in enabling not only the reversal of capital flows that precipitated the crisis, but the imbalances that were involved (e.g. the overvalued currency and swelling trade deficit-- $28.8 billion in 1994, from a $4.2 billion surplus in 1987).

The Mexican crisis also had an impact on the rest of the region. Annual GDP growth was zero for Latin America in 1995 and unemployment rates rose that year in Argentina, Costa Rica, Paraguay, Uruguay, and Venezuela. The crisis had a particularly large impact in Argentina and Uruguay, where GDP fell 5.0% and 2.3%, respectively, in 1995. Argentina also opened up its capital account in the early 1990s and pursued a *laissez-faire* approach like Mexico, which at least partially explains that country's heightened sensitivity to the Mexican crisis, in comparison with other economies in the region.[33]

Not all Latin American economies were affected as severely as Argentina by the Mexican crisis. Chile and Colombia, for example had different policies towards large inflows of foreign capital. Rather than adopting complete financial and capital-account liberalization, these countries maintained various kinds of controls and restrictions on short-term inflows. In 1995, for example, the Chilean economy grew by 10.6% and Colombia by 5.8%; it is possible that their capital controls helped insulate them from the fallout of the Mexican peso crisis.

III. The Need for Capital Controls and "Speed Bumps"

[29]Lustig and Szekely 1999.

[30]Ibid.

[31] Ironically, the IMF policies in Asia were so much more destructive (e.g. a 15.5% annual decline in GDP in Indonesia), as well as more clearly unnecessary (and therefore widely criticized by prominent economists), that the Fund's handling of the Mexican peso crisis subsequently came to be viewed as a success story.

[32]See Blecker 1996, for a review of some of the mainstream economists' explanations of the crisis.

[33]Ffrench-Davis 1998, op cit, p. 30.

In light of the experience with recent financial crises, which ensued largely because of sudden reversals of international capital flows, a growing number of economists has begun to consider the need for capital controls. In fact, some countries in Asia and Latin America already have such controls in place, despite the general opposition to such measures by the United States, the IMF, and private financial institutions. As recent country experiences with capital controls demonstrate, these measures are not inconsistent with orderly and robust economic growth and development. To the contrary, capital controls can be a highly effective tool in a country's efforts to return to economic growth after a financial crisis, or to prevent excessive and volatile capital inflows from building up in the first place. If the deregulatory model (i.e., based on the NAFTA and the MAI) for international investment is followed, however, these controls would be prohibited by the FTAA's investment provisions.

A. Some Country Experiences with Capital Controls

1. Chile

In Latin America, Chile is the most frequently cited example of a country whose application of capital controls protected its economy from speculative capital inflows. In the early 1990s, as large amounts of capital entered the country, authorities adopted a range of policies to regulate the inflow of capital. In June 1991, a non-interest bearing reserve requirement of 20% was established on external credits. This meant that foreign investors had to place sums equal to 20% of their investment into a zero-interest account with the Central Bank, with the requirement that these reserves be maintained at the Bank for a minimum of 90 days. A stamp tax (at an annual rate of 1.2% on operations of up to one year) that had formerly only applied to domestic loans was applied to external credits as well. As upward pressures on the currency grew in May 1992 (mainly due to growing capital inflows), authorities raised the reserve requirement to 30%. In October, the central bank increased the length of the reserve.[34]

With these measures, Chile sought to protect itself from the destabilizing effects (eg. Excessive currency appreciation) of capital inflows by discriminating against the least desirable and volatile inflows. Discrimination against short-term flows is inherent in the reserve requirement. Because the requirement is fixed regardless of the term of the credit, the cost of the requirement decreases with the duration of the investment. For example, with the reserve requirement at 30% and an international interest rate (LIBOR) at 5%, the cost of the reserve requirement to an investor who borrows abroad to invest in Chile for a one-month period is 29%; for a two-month period, the cost falls to 13.5%. At the same rate, the cost of borrowing falls to 2.1% for a year-long investment term and to .2% for a ten-year term.[35]

Another important feature of Chile's policy is its flexibility. As seen, the requirements were phased in – but they were also designed to move up or down, depending upon the amount of funds coming in at a given time. An example of this flexibility was demonstrated as the current account deficit grew in 1998 and investors became less interested in Chile (due to a steep drop in the price of copper, its chief

[34]Agosin and Ffrench-Davis 1996, op cit, p. 14-16.
[35]Cowan and De Gregorio 1998, p. 467-68.

	Chile				Colombia				Mexico			
	1991	1992	1993	1994	1991	1992	1993	1994	1991	1992	1993	1994
Foreign Direct Invest.	3.1	1.8	3.2	4.2	1.0	1.7	1.6	2.6	1.7	1.6	1.4	NA
Medium / Long-Term Credits	0.7	1.2	1.4	2.3	NA	-0.1	1.2	3.7	2.7	1.9	NA	NA
Portfolio Flows	0.8	1.1	2.3	2.0	NA	0.1	0.4	0.7	3.2	4.3	7.7	NA
Short-term Credits	1.9	2.4	1.7	1.0	-1.3	1.4	2.9	0.6	1.2	1.8	0.2	NA
Other	-3.4	-1.0	-3.0	-1.9	0.7	2.3	1.5	2.5	-0.3	-1.5	-0.3	NA
Total	3.0	5.4	5.6	7.6	-1.0	0.8	4.6	5.1	8.5	8.0	8.9	5.1

Source: Agosin and Ffrench-Davis 1996. Data from Central Bank of Chile, Banco de la Republica (Colombia) and CEPAL.

Table 1. Net inflows of foreign capital to Chile, Colombia and Mexico, 1991-1994, as a percentage of GDP

export, and the effects of decreased demand in Asia). As a result, Chilean authorities reduced the reserve requirement from 30 to 10 percent. Even with the decline in the reserve requirement, the policy still served as a barrier to the most speculative and volatile forms of foreign capital inflows.[36] Since September 1998, Chile has temporarily dropped the reserve requirement to 0% – based on the fact that there are currently no speculative, short-inflows. But the authorities have reserved the right to re-establish the reserve requirement when necessary.

While Mexico experienced tremendous increases in portfolio inflows in the lead-up to the peso crisis as a percentage of GDP, Chile was able to keep portfolio flows under relative control and avoided the balance of payments crisis that occurred in Mexico. Recall that in Mexico in 1993, portfolio flows were 7.7% of GDP and FDI inflows amounted to 1.4% of GDP. In Chile in 1993, FDI and medium and long-term credits represented 4.6% of GDP, while portfolio flows and short-term credits represented 4% of GDP. In 1994, FDI and medium and long-term credits were 6.5% of GDP and portfolio flows and short-term credits were 3% of GDP.[37]

As Cowan and De Gregorio conclude: "The reserve requirement...has imposed a relatively higher cost on short-term inflows. As the evidence partially shows, this has tilted the composition of capital flows toward longer maturities." The authors also point out that reserve requirements have permitted Chile's government to maintain a degree of control over monetary policy that would not be possible without them.[38]

Chile's mixture of capital controls would violate the national treatment and financial transfers requirements of the NAFTA and the MAI. Since Chile's reserve requirement is directed specifically at foreign investors but it is not required of domestic investors, the policy, however effective, is "discriminatory" according to the NAFTA definition of the term. Similarly, the transfers sections mandates

[36] Andrea Mandel-Campbell, October 2, 1998, p. 30.

[37] Agosin and Ffrench-Davis 1996, p. 9 (data from the Central Bank of Chile).

[38] Cowan and De Gregorio 1998, op cit, p. 486.

the free flow of capital relating to investments – and reserve requirements impede such capital flows. Chile's controls would have to be abolished under the NAFTA model. In fact, the U.S. Treasury Department reportedly demanded that in order for Chile to join in a free trade agreement with the United States, its capital controls would "have to go."[39]

2. Colombia

Reserve requirements and taxes on short-term capital inflows were also used in Colombia. In April 1991, Colombian authorities began to charge a commission of 5% on foreign exchange sold to the Central Bank – along with a retention fee of 3% (later raised to 10%) on non-export foreign exchange receipts. In September 1993, this system was replaced with a reserve requirement of 47% on all credits of less than 18 months. By August 1994, this requirement had been extended to all loans of up to 60 months' maturity.[40]

There has not been as much analysis of the impact of the Colombian measures as in the Chilean case. In Table 1, data on the composition of inflows in Colombia shows that, between 1993 and 1994, inflows shifted from short-term credits (2.9% of GDP in 1993; .6% of GDP in 1994) to FDI and medium and long-term bank credits (2.8% in 1993 and 6.3% in 1994).[41] Agosin and Ffrench-Davis offer a tentative conclusion: "Although there is no hard evidence on the effects of the reserve requirement mechanism used in Colombia, perhaps one of its results has been the lengthening of maturities on foreign borrowing and the near disappearance of short-term borrowing since late 1993."[42] As in the case of Chile, Colombia's capital controls would be found illegal under the national treatment and the financial transfers sections of the NAFTA and the MAI.

3. The Use of Capital Controls in Response to the Asian Crisis

Realizing the role played by financial liberalization and volatile capital flows in the Asian crisis, some Asian countries have undertaken measures to look for ways to insulate themselves from further damage and protect themselves in the future. As Robert Wade explains, "The crisis has taught Asian governments just how risky it can be to open their economies to inflows and outflows of short-term finance."[43]

(a) Malaysia

In this vein, Malaysia surprised the world on September 1, 1998 by instituting strong controls to protect its economy from currency speculators and to regain control of its monetary and fiscal policy. The measures included fixing the value of the Malaysian currency, the ringgit, at 3.8 to the dollar; the closure of secondary currency markets so that trading can only be done on the Kuala Lumpur Stock Exchange; setting a September 30, 1998 deadline for ringgit held abroad to re-enter Malaysia (after which they would no longer have value); locking in portfolio investment for one year before allowing it to leave the country; and other measures imposing conditions on the operations and transfers of funds in external

[39]See Kristof and Sanger, February 16, 1999, p. A10.
[40]Agosin and Ffrench-Davis 1996, op cit, p. 20.
[41]Ibid, p. 9, citing data from Banco de la Republica de Colombia.
[42]Ibid, p. 21.
[43]Wade 1998-99, p. 48.

accounts.[44] The specific objective of Malaysia's policy was to contain speculative capital and the actions of speculators betting on the value of the ringgit. Another important objective was to "regain monetary independence and insulate the Malaysian economy from the prospects of further deterioration in the world economic and financial environment."[45]

The controls have largely stopped overseas speculation in the ringgit, which had previously been carried out mostly by hedge funds based in Singapore.[46] The controls have also allowed the Malaysian government to undertake measures to stimulate the economy – including deficit spending on infrastructure projects and tax cuts without facing the capital flight and currency collapse that such policies might otherwise meet. Interest rates have also been allowed to fall: by January1999, the real short-term interest rate was just under 1%,[47] as compared to 4.2% in August 1998, before the implementation of currency controls. The government has also encouraged banks to increase their domestic lending. The government projects 1% GDP growth in 1999; private analysts have predicted up to 2-3% growth.[48]

(b) Hong Kong, Taiwan, China, and India

Malaysia was not the only Asian country to respond to the crisis by increasing its intervention in capital markets. Hong Kong also took measures to protect itself from hedge funds when its currency and stock market came under attack in the summer of 1998. The Hong Kong Monetary Authority (HKMA) discovered that speculators, including international hedge funds were making a deliberate effort to topple the stock market in order to bring down the Hong Kong dollar. In Hong Kong's quasi-currency board system, the Hong Kong dollar is pegged to the US dollar, the speculators were happy to profit by betting against the Kong dollar and breaking the peg. In August and September 1998, Hong Kong's government introduced restrictions on certain kinds of speculative trading against the Hong Kong dollar and in the Hong Kong stock market. The HKMA also bought up 6 percent of the stock market to keep the price of stocks high, "to show them [speculators and hedge funds] that selling stocks short was not a one-way bet."[49] The HKMA intervened primarily to wipe out those speculators' "short" positions taken in equities. Their effort was a success: the hedge funds took losses and stopped their attack.[50]

At about the same time, the government of Taiwan temporarily curbed capital flows in and out of the country in order to ward off excessive speculation. The central bank was given the authority to regulate the inflow of funds to the stock market. The Taiwanese central bank also decided to essentially isolate the New Taiwanese dollar from the region's currency decline by virtually shutting down trade in futures instruments and by closing the offshore market in the New Taiwanese dollar.[51] The central bank also issued public notice that foreign currency speculators would find 'no quarter' to operate in

[44]Keenan, September 10, 1998, p. 12.
[45]Statement from Bank Negara Malaysia, 1 September 1998.
[46]Landler, February 14, 1999, p.10.
[47]Official Statistics cited in Far Eastern Economic Review, Economic Indicators, January 21, 1999.
[48]FT Asia Wire, "...Malaysia in on Track Toward Recovery," January 24, 1999.

[49]See Wade and Veneroso 1998, p. 23-25.
[50]Ibid.
[51]Ibid, p. 25

domestic currency market.[52]

China and India have maintained restrictions on capital flows throughout the crisis. China's currency, the renmimbi, is not freely convertible and therefore cannot be subject to speculative trading. The fact that China's economy continued to grow (at annual rate of 7.8% for 1998) while the rest of East Asia has suffered through recession or depression, has prompted a re-consideration of currency controls.

The policies adopted by China, India, Malaysia, Hong Kong, and Taiwan to shield themselves from turmoil in international capital markets would not be permitted under the provisions on national treatment and financial transfers in Chapter 11 of the NAFTA and the MAI. At a time when financial instability is an important concern, should such provisions be included in new international agreements? Economists from across the spectrum have begun to address this very question in recent months.

B. The Changing Economic Debate: Will New Commercial Agreements Heed the Warnings?

The Asian and Mexican crises are by no means anomalous in the history of international finance. As Harvard economist Dani Rodrik, citing the Mexican crisis of 1994-1995 and the Latin American debt crisis of 1982 has noted, "Boom and bust cycles are hardly a sideshow or minor blemish in international capital flows; they are the main story."[53]

Rodrik is not alone among the prominent economists who have entered the debate over global capital flows and the need for national controls. Along with Columbia's Jagdish Bhagwati and Harvard's Jeffrey Sachs, World Bank Chief Economist Joseph Stiglitz has repeatedly spoken out against further capital account liberalization. In an October 1998 speech, Stiglitz concluded: "Capital account liberalization has the potential of imposing greater risk and greater inequality. At the same time...studies show there is no systematic relationship between capital account liberalization and economic growth and investment."[54]

Rodrik recently conducted one such study -- to find out if countries with no restrictions on capital-account transactions performed better than those with restrictions. The sample covered nearly 100 countries and looked at the correlation between economic growth, investment as a share of GDP, and inflation and capital-account liberalization from 1975-1989. Rodrik found no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation.[55] The study also tested the hypothesis often cited by proponents of further capital account liberalization that it works better in countries with "strong financial systems." This claim was also found to be unsupported by the evidence.

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[52]Ibid, citing Kynge and Lewis, September 1, 1998.

[53]Rodrik 1998, p. 56.

[54]Rebello, October 5, 1998.

[55]Rodrik 1998, op cit, p. 60-64. Rodrik notes in his study that countries are more likely to remove their capital controls when their economies are doing well. Because of this bias, this study probably overstates the case in favor of capital account liberalization. If there was some way to remove this bias, Rodrik postulates, "we might even find a *negative* relationship between open capital accounts and performance."

Paul Krugman of MIT has also noted the role of unregulated capital flows in causing the Asian crisis. He has endorsed the use of capital controls, including restrictions on currency convertibility, in Malaysia, and has recently advocated the same for Brazil.[56] "As long as capital flows freely," writes Krugman, "nations will be vulnerable to self-fulfilling attacks, and policymakers will be forced to play the confidence game. And so we come to the question of whether capital should really be allowed to flow so freely."[57]

Despite the powerful critique emerging from the worlds most prominent economists, as well as the growing willingness of some developing country governments to challenge the "Washington Consensus," the United States government and the IMF have continued to promote the liberalization of capital flows. This is undoubtedly driven at least partly by domestic political interests: politically powerful banking and financial interests in the United States have an interest in maintaining and expanding the free worldwide movement of capital. But these policies, as we have seen, can have a significant impact on the economies of Latin America. The FTAA investment negotiations may play an important role in determining what that impact will be.

RECOMMENDATIONS FOR FTAAINVESTMENT NEGOTIATORS

1. No provision should be adopted which restricts a signatory government's ability to impose limits on currency convertibility, during time of financial crisis, or under other circumstances in which the government determines that such action is in the national interest.

2. No provision should be adopted which restricts a signatory government's ability to impose so-called "speed bumps," in order to promote long-term investments over short-term inflows. No provision should be adopted which restricts a signatory government's ability to impose reserve requirements on portfolio investment.

3. No provision should be adopted which limits a signatory government's ability to impose a ceiling, or other restrictions, on foreign borrowing by domestic banks. Such measures may violate national treatment provisions under the NAFTA or the draft MAI.

4. No provision should be adopted which restricts a signatory government's ability to withhold government-subsidized insurance for the bank deposits of foreign investors.

5. No provision should be adopted which restricts a signatory government's ability to require administrative permission for a foreign bond issue and or impose minimum maturity periods for foreign bond issues

6. A signatory government's power to control the inflow and outflow of capital from its borders, even if such controls have the effect of "discriminating" against foreign

[56]See Krugman, September 7, 1998. On Brazil see, "Alas Brazil,"
[57]Krugman, October 5, 1998.

investors, must be affirmed and strengthened by any pan-hemispheric commercial agreement.

Appendix

Source: International Monetary Fund, *World Economic Outlook*, October 1997, October 1998. Data for 1998 and 1999 are IMF projections. (Note: Private projections and recent press reports suggest that net private capital flows for 1998 and 1999 will be markedly lower than the projections indicated above.)

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Investments and FTAA: Asymmetries in Investment Agreements Threaten Environmental Protection, Social Development and Sovereignty

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Executive Summary

Investments in production are necessary (but not sufficient) for economic development, social progress and environmental protection in Latin America.

Nevertheless, foreign investments, particularly short-term and speculative ones, represent a threat to the balance of payments and to the long-term financial viability of a model for development in which foreign investments predominate or are not regulated, as was demonstrated by the crisis initiated in southeast Asia.

The predominant perception of civil society in Latin America is that the negotiations on investments within the scope of the Free Trade Agreement of the Americas (FTAA) are based on similar principles already incorporated into the North American Free Trade Agreement and proposed in the Multilateral Investment Agreement within the scope of the OECD.

Such principles expand the rights of transnational corporations without creating any counterbalancing obligations, and they limit the capacity of governments and of citizens to establish national policies for social and economic development and environmental protection.

These measures have been rejected by significant sectors of civil society, including qualified spokespersons for churches, legislators, labour unions, women's groups, non-governmental organizations working on development issues, and Latin-American intergovernmental organizations.

The negotiations should not continue hidden away from public opinion and without an express political mandate of governments. They should not continue without prior consultation with civil society through democratic measures that include making available ample public information on the content of the negotiations and conducting studies on the social and environmental impacts of the eventual implementation of the measures being negotiated.

Introduction

If the Free Trade Agreement of the Americas (FTAA) were a person, it could be diagnosed with a serious case of multiple personality disorder. The few documents that have been approved and the preambles and declarations of good intentions describe it as an hemispheric agreement on education, democracy, and sustainable development. For negotiators and the press specialized in these issues, the agreement is a commercial negotiation in which the Latin American governments and the White House are allied against a strange protectionist alliance between the Republican right and environmentalists. Nevertheless, during the Santiago Summit, investments were the large underlying issue. What really is occurring is a battle between the rights and ambitions of large corporations and the capacity of civil society within the hemisphere and of the governments they have elected or will elect to decide their destinies.

References to investment issues in FTAA documents are rare. Heads of State, meeting in Miami in 1994, concluded that "A key to prosperity is trade without barriers, without subsidies, without unfair practices, and with an increasing stream of investments in production"[1] (underlined by the author)*. On deciding to enter into the FTAA process, governments resolved to "progressively eliminate barriers to investments and trade", declaring themselves "aware that investment is the main engine for growth in the Hemisphere". It seems obvious that presidents were referring to direct investments in production and that their explicit purpose was to increase these kinds of investments.

At the Second Summit, which took place in Santiago de Chile in April, 1998, the word "investments" was hardly mentioned and what was said was not much: "We believe that economic integration, investment, and free trade are key factors for raising standards of living, improving the working conditions of the people of the Americas and achieving better protection the environment. These issues will be taken into consideration as we advance the process of economic integration of the Americas." [2]

On the one hand, this could be due to the concern raised by the southeast Asiatic crisis and to the inherent warning from this crisis about the implicit risks of a rapid opening to capital markets. On the other hand, it is obvious that the lack of substantial political agreements in Santiago is due to the fact that President Bill Clinton arrived at the Summit with his hands tied, because the United States Congress had not approved the "fast track" proposal that would have authorized President Clinton to negotiate trade agreements with other countries without having to re-negotiate each of the clauses with the legislators of his country.

Respecting the letter, if not the spirit, of this disposition, the United States proposed at Santiago to delay the trade issues of the FTAA and to approve the investment chapter first. Brazil lead the rejection of this proposition, and obtained approval of the principle stating that "nothing is agreed until everything is agreed". In the corridors, some Latin-American negotiators expressed their frustration: after having paid high social costs by opening their economies, they maintained, it should have been time for the developed country "partners" of the region to open their economies to Latin-American trade, so that the Latin American countries could also reap some benefits. In reality, the only thing that they had obtained were vague promises to have access to Northern market in the year 2005 and stricter requirements for immediate liberalization in the realm of investments.

I. Foreign Investment and Development

Southeast Asia at the end of 1997 dramatically alerted those who had paid little attention previously to the risks of uncontrolled liberalization of economies and, more concretely, about some

[1] Declaration of Principles, Partnership for Development and Prosperity: Democracy, Free Trade and Sustainable Development in the Americas, Miami, December 1994.

[2] Santiago Declaration, Second Summit of the Americas, Santiago, Chile, April, 1998.

problematic aspects of foreign investment.

In a prescient work about foreign investment, economic growth and balance of payments, in 1996 the Malaysian economist Ghazali Atan predicted the southeast Asiatic crisis which took the IMF by surprise. [3]

Based on an analysis of the existing literature and on an empirical study of the Malaysia case (in which country he had worked in the Ministry of Planning and where he is now an investment advisor to the Kuala Lumpur stock market), Ghazali concluded that the economic growth of developing countries is based more on increases in internal savings and on investments of these savings into production than on foreign capital, including foreign direct investment (FDI).

Foreign capital, whether it comes as aid or debt or as FDI, can complement internal saving. In particular, FDI can contribute to capital for production, and can contribute to technology, markets and employment.

However, FDI, as well as other capital inflows, can have a negative impact on internal saving and, even more seriously, can effect the flow of trade and financial accounts.

From the point of view of the balance of payments, FDI signifies a capital inflow at the moment that it takes place, but later it leads to capital outflows through the remittance of profits. These outflows increase as the stock of FDI increases in the country, creating a tendency for there to be decapitalization (a reduction in capital assets). Comparing FDI with aid and debt, the study concludes that the "decapitalization effect" of FDI is greater, for the simple reason that aid pays 1.5% annual interest rates (soft loans) and commercial debt pays 10% (in countries with good credit), while investments expect an annual return of 15% on capital. Avoiding decapitalization by increasing the capital inflows would lead to a "financial pyramid" that would not be sustainable in the long term.

From the commercial side, FDI has a positive effect because it increases the income from exports and reduces the imports (if at least part of the investment is used to produce goods for the local market). Nevertheless, there is also a growth in the import of capital goods and materials. And in many cases it has been demonstrated empirically that FDI changes local consumption patterns by stimulating the import of consumer goods and luxury items.

For FDI to have a positive effect on the balance of payments, the positive commercial effect must be strong enough to compensate for decapitalization.

Ghazali concludes that FDI can have positive effects on economic growth and development if it meets the following conditions:

- FDI is not higher than internal savings;

[3] Dr. Ghazali Atan, "The effects of FDI on trade, balance of payments and growth in developing countries, and appropriate policy approaches to FI", Third World Network Seminar on the WTO and Developing Countries, Geneva, 1996.

- it stimulates joint ventures such that at least part of the earnings are retained in the local economy;
- the foreign companies are priced in the local stock market;
- the FDI is concentrated in the export sector; and
- the local component of production increases, so as to improve the commercial impact.

The financial crisis which started in

Ghazali warns that "countries that encourage FDI without paying attention to these conditions are running risks." The economic debacle of southeast Asia soon after departing from these conditions and opening capital markets in an unrestricted fashion proved him correct.

Dani Rodrik reaches similar conclusions[4], after conducting a comparative study of the economic growth between 1960 and 1975 (under the industrialization strategy of import substitution) and that between 1975 and 1989 (with the political predominance of economic liberalization): "…the greatest difference between Latin America and southeast Asia is not that the first was closed and isolated, while the other one was integrated with the world economy. The difference is that the first did not do a good job of contending with the turbulence emanating from the world economy. It is not the liberalization *per se* that matters, but rather how it is managed."

With a similar meaning, the 1997 World Investments Report[5] of the United Nations Conference on Trade and Development (UNCTAD) points out that the "governments in all countries are often (if not always) faced with having to choose between competing objectives". Those objectives that would be in opposition to a rapid opening of foreign investment "include safeguarding national security; protecting labour rights; safeguarding culture; protecting consumers; and promoting development."

Balancing these conflicting objectives is precisely the task of a democratic government which, by definition, must represent the common good and must balance conflicting interests. In the case of developing countries, as stated by Rubens Ricupero, the Secretary-General of UNCTAD, in the aforementioned Report, "the promotion of economic development of course occupies a position of primary importance. Given the particular characteristics of developing countries—low income levels, skewed distribution of wealth, insufficient infrastructure, low levels of education, and asymmetries in information—(…) when such conflicts occur, their resolution may require formulation of a mix of policies that limit exposure to free competition for a certain period of time (…) as well as measures to assist and stimulate increases in domestic capacity, on the other hand. Indeed, the key issue is to help domestic companies develop their potential."

[4] Rodrik, Dani, "Globalization, social conflict and Economic Growth", 8th Raul Prebisch Lecture, delivered at the Palais des Nations, Geneva, on 24 October 1997.

[5] UNCTAD, "World Investment Report 1977, Transnational Corporations, Market Structure and Competition Policy", United Nations, New York and Geneva, 1977.

Even after many year of economic liberalization and efforts to attract foreign investment, Humberto Campodónico[6] finds restrictions to the flow of FDI for communications in Argentina, Bahamas, Brazil, Chile, the Dominican Republic, Ecuador, Honduras, Panama and Venezuela, in national security and defense in the Bahamas, Chile, Colombia, the Dominican Republic and Ecuador; in fossil fuel production and exploration in Costa Rica, the Dominican Republic and Paraguay; in nuclear energy in Brazil and Trinidad and Tobago; in air transport in the Bahamas and Brazil; in mining activities in Costa Rica, the Dominican Republic and Guatemala; in banking activities in Ecuador, El Salvador, Guatemala, Paraguay and the Dominican Republic. Furthermore, (and the list is not exhaustive), Honduras and Paraguay require equal local participation for certain industries and in air and maritime transportation; the Bahamas in the generation and distribution of gas and electricity; Guatemala and Honduras in the exploration and exploitation of fossil fuels; Costa Rica in radio and television; the Bahamas in hotels; Brazil, the Dominican Republic and Venezuela in fisheries; the Dominican Republic, Honduras and Venezuela in the insurance industry. Foreign investment in the petroleum sector is limited in Mexico and Venezuela. In Uruguay, oil refining, electricity generation, and telephone services continue to be State monopolies. Argentina, which has one of the most liberalized regimes, restricts foreign land ownership in boundary zones, as do many of the other Latin-America countries. Studies done by the working groups of the FTAA[7] have found abundant examples of this kind, even when, in efforts to appear attractive to foreign investors, the existing regulations are concealed or omitted.

[6] Campodónico, Humberto, "The MIA and Latin American countries", Desco Peru, 1996.

II. Transnational's Claim

Despite the lack of progress in the negotiations reflected in the presidential Santiago Declaration, the Heads of State endorsed in the Chilean Capital that which their Ministers of Trade had worked out in San Jose de Costa Rica. There it had been decided to elevate the "study groups" and transform them into "negotiation groups", among them one on investment.

The objective of the study group on investment was:

- Prepare a guide to the investment regimes of the Hemisphere;
- Promote access to existing Arbitration Conventions;
- Publish an inventory of the existing investment agreements and treaties in the region.[8]

In comparison, the negotiation group has a much more ambitious objective: "To establish a fair and transparent legal framework that promotes investment through the creation of a stable and predictable environment that protects the investor, her investment and related flows, (…)."[9]

[7] See: "Trade and Integration Arrangements in the Americas: An Analytical Compendium" and "Western Hemisphere Trade Arrangements: An Analytical Compendium ", Organization of the American States, Trade Unit.

[8] Cartagena Declaration.

[9] San Jose Declaration.

There is nothing in the official documents that indicates by what magic the group moved from the task of compiling existing regulations, with the purpose of exploring their similarities and particularities, to the task of establishing a "new legal framework", i.e. an international treaty or agreement. The documents set forward that said framework should "protect the investor", but do not mention protection of consumers, workers, or even free competition. Nor do the documents mention the existing rights of the country that receives investments to protect their priorities for national development.

Furthermore, the San Jose Declaration says that the negotiating group on investment can coordinate its work with the group on services (obviously, to be able to provide services in a country—as compared to being able to sell a product— the foreign company has to be able to establish itself within the country, or, in other words, to invest), but it does not mention a link with the negotiating group on policies on competition. As is well known, transnational corporations that establish themselves in smaller countries or in countries with developing economies rapidly gain a monopoly position in the local markets, eroding the possible benefits that this investment could bring to national development and to consumers. Nevertheless, the Declaration recommends that the negotiating group on policies on competition coordinate its actions with the group that handles subsidies, suggesting that those which need protection are the the transnational corporations from the dumping practices of local subsidized enterprises.

The official documents of the negotiating groups are so scarce that, in order to have an idea of what is being negotiated, it is necessary to consult unofficial documents that come from the Business Forums. These Forums have been developing in parallel to the official negotiations and in close interaction with the official negotiations, in contrast to the Civil Society Forums (the labour unions, environmental and even legislative forums) which not only are few but have been largely ignored by the negotiators.

In this sense, the Workshop on Investment held in San Jose claimed to "negotiate an Hemispheric Agreement that permits national treatment, the right to establishment, repatriation of profits, and access to convertible currency." [10] The Workshop on Large Corporations was claiming two years before to have "negotiated an Hemispheric Agreement on Investment [that stipulates]: national treatment, the right to establishment, repatriation of profits and capital, protection against expropriation and access to internal markets, without restrictions such as requirements for exportation." [11]

These reports appear to be a literal translation into Spanish of the position paper by the Association of American Chambers of Commerce in Latin America, which demanded a Convention on Investment for the year 2000 including: “national treatment; the right of establishment in sectors now opened to investment; full and free repatriation

[10] Fourth Ministerial Meeting on Trade and Business Forum, “Synopsis of the Workshop on Investment”, San Jose, Costa Rica - March, 1998.

[11] Americas Business Forum, “Final Report, Workshop IIB: Big Enterprises and Integration", March 18 to 21, 1996.

of capital, profits, and dividends; protection against expropriation, and fair, adequate, and effective compensation in cases where expropriation occurs; and a prohibition against performance requirements." [12]

The sharpest summary is that of the American Electronics Association: "AEA suggests that a hemispheric investment agreement draw upon the principles of the Multilateral Agreement on Investment (MAI) under the auspices of the OECD." [13]

III. Peak, fall and resurrection of MIA

During the 1970's, transnational corporations energetically and efficiently opposed the adoption of international rules or codes of conduct that would regulate their activities. In the following decade, encouraged by the political climate in Reagan-Thatcher era, these corporations moved into the offensive position and began to demand from the GATT Uruguay Round the imposition of codes of conduct on governments that would not impede them from regulating the transnational's activities. [14] They achieved part of what they wanted to. In exchange for promises of the future opening of the North's markets to the South's products, the Uruguay Round obtained from the developing countries the opening of their markets to services, the recognition of their intellectual property rights and the so called TRIMS (Trade Related Investment Measures) that include some dispositions concerning investments following the parameters of the Wold Trade Organization (WTO).

In terms of the explicit goal of transforming the whole world into a uniform and level "playing field", the achievements gain at the Uruguay Round were not enough. Even before the signatory countries fully understood the implications and significance of the obligations they had assumed, and even before the period for adjusting national legislation and economies to meet the new obligations had closed, the proposal for the Multilateral Investment Agreement (MIA) was introduced. It is argued that, without this agreement, foreign investors would not have confidence and would decide to place their capital somewhere else.

MIA's principles truly constitute a "charter of rights for transnational corporations", rights that are not accompanied by "obligations", as is the case with citizens in relation with their States. The MIA defines "investments" in a very broad manner and its first principle is the one of so-called "no discrimination", which establishes that a foreign investor must not be treated less well than the national investor. This does not mean that they will be treated "equally", because the proposed agreement does not impede a foreign investor from receiving BETTER treatment than a national investor (e.g. exemption from taxes that the national investors are not granted), which could foreseeably occur, given the competition among the countries to attract investors. With this favorable treatment is the right of investors to appeal an any

[12] Position Paper presented by the Association of American Chambers of Commerce in Latin America, San Jose, Costa Rica - March 1998, Workshop 3: Investments.

[13] Position Paper presented by the American Electronics Association.

[14] Haxton, Eva y Claes Olsson, editors, "WTO as a Conceptual Framework for Globalization", Global Publications Foundation, Uppsala, Suecia, 1998.

governmental measuring before an international arbitrator, instead of making the appeal within the national justice system. Such arbitration, which must be resolved within a few months, is unappealable and has higher authority than the national justice system and, it can only be invoked by the foreign investors and not by national companies nor the citizens of the country.

Expropriation is one of the measures about which the investor can make an appeal before such arbitration, demanding its elimination, demanding monetary compensation, or both at the same time. For MIA, "expropriation" is defines in such a broad way that it includes not only the classic expropriation of property or assets of an investor for public interest reasons, but also "expropriation of rights". The latter could occur when, for ezample. governmental dispositions limit or prohibit certain activities for reasons of public health or environmental protection. Based upon already existing similar dispositions of the North America Free Trade Agreement (NAFTA), the United States company Ethyl sued the Canadian government for banning the addition of manganese to gasoline because of the neurological damage that these gases could cause. The simple threat of demanding 400 million [dollars] in compensation for "lost profits" compelled the Canadian government to lift the ban, to apologize to the company, and to compensate it with 15 million dollars for damages incurred to their reputation, despite the fact that Ethyl did not prove that the concerns of the Canadian sanitary authorities where unfounded.

The wisdom of conceding [the right to grant] national treatment was put in doubt by a group of experts on the matter who were convened by UNCTAD meeting of experts on these issues, "because the public authorities would then be deprived in this situation of their capacity to increase the success of national companies in the face of foreign competitors."…The experts pointed out "that the host Governments should have the option of implementing policies to address specific cases, and to offer protection guarantees for investments only to those investors which had already been admitted."[15]

But this capability to admit or deny investments, equivalent to the right of granting or denying residency to foreign citizens, would be expressly prohibited by MAI, as MAI guarantees the "right to establishment" (including the right of residency for its executives, managers and technicians) to any foreign corporation in any sector of activity, including ownership of land, of natural resources and of the communication media, currently reserved for national or public companies by the legislation of many countries.

Putting together the clauses against discrimination and those of "expropriation" would in fact impede the improvement of environmental and sanitary regulations, and would impede any action directed at promoting a specific sectors of the population: peasants, small businesses, women, or members of disadvantaged groups, as any foreign investor could automatically

[15] UNCTAD, Report of the Expert Meeting on Existing Regional and Multilateral Investment Agreements and their Development Dimensions. Geneva, April de 1998 (TD/B/COM.2/11).

demand the same benefits and demand compensation.

Finally, once a country subscribes to the Agreement, it will not be able to withdraw from it for 5 years and, if it does, any benefit obtained by the investors during this period must be maintained for 15 years.

The MIA does not require compliance with any code of conduct on the part of the foreign investor in exchange for such concessions. On the contrary, any "performance requirements" demanding, for example, employment of national labour and utilization of national inputs, technology transfer, exports of a certain percentage of production, or the incorporation of national personnel into management, are expressly prohibited. With this agreement, one erases with the stroke of a pen the possibility for governments to establish development policies or even to try to limit some of the positive impacts of FDI or to neutralize the negative ones.

Are these sacrifices necessary to attract investors, and to generate employment and economic growth? The Agreement does not guarantee that, once it is signed, investors will come.[16] If the whole world shares these rules, countries will have to offer additional attractions to be more attractive than their neighbors. In fact, however, during the last few years, foreign investment has entered extensively into countries like China where foreign investment is strictly regulated, while rejecting many countries that unilaterally have offered similar conditions to the MIA, but that lack consumer markets, natural resources or other comparative advantages that would guarantee high profit returns.

Scandalized by the concessions that were demanded of them in the drafts of the investment agreements, many developing countries successfully opposed their incorporation into the negotiating agenda of the World Trade Organization (WTO). The investment agreement proposal was transferred to the OECD, the select "club of the rich" that brings together 29 industrialized countries. As the objective never was to have an "agreement among equals" but to establish a universal regime for investments, Argentina, Brazil and Chile were invited to participate as observers in these negotiations. The OECD initiated a public relations campaign in Africa, Asia and Latin America to convince the developing countries to sign the agreement, which had just been signed in April of 1998, even though they had not participated in the discussions.

Nevertheless, when the terms of the discussions were leaked and were publicized on the Internet halfway through 1997, the alarm of public opinion within the developing countries was able to detain the negotiation process for MIA in the scope of the OECD. A broad coalition of citizens groups, environmentalists, labour unions, human rights groups, and consumer groups opposed the MIA and obtained the support of local governments and parliaments, who felt threatened about loosing the right to

[16] "It was generally agreed that international agreements per se, however friendly to investors, could not guarantee an increase in FDI flows". Economic conditions for investment determine the capability to attract investments. Among those condition we also find political and economic stability, stable and transparent institutional and legal framework (…). Ibid.

decide over many issues that had always been under their authority.

In Canada, the provincial governments announced that they would not tolerate the implementation of such an agreement within their territory. The French Assembly opposed the terms of the Agreement.

If such an agreement is bad for developed countries, its impact would be worse for developing economies. In the opinion of Magda Ibrahim, the Vice-Minister of Foreign Affairs of Egypt, who is responsible for International Economic Affairs, "a rational economic basis for a multilateral investment agreement does not exist. The only justification for this agreement is that it will benefit transnational corporations. If developing countries panic and believe that as soon as they liberalize their markets, they will have more investments, their mistake will only add to the damage to the development cause." [17]

During a dialogue session between governmental negotiators and a group of NGOs from around the world that took place in Paris in December, 1997, the author of this paper asked the Asiatic members of the OECD if their countries would have developed such that they could be present in the organization of OECD if they were to have implemented the MIA rules two decades ago. The rules agreed upon for participation in the meeting prevent attribution of the response to a particular delegate or country, but do not prohibit the quotation of the statements made: "we would never have been able to develop following those rules, but now that we are an industrialized country and our companies invest overseas, we are in condition to reach agreements amongst equals."

Instead of signing the agreement, in April of 1998 the ministers of OECD resolved to suspend the negotiations for six months and promised to start a broad debate on the theme. "MAI is not bad because it is secret, it is secret because is bad" declared a representative of Third World Network upon becoming aware of this resolution. Even more energetic was the statement made by Lori Wallach, an effective lobbyist for United States consumers, who compared the agreement with Dracula: "it can not live under the light of day".

The influential Financial Times editorialized on the issue, commenting that “the international negotiations on the economy will not be as they were", and alerting governments about the risks of continuing to exclude or ignore public opinion and citizens groups in the hour of making decisions about globalization. [18]

The MIA is also an issue of concern for intergovernmental organisms: a resolution adopted by consensus on August 20, 1998, by the United Nations Human Rights Commission Sub-Committee for the prevention of discrimination and for protection of minorities, reminds governments that the protection of human rights " is the first and fundamental responsibility and objective of the States." Taking note of "the general protests of civil society

[17] ShaHIN, Magda, Multilateral investment and competition rules in the WTO: an assessment”, EN Transnational Corporations, Volume 6, Number 2, August 1997.

[18] Financial Times , “Network guerrillas”, THURSDAY APRIL 30 1998.

against MAI based upon concerns about its adverse impacts on human rights, the environment and sustainable development", the Sub-Committee expressed its fears that the agreement "could limit the capacity of States to take pro-active steps to ensure that everyone enjoys economic, social and cultural rights and that it could create benefits for a small privileged minority at the cost of an increasingly marginalized majority".

In October 1998, when the negotiations were going to begin again, the German president of the negotiating group did not attend, the European Parliament emitted a resolution of oppostion, and the initiative collapsed.

The Multilateral Investment Agreement in the FTAA

Despite having received such strong blows, the MIA, like Dracula, is being reborn into the framework of other negotiations. Already floating in diplomatic negotiations is the idea of reviving the Agreement within the framework of the proposed "Millenium Round" that would be launched in the ministerial meeting of the WTO that is to take place at the end of this year. In addition, MIA's terms reappear in the preliminary talks of the Transatlantic Treaty between North America and Europe, and the cornerstone of the Treaty's philosophy appears to be taken from the FTAA. Every polemical aspect of the MIA is on the table of the negotiating group.

FTAA's official Internet site points out with a certain pride that "the breadth of the negotiations which will be set in place by the San Jose Declaration is unprecedented even by the standards of the Uruguay Round." They have set the goal (not established in any official document) of even "going beyond previously agreed measures for liberalization within the hemisphere" and "will include new themes such as a common investment regime, […] which themes are not currently addressed within the framework of the WTO and which are not even a part of the agreements existing amongst a great number of countries." [19]

This editorializing, apart from being inadmissible for an official site in treating themes over which there is no agreement yet, does not raise the question of why there is such resistance "amongst a great number of countries" that is impeding the adoption of such measures; furthermore, it ignores the internal opposition within the Hemisphere. The FTAA official Internet site would have done well to quote from the Declaration of San Jose where the latter points out that "in the designing of the FTAA, we shall take into account differences in the levels of development and size of the economies in our Hemisphere[…]." [20] In light of this concept, the idea of liberalizing so as to compete is equivalent to maintaining that a fight between Mike Tyson and an undernourished teenager from a shanty can be fair, because the combat rules for both would be the same.

During the Parliamentary Forum and the Civil Society Forum of the "People's Summit" held in Santiago in a parallel manner to the official events, criticisms related to these themes were strong and expressive. The MIA and its

[19] http://www.ftaa-alca.org/view_e.asp

[20] Ministerial Declaration of San Jose, Summit of the Americas, Fourth Trade Ministerial Meeting, San Jose, Costa Rica, March 19th, 1998.

Hemispheric alternative were for the first time were publicly debated in Latin America, and the rejection of such initiatives was practically unanimous at both events.[21] "We denounce and we reject the negotiation and adoption of MIA because it attempts against sovereignty" states the Common Declaration of Parliaments. The final Declaration of the People's Summit demands "that the fundamental renunciation of our economic sovereignty —which would imply settlement of Free Trade in the Americas or Multilateral Investment Agreements— must be decided finally and directly by the citizens of America, through mechanisms of public consultation preceded by well informed national debates."

The Brazilian bishops made similar pronouncements: "MAI concerns us, as its approval on the part of Brazil would have disastrous consequences for our capacity to direct our development in a sovereign manner."[22]

The Association for Latin America Integration (*Asociación Latinoamericana de Integración, ALADI*) expresses similar concerns: "The Multilateral Investment Agreement could deepen asymmetries", warns a public analysis done by the General Secretariat.[23]

The document concludes, among other aspects, that the inclusion of short-term investments into MAI could seriously "limit government's capacity to regulate capital flows with the intention of avoiding financial crises and problems with the balance of payments.

MAI "invades other areas already contemplated by other agreements", such as services, intellectual property, or investments treated in the World Trade Organization, and even if one does not now know what the impact will be upon such areas, "the important point is that MAI not invade other areas nor contain more restrictive dispositions than those already existing".

The document questions the argument that a multilateral agreement will generate an important increase in foreign direct investment in the region: it recalls that a great increase in this flow has already occurred over the last fifteen year without the existence of this kind of agreement and that "furthermore, there does not seem to be a correlation between liberalization and in-flow of capital."

For its part, the Latin America Economic System (SELA, in its Spanish acronym) recalls the two principal arguments raised by several countries opposed to negotiations on investments within the WTO: (i) preservation of each country's sovereignty in determining treatment of foreign investment; (ii) bilateral or multilateral agreements on investments are not fundamental to attracting foreign capital. Both arguments can by applied to the FTAA investment negotiations.

In a previous "strategic note", the SELA enumerates "some questions" that the Latin American and Caribbean

[21] Memoria de la Cumbre de los Pueblos de las Américas, Ediciones Cumbre de los Pueblos de América, Santiago de Chile, enero de 1999.

[22] "Declaração do Conselho Permanente da CNBB Diante das Eleições de 1998" distribuía y leída en todas las iglesias en setiembre de 1998.

[23] Boletín mensual editado por la Secretaría General de la ALADI, Enero 1999 / Año III - Nº 30. Ver en http://www.aladi.org/noticias/98/news_30.htm#5

countries should consider in formulating policies on investment matters.

- How to achieve compatibility between the need for protection, non-discrimination and attraction of foreign investment and the high-priority need to attract capital that is stable and productive?

- How to reconcile non-discriminatory opening, national treatment and most favored nation with national development objectives and with the consolidation of schemes for integration?

The MIA, or the inclusion of its principles in a hemispheric agreement, is not the answer to any of these dilemmas.

CONCLUSIONS

The predominant perception of Latin American civil society is that the negotiations on investments within the scope of the FTAA are based on similar principles already incorporated into the North American Free Trade Agreement (NAFTA) and proposed in the Multilateral Investment Agreement within the scope of the OECD.

Such principles expand the rights of transnational corporations without creating any counterbalancing obligations, and they limit the capacity of governments and of citizens to establish national policies for economic and social development and environmental protection.

These measures have been rejected by significant sectors of civil society, including qualified spokespersons for churches, legislators, labour unions, women's groups, non-governmental organizations working on development issues, and Latin-American intergovernmental organizations.

The negotiations should not continue hidden away from public opinion and without an express political mandate of governments. They should not continue without prior consultation with civil society through democratic measures that include making available ample public information on the content of the negotiations and conducting studies on the social and environmental impacts of the eventual implementation of the measures being negotiated.

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Environmental Protection and Investment Rules in the Free Trade Area of the Americas

The Center for International Environmental Law*

* Brennan Van Dyke, Stephen Porter and Bella Sewall drafted this paper with valuable research assistance from Tiffany Donovan, Braden Penhoet and Zachary Tyler.

I. Introduction

The connection between investment rules and environmental concerns has received considerable attention over the past several years as international capital flows have increased, thereby increasing the environmental impacts of international economic activities. The purpose of this paper is to discuss the concern that FTAA investment rules could undermine efforts to promote sustainable development if those rules are based on the deregulatory model of international investment liberalization typified by the investment chapter of the North American Free Trade Agreement (NAFTA).[1]

While this paper focuses on the negative effects of some of the key provisions of liberalized investment rules, we note but do not explore in detail a number of "positive provisions" that could improve investment regimes. In particular, investment rules must contain provisions that: prevent host countries from attracting investment by lowering or relaxing health and environmental standards; require investors to conduct environmental impact assessments for any significant projects; give citizens and local communities access to relevant information regarding investments; ensure that environmental standards are progressively improved and consistently enforced; and create mechanisms for Parties and citizens to raise issues related to the environmental and social impacts of increased economic activity due to greater investments flows. Above all, a regime that grants broad rights to investors, as the NAFTA does, should impose concomitant responsibilities on investors to ensure that their actions meet minimum corporate accountability standards.

The NAFTA investment chapter is chosen for analysis because NAFTA was negotiated by three of the most economically powerful countries in the region, and is a likely model for FTAA investment rules. Based on case studies of suits that have been brought under the NAFTA's investment chapter and a discussion of the threats that NAFTA investment rules pose to the ability of governments to regulate to achieve environmental goals, to protect public health and safety, and to promote the fundamental goals of sustainable development, this paper concludes that the NAFTA model should not be used as a template for the FTAA investment negotiations, and offers preliminary recommendations for approaches to ensure that regional investment rules better promote the goals of sustainable development.

Section II briefly describes the environmentally harmful effects of key NAFTA investment chapter provisions. The following sections explain these environmental problems in greater detail and note the risks for the Western Hemisphere of basing the FTAA investment rules on the deregulatory models of the NAFTA. The final section concludes with guidelines for regional investment rules that will produce environmentally responsible as well as commercially secure investment.

II. Overview of Environmental Impacts of NAFTA Chapter 11

[1] North American Free Trade Agreement, 8 Dec. 1992, Can.-Mex.-U.S., 32 I.L.M. 289 (entered into force January 1, 1994).

Although at first glance NAFTA's investment chapter does not relate to environmental protection, the rules set forth in this chapter have the potential to restrict the ability of governments to take action to protect and promote the common good, and may therefore undermine the ability of the public to safeguard the environment. Investment rules should not elevate the right of investors to profit from their investments over the public interest. The danger of NAFTA-style investment rules is that they do not provide a mechanism for balancing the rights of neighboring property owners and local communities to a safe environment against the rights of foreign investors.

NAFTA's investment chapter, Chapter 11, is composed of two main parts: general rules governing treatment of investors of NAFTA Parties, and rules establishing a procedure for settling disputes between a Party and investors of another Party ("investor-to-State dispute resolution process"). The general rules that raise the most immediate concern from an environmental perspective include the provisions relating to expropriation and technology transfer and other performance requirements.[2]

The expropriation provisions are drafted broadly enough to raise concern that corporations will use them to exact compensation from governments for imposing regulations, even when such regulations are promulgated in the normal course of regulating in the public interest. The prohibitions against performance requirements, such as conditioning foreign investment on technology transfer, diminish the bargaining power of developing countries when negotiating with corporations over the terms of access to their economies and natural resources and undermine fundamental principles of sustainable development set forth in multilateral environmental agreements such as the Rio Declaration, Agenda 21, the Convention on Biological Diversity, the Convention to Combat Desertification, and the Framework Convention on Climate Change.[3]

If the NAFTA included provisions for resolving disputes between government regulators and investors that balanced the interests of the many stakeholders involved, then these rules would pose less of a threat to the environment because avenues would exist for adjusting them through democratic process. However, the NAFTA's investor-to-State dispute settlement procedure exacerbates all the environmental concerns related to

[2] *See* NAFTA, *supra* note 1, Art. 1106: Performance Requirements and Art. 1110: Expropriation and Compensation. There are also concerns relating to the most-favored-nation provisions of Chapter 11 (requiring that all foreign investors be treated as well as the foreign investor that receives the most favorable treatment) and future operations of the Clean Development Mechanism (CDM) of the Kyoto Protocol to the Framework Convention on Climate Change. The CDM allows those countries with commitments under the Protocol to gain credit against those obligations by investing in developing countries. Thus the CDM regime may create a situation where certain investors would get approval and/or credits for investments that another investor would not. These issues will not be addressed further in this paper.

[3] *Rio Declaration on Environment and Development,* June 13, 1992, U.N. Doc. A/CONF.151/26 (vol.I), 31 I.L.M. 874 (1992); *Agenda 21,* June 13, 1992 U.N. Doc. A/CONF.141/26 (vols. I, II, & III) (1992); *Convention on Biological Diversity,* June 5, 1992, 31 I.L.M. 818 (1992) (entered into force December 29, 1993; *United Nations Convention to Combat Desertification in Countries Experiencing Serious Drought and/or Desertification, Particularly in Africa,* October 14, 1994, 33 I.L.M. 1328 (1994) (entered into force December 26, 1996); *United Nations Framework Convention on Climate Change,* May 29, 1992, 31 I.L.M. 849 (1992) (entered into force March 21, 1994) .

provisions in Chapter 11 because the process is biased, secretive, and closed to the participation of the majority of potentially affected members of civil society.

Chapter 11 is unbalanced: it fails to protect the interests of non-investors. It forfeits an opportunity to promote national development and constrain corporate behavior by balancing the rights of investors with appropriate responsibilities designed to ensure that investment activity contributes to sustainable development.

III. Expropriation and Compensation in Chapter 11

Chapter 11 requires Parties[4] to compensate investors for acts, taken in the public interest, that expropriate or nationalize a foreign investment and for measures *tantamount to* nationalization or expropriation.[5] Requiring compensation for State deprivation of property is common policy; indeed, the expropriation language in Chapter 11 echoes that found in bilateral investment treaties (BITs) throughout the Hemisphere.[6] However, under the BITs, expropriation provisions have been used conservatively enough to permit governments to regulate uses of private property for public protection. There is evidence that investors are not showing the same restraint in bringing NAFTA expropriation claims.

Under a broad construction of expropriation, a government could be required to "pay to regulate" polluters if a court or international arbitration panel were to decide that an environmental regulation (e.g. refusal to permit construction) had reduced the value of a foreign investment, either directly or indirectly. Such an approach to environmental regulation would turn the polluter pays principle on its head—the government would have to pay the corporation for not polluting.

The NAFTA model for expropriation provisions raises concern that companies will successfully use such provisions to attack legitimate environmental regulations. The following look at recent claims brought under the NAFTA's expropriation and compensation provisions reveals that the concept of expropriation may be evolving in a dangerous direction. Moreover, the NAFTA places responsibility for the evolution of the expropriation doctrine in the hands of closed arbitration panels. As discussed in Section V below, certain characteristics of these arbitration fora

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[4] Chapter 11 also includes an obligation on the parties (national governments) to "ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments." NAFTA, *supra* note 1, Article 105.

[5] The operative language is contained in Article 1110 and reads:

1. No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except:
   - (a) for a public purpose;
   - (b) on a non-discriminatory basis;
   - (c) in accordance with due process of law and Article 1105(1); and
   - (d) on payment of compensation in accordance with paragraphs 2 through 6.

While the agreement contains some exceptions, the expropriation and compensation obligations are excluded from the scope of those exceptions. NAFTA, *supra* note 1, Article 1108.

[6] OAS, INVESTMENT AGREEMENTS IN THE WESTERN HEMISPHERE: A COMPENDIUM, SG/TU/WG.INV/DOC. 10/Rev.1, May 1997. The most common formulation of the prohibition against state deprivation of property in the BITs between countries of the Hemisphere is "expropriation, nationalization or measures which have a similar effect."

heighten concern over treatment of environmental regulations. Similar expropriation and compensation rules in an FTAA that would likewise be vulnerable to broad interpretation could severely retard the development of environmental law across the Americas. The mere threat of litigation may be enough to prevent the adoption or enforcement of environmental legislation, particularly in smaller countries that lack the resources to defend their laws before arbitral panels.

A. The Definition of Expropriation Is Still Evolving and Highly Controversial.

What do "expropriation and nationalization" mean under international law, and what are measures "tantamount to" expropriation or nationalization? If the experience of national courts is any guide, the application of the law of expropriation to government regulation will be a subject of heated political and legal controversy. In borderline cases, governments do not seize property, but they do impose limits on what the owners can do with their property. While nations are in general agreement that the physical taking of property by the State should be compensated, the question of at what point regulations deny investors the "use and enjoyment" of their property to such an extent that they deserve compensation remains open. Absent clearly defined limits to the types of regulatory action deemed to trigger compensation requirements and in the context of an international dispute settlement process with a strong pro-business slant, international corporations could easily take advantage of an expropriation clause to place far more limitations and financial obligations upon governmental agencies than many of the framers of these agreements are intending.

In the United States, property rights proponents have introduced "takings" legislation (the national equivalent of expropriation)[7] that would require compensation for government regulatory actions. These efforts have been defeated repeatedly by grassroots opposition on the grounds that such laws would severely constrain the government's ability to protect the environment and public health and safety. Cases involving regulatory expropriation have come before the U.S. courts, and rulings have varied as courts attempt to balance the investment backed expectations of private property owners with the responsibility of government to enact regulation to protect the public. The proper balance between private and public rights remains a deeply controversial issue for governments everywhere. [8]

Now, it appears that the domestic U.S. debate over whether government regulation constitutes a taking has

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[7] *See* Frank I. Michelman Testimony Before The Senate Committee On Environment And Public Works, June 27, 1995 49 Wash. U. J. Urb. & Contemp. L. 1 (1996) (asserting that such elevation of private property rights would run counter to traditional American constitutional jurisprudence); *see also*, COMMENT: Legislative Expansion of Fifth Amendment "Takings"? A Discussion of the Regulatory Takings Law and Proposed Compensation Legislation, 15 UCLA J. Envtl. L. & Pol'y 243 (1997).

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[8] The "takings" debate is more contentious in the United States than it is in some other countries that recognize that property ownership carries with it social obligations. For example, Article 14 of the Constitution of Germany states that "property imposes duties. Its use should also serve the public weal" (Available at http://www.jura.uni-sb.de/law/GG/gg1.htm). This provision explicitly links property ownership with the responsibility to respect regulations deemed to be in the public interest.

emerged at the global level. Disturbingly, these international efforts have stretched interpretations of what constitutes expropriation of an investor's property, and threaten to elevate property rights above all other considerations. Claims brought under the NAFTA's expropriation provisions seek to force governments to compensate investors for regulatory action that diminishes the value of investments, even when such regulatory action is prompted by serious environmental and health concerns. In one case, a U.S. based corporation was successful in obtaining compensation from the government of Canada and forcing the repeal of an environmental law.[9] These cases differ substantially from cases involving literal government expropriation of property or creeping expropriation where discriminatory and arbitrary government conduct deprives property owners of effective control over the use or disposition of a substantial portion of their property.[10] It is useful to review these cases to reveal how far from traditional notions of expropriation the NAFTA cases may be moving.[11]

B. Evolution of Expropriation Rules in NAFTA Jurisprudence: Two Cases.

1. The Metalclad Case. Concern over the possibility that the expropriation and compensation provisions of the kind found in the NAFTA might be used to bring regulatory takings claims against developing country national, state and local governments is not merely speculative. A regulatory takings claim for $90 million in damages was brought on January 2, 1997 by the Metalclad Corporation, a United States multinational with Mexican subsidiaries, against the government of Mexico.

The Metalclad corporation purchased a hazardous waste disposal facility in the Mexican state of San Luis Potosi. The facility had had a history of unregulated toxic discharges and conflict with local communities. The Mexican federal government approved operation of the facility in 1995, but at the time Metalclad brought the claim, the state government had yet to grant its approval as required under Mexican law. The company filed an investor-state action under NAFTA alleging that the approval delays at the national and state levels expropriated its investment.

The Metalclad case shows that investors will use the law of expropriation to demand the right not only to continue activities that have been permitted in the past, but also to initiate new activities even before government regulators have determined whether the new activities pose a danger to public health or the environment. This case attacks a *failure* to act on the part of a government as a sort of "regulatory expropriation." If successful, the Metalclad corporation will have opened not only government regulatory action, but also government inaction, to legal attack by foreign corporations.

The Metalclad company's interpretation of expropriation threatens to interfere significantly with government choices about resource allocation. Governments, especially

[9] The Ethyl case referred to here is discussed in detail below in section III B.

[10] OPIC Contract of Insurance, Governing Terms and Conditions, art. 13; See also M.N. SHAW, INTERNATIONAL LAW 519 (3d. ed. 1991).

[11] In addition to the Ethyl and Metalclad cases discussed here, at least four other cases have been filed by corporations citing NAFTA provisions by the following corporations: SD Meyers (US), Loewens (Canadian), Sunbelt (US), and Pope and Talbot (US).

local and state governments in developing countries, often have limited resources. Sometimes as a result even legitimate permits are not processed quickly. The more complex the regulatory issues involved, the slower the regulatory process may become.

Environmental impact studies are often required for new projects that may entail significant environmental impacts. A country facing a limited budget may make a sovereign decision not to increase allocations of scarce resources to reviewing these studies, and thus to delay acceptance or rejection of new projects. A result could be to slow the pace at which new investors can enter the country.

Countries, especially developing countries, have limited governmental resources that must be distributed selectively. National and local governments are chosen by the public in order to make difficult decisions about how to allocate risks and resources, and each decision about whether to grant, deny, or delay an environmental permit reflects the choices that a government makes as it balances social, environmental, and economic priorities. Such decisions form the core of a country's sovereign right to allocate risks and resources. It would be inappropriate for an international agreement to constrain these sovereign decisions.[12] If investors do not like the pace of regulatory action by the host government, they are free to invest elsewhere.

While resource allocation decisions might not have been at issue in the Metalclad case, [13] the arbitration shows that regulatory delay can be the basis for an expropriation claim under the NAFTA investment rules. An international agreement should not force the country to regulate at a pace suited to international investors. Foreign investors should make their decisions to invest contingent on receiving the necessary permits and take into account the resources and laws of the governments of the countries in which they are investing. Government regulation serves a legitimate purpose, protecting society from threats to human health and the environment. Allowing investors to set the pace of regulation could overwhelm government capacity and leave the public unprotected.

2. The Ethyl Case. This case is the first expropriation claim, of those known to have arisen under NAFTA's investor-to-State dispute settlement system, to have been resolved. In April 1997, Canada banned the import of the gasoline additive, MMT, a suspected toxic substance .[14] Days later, the U.S.-based Ethyl Corporation brought a $251 million claim against the

[12] There are examples in international law in which countries have committed multilaterally to prioritize resources and thereby ensure the expeditious provision of specified government services. For example, governments' obligation to afford their citizens a prompt trial has been recognized in international and regional human rights accords. However, countries should be judicious in creating international obligations to allocate resources. In the area of environmental regulation, many countries are just beginning to develop the administrative infrastructure necessary to regulate their economic actors. Where an investment carries with it new technologies and environmental risks, adequate resources to make rapid permitting decisions may not exist.

[13] As filings in these arbitrations are not usually available to the public, it is not possible to detail the arguments on which the parties to this controversy have based their claims and defenses.

[14] *See* Herman, Lawrence, "'Expropriation' takes on New Meaning: MMT Case Sets Far-Reaching Precedent," *Financial Post (*July 28, 1998). Before the Ethyl case was brought, the US Environmental Protection Agency refused to allow the sale of MMT in the U.S. based on health concerns, but a December 1995 court decision overturned the EPA's ban.

Canadian government citing, among other issues, the expropriation provisions of the NAFTA. In August 1998, the Canadian government agreed to pay Ethyl $13 million in damages and to cover the company's legal costs. [15]

The threat of such legal actions is bound to intimidate governments that are contemplating the adoption of new environmental requirements. In response to the Ethyl claim, the Canadian government opted to change its law and pay damages rather than fight for its right to protect human health through environmental regulation. NAFTA-style rules could paralyze governments wishing to enforce environmental regulations but lacking the resources to confront a challenge – or the threat of a challenge – from lawyers representing U.S. investors. Indeed, the majority of the publicly-known NAFTA expropriation claims involve challenges to environmental and public health regulations. These claims demonstrate how expropriation provisions may interfere with the sovereign ability of state or local governments to set environmental standards.

C. Conclusion

Should the FTAA include expropriation provisions similar to those found in the NAFTA, the mere threat of being sued for compensation under these provisions will pressure governments, especially local and state governments, to abandon efforts to foster environmentally-sustainable development. This chilling effect could present a particularly acute problem in countries with very limited resources that are just beginning to reform environmental regulations and implement sustainable development policies. An approach to environmental regulation that accorded undue deference to property rights would severely limit the ability of governments—particularly developing country governments—to impose legitimate and desirable environmental or health laws.

In practice, the NAFTA expropriation language appears to stand the polluter-pays principle on its head, raising the spectre that governments will have to pay foreign investors where regulations decrease the value of their investments. This suggests that if expropriation language is to be included in the FTAA, it must be drawn much more narrowly than the NAFTA Chapter 11 language. Based upon these considerations, if expropriation protection is included, the act of expropriation must be narrowly defined to cover physical possession of investors' property. Beyond that, the burden is on proponents of a broader rule to devise language that clearly protects the traditional regulatory functions of national and sub-national governments.

IV. Chapter 11 and Technology Transfer

Chapter 11 as currently formulated prevents governments from *imposing or enforcing* any requirement for foreign investors to "transfer technology, a production process or other proprietary knowledge" to domestic persons or firms.[16] This rule

[15] *See* Tower, Courtney, Canada Backs Away from US firm's NAFTA challenge, *Journal of Commerce* (July 22, 1998) and Opponents Stem Tide of Globalization, *Toronto Star* (May 1, 1998).

[16] NAFTA, *supra* note 1, Chapter 11, article 1106 (1)(f):

> 1. A Party shall not impose the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an

could prohibit developing countries from using their natural wealth to bargain for access to technology that is essential to achieving sustainable development.

A. By Impeding Dissemination of Environmentally Progressive Technologies, Chapter 11 Would Undermine the Achievement of Global Sustainable Development.

Technology transfer is an integral part of the sustainable development plan of action conceived during the United Nations Conference on Environment and Development (UNCED) and has been universally recognized as indispensable to the global achievement of sustainable development for decades.[17] The Climate Change Convention, the Biodiversity Convention, and the Montreal Protocol all require governments to promote technology transfer to build capacity in developing countries and to address global environmental problems.[18] Technology transfer can bring environmentally-sound technologies and build local knowledge of how to use these technologies to developing economies as they develop and build the capacity of those economies to manage environmental issues locally from the start.

The recognition of the pivotal role of technology transfer to the sustainable development of countries was forcefully reiterated at the 1992 UN Conference on Environment and Development (UNCED). At UNCED States committed themselves to:

> . . . cooperate to strengthen endogenous capacity-building for sustainable development by improving scientific understanding through exchanges of scientific and technical knowledge, and by enhancing the development, adaptation and transfer of technologies, including new and innovative technologies.[19]

However, technology transfers to developing countries since UNCED have been inexcusably insufficient. A recent report from the RIO +5 meeting acknowledged that "technology transfer and technology-related investment from public and private sources, which are particularly important to developing countries, have not been realized as outlined at the UNCED…. The technology gap between developed countries and, in particular, the least developed countries has widened."[20] The report identified greater technology transfer as central to many areas of sustainable development including: developing sustainable human settlements and energy sources, protecting forests,

investment of an investor of a Party or of a non-Party in its territory:

(f) to transfer technology, a production process or other proprietary knowledge to a person in its territory, except when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws;

[17] *See Stockholm Declaration on the Human Environment*, 16 June 1972, U.N. Doc. A/CONF.48/14/Rev 1. 11 I.L.M. 1416 (1972).

[18] Montreal Protocol on Substances that Deplete the Ozone Layer, 26 I.L.M 1550 (1987) (entered into force January 1, 1989, at Article 10; United Nations Framework Convention on Climate Change, *supra* note 3 at Article 4.5; Convention on Biological Diversity, *supra* note 3, at Article 16.

[19] Rio Declaration on Environment and Development, *supra* note 3, principle 9.

[20] U.N. GA, 19th special session, Overall Review and Appraisal of the Implementation of Agenda 21: Report of the Ad Hoc Committee of the Whole of the Nineteenth Special Session, Agenda Item 8, U.N. Doc. A/S-19/29, para. 21.

controlling greenhouse gas emissions, ozone depletion, and toxic chemicals.[21]

"Performance requirements" – the acts investors are *required to perform* as a precondition to investment access – have traditionally been important policy tools for developing country governments to require foreign investors to transfer environmentally sound technology in exchange for the right of entry into a country, which includes access to the country's natural wealth and human resources. This *quid pro quo* is a negotiated agreement between governments and potential investors to achieve the technology transfer goals of UNCED and many specific multilateral environmental agreements.

By banning such performance requirements, a NAFTA-style investment agreement in the FTAA would inhibit hemispheric efforts to develop sustainably by diminishing the bargaining power of developing countries to encourage technology transfer on favorable terms.[22] The United Nations General Assembly has recognized that States have permanent sovereignty over their natural wealth and resources.[23] That sovereignty must be exercised in the interest of their national development and for the benefit of the people of that State. This principle of permanent sovereignty over natural resources implies that governments have the sole authority to create, design and confer private property rights over the natural resources located within their territory.

This principle has economic as well as political implications because natural resources, such as minerals and petrochemicals, are nonrenewable. Available in limited quantities, their selling price should be higher than the cost of producing them; the difference is the resource's scarcity value, or rent. Inevitably the existence of rents leads to rent-seeking behavior, that is, efforts to capture rents. Corporations seeking government concessions granting them access to scarce natural resources are engaging in rent-seeking behavior, and the principle of permanent sovereignty over natural resources gives governments an ability to match corporate efforts with strategies to ensure that rents obtained by exploiting nonrenewable resources are used to benefit the public. Performance requirements and demands for technology transfer are mechanisms for governments to capture the rent on their nonrenewable resources for the benefit of their citizens. This is an important government function since by definition nonrenewable resources will not be equally available to later generations and therefore these resources must be used in ways that create other kinds of benefits for these future generations. Rents from nonrenewable resources must be reinvested in other productive assets, such as education or new technology, which will yield returns to later

[21] *Id., see e.g.* para. 25, 27, 28, 32, 33, 39, 40, 42, 46, 53, 57, 58, 74, 88-97, 104, 110 (all identifying technology transfer and greater access to technology as essential to realizing sustainable development).

[22] Chapter 11 would also prevent governments from requiring investors to achieve a given level of employment, investment or research and development in their territory, hire local personnel, establish a joint venture, achieve a minimum level of local equity participation, achieve a given level of domestic content, or to accord preference to domestic goods or services.

[23] *Resolution on Permanent Sovereignty over Natural Resources*, 14 Dec. 1962, G.A. Res. 1803, U.N.Doc. A/5217 (1963), 2 I.L.M. 223 (1963). Moreover, the Charter of Economic Rights and Duties of States explicitly recognizes the right of every State to regulate foreign investment and the activities of multinational corporations within is jurisdiction. *Charter of Economic Rights and Duties of States*, Art. 2, G.A. Res. 3281, U.N.Doc. A/9631 (1975), 14 I.L.M. 251 (1975).

generations in order for a nation to maintain a sustainable income over time and thus for the extraction of such natural resources to be compatible with the principles of sustainable development.

As the above discussion of rent seeking explains, governments should be rewarded for structuring private property rights in such a way that the entire population will benefit from the exploitation of natural resources, not only an individual investor or corporation. By facilitating the transfer to local businesses of environmental technologies and the know how to use such technologies, the government helps the entire country develop in exchange for permitting investors access to the natural wealth found in the country's territory, capturing the value of scarce natural resources for the benefit of present and future generations. By prohibiting such technology transfers and by banning other performance requirements, the deregulatory international investment model eliminates the possibility of such mutually beneficial exchanges.

An actual investment scenario illuminates how the technology transfer condition prohibition might operate in practice.

B. Case Study - Suriname Rain Forest[24]

Recent events in Suriname highlight the vulnerability of developing countries to seemingly lucrative foreign investment proposals that, in fact, pose significant environmental threats and offer limited developmental benefits.[25]

In 1994, Suriname was considering several offers from Asian logging firms, totaling about $500 million in investments, and involving the harvest of between 25 and 40 percent of Suriname's forest cover.[26] However, studies conducted by Conservation International and World Resources Institute[27] indicated that such extensive logging efforts would harm Suriname's environment while providing limited long term economic benefits. The studies recommended that any use of the country's forest resources focus on sustainability and include provisions requiring transfer of skills and technical know-how to Surinamese nationals.[28] The government of Suriname accepted these recommendations, and decided to investigate sustainable non-timber alternatives for fostering economic development. Conservation International, in association with the US-based pharmaceutical company Bristol-Myers-Squibb, was invited to

[24] Based on *The Multilateral Agreement on Investment's Potential Impact on Environmental Law in Developing Countries: Impacts on Technology Transfer* prepared for CIEL by Matthew Stilwell, Vincenzo Franco, and Orestes Anastasia, with support from Eric Dannenmaier. On file with authors.

[25] Many international investors have been attracted to untapped and inexpensive sources of logging ventures in developing countries. For example, several Indonesian, Malaysian, and Korean investors have expressed interest in, or already applied for, concessions in Guyana, Panama, Venezuela, Honduras, and elsewhere in the Andean region. Nigel Sizer and Richard Rice, *Backs to the Wall in Suriname: Forest Policy in a Country in Crisis* (World Resources Institute, April 1995) at 3 [hereinafter World Resources Institute].

[26] World Resources Institute, *supra* note 25, at 1. *See also* Goering, Suriname's Money Woes Imperil Nature, *Chicago Tribune* (Monday, August 14, 1995) (indicating that the timber proposals amounted to 22 percent of the country's forest cover).

[27] These studies, compiled into the report *Backs to the Wall In Suriname: Forest Policy in a Country in Crisis*, World Resources Institute, *supra* note 25, were conducted with assistance from the US, Netherlands, and German governments, as well as from private funding. Goering, *supra* note 26.

[28] Interview, John Matuszak, U.S. Agency for International Development (September 19, 1997).

implement a biodiversity prospecting initiative to identify extracts for new medicines to treat HIV and other diseases. The initiative incorporates traditional knowledge of indigenous populations and will provide up to 50 percent profit-sharing with local interests. Through technology transfer support and capacity building, a Suriname-based drug retailer, BGVS, will also conduct plant extraction in coordination with the Virginia Polytechnic State University.[29]

C. Potential Conflicts with Chapter 11

This case study shows that a country should make careful decisions about the uses to which its natural resources are put and intelligently structure projects exploiting those resources. By thinking strategically, a country can extract the greatest benefit from the utilization of it natural wealth and thereby both enhance economic development and better protect the environment.

But countries might be prohibited from structuring foreign investment projects to better enhance economic development under the deregulatory international investment model. Although Chapter 11's performance requirement prohibition provisions have yet to be interpreted, the Suriname project would likely not have been possible under NAFTA.

As Chapter 11 is currently formulated, developing countries such as Suriname would lose their ability to *require* an investor to transfer technical knowledge and expertise in monitoring and regulating their forestry resources.[30] While Conservation International and Bristol-Myers-Squibb were amenable to technology and know-how sharing, other investors are often less hospitable to such conditions on investment. Under Chapter 11 conditions, Suriname could not have demanded the kind of progressive elements contemplated in the Suriname deal and their voluntary inclusion would have been less likely.

Even a country's ability to *bargain* to include technology transfer and other such elements in investor-State contracts could be limited. Depending on how this provision is interpreted, the State's participation in the bargaining process could be deemed to be imposing a requirement. Under Chapter 11, a prospective investor could threaten to bring suit in the investor-to-State forum, arguing that a bargaining position requiring technology transfer contravenes the performance requirement prohibition.[31]

Further, a country's right to *enforce* any commitment to transfer technology would be lost.[32] Chapter 11 explicitly prevents a government from enforcing an agreement, except pursuant to a government procurement contract, for the transfer of environmentally sound

[29] Van de Redactie, *Suriname Biodiversity Prospecting Initiative* (not dated) (located on the World Wide Web at: http://www.fsw.leidenuniv.nl/www/w3_cuan/decherin/rainmed/rain_3.htm).

[30] As discussed in more detail below, what constitutes a technology transfer "requirement" by government is not entirely clear from the NAFTA. For example, it is not clear whether a government negotiating a natural resource concession that seeks technology transfer from a foreign investor as a condition of the agreement would be interpreted as "requiring" technology transfer in a manner inconsistent with Chapter 11, or merely as negotiating a contract at arms length. This doubt may of itself reduce the bargaining power developing countries have with multinational companies.

[31] This would not be the case for government procurement contracts, which are exempted by the NAFTA technology transfer provisions (see NAFTA, *supra* note 1, Chapter 11, *Reservations and Exceptions* section, article 1108(9)).

[32] NAFTA, *supra* note 1,Chapter 11, *Performance Requirements* section, article 1106(f).

technologies.[33] This provision raises the specter that even "voluntary" commitments to transfer technology could later be deemed unenforceable. This provision could tie the hands of governments wishing to negotiate, not legislate, contracts for technology transfer in exchange for the granting of resource concessions.[34]

Finally, as currently drafted Chapter 11 prevents governments from requiring technology transfer by *any* investor, whether the investor is a party to the NAFTA or not. Therefore, a country which enters into a NAFTA-style investment agreement is precluded from requiring technology transfer from *any* investor, regardless of whether their home country is a party to the investment agreement.

D. Consequences of the Ban on Technology Transfer

Had Suriname faced NAFTA-type constraints, it might have chosen to extensively log its rainforests and extract the greatest short-term profits possible. Included in the package of benefits offered by the Bristol-Myers-Squibb project was a commitment to transfer environmentally sound technology and knowledge to Suriname. The long-term economic development benefits of such a project made this option for resource use economically rational as well as environmentally sustainable. Without this benefit (and some of the other performance requirements in the project), the value of this project to Suriname would have been substantially reduced and short term business interests would have prevailed over longer term environmental concerns.

E. Conclusion

Technology transfer is not only an issue of economic development in countries that need more thriving economies. The entire world needs global dissemination of environmentally sound technologies to ensure that future economic development is more sustainable than past economic development has been. Environmental degradation caused by unwise development policies in one country affect all of us: aggravating global climate change and ozone depletion or degrading our oceans. Sustainable investment policies that embrace the transfer of environmentally sound technologies are a central component of global sustainable development, as recognized by such international agreements as UNCED. Such policies are an important mechanism for guaranteeing that rents from scarce resources benefit the public at large and not only investors who are fortunate enough to be granted concessions.

At a minimum, an international investment agreement must ensure that governments retain the ability to mandate, negotiate and enforce contracts for the transfer of technology. The freedom to negotiate the transfer of technology for desired benefits should not be impaired by an international agreement between nation states.

V. Investor-to-State Arbitration Compounds Concerns over the Substantive Provisions of Chapter 11

[33] NAFTA, *supra* note 1,Chapter 11, article 1106(f).

[34] Such an effort by governments may also run afoul of the national treatment provisions of Chapter 11 if it can be shown that a local investor is not similarly required to transfer technology in order to qualify for a concession right (even though the local investor may have no new technology to transfer).

The concerns raised above with respect to expropriation and performance requirements are compounded by inclusion in the NAFTA investment chapter of an investor-to-State dispute resolution process. This mechanism allows an investor that believes that its rights under Chapter 11 have been violated to bring a claim for monetary damages against the host country. It delegates to a closed and structurally biased forum oversight over national environmental regulatory decisions.

A. The FTAA Should not Vest Control over the Development of the Expropriation and other Substantive Doctrines in International Arbitral Panels.

As the previous discussion of expanding notions of expropriation indicates, the development of the laws that will regulate international investment in the future will be a controversial process. The language in international investment agreements requiring compensation for regulatory expropriation and prohibiting performance requirements allows room for interpretation, and the extent to which these provisions will limit government prerogatives will depend greatly upon the judgements made by those who are asked to resolve disputes between governments and investors.[35] Therefore, the integrity and expertise of the body that will interpret these provisions may be as important as the content of the agreement itself.

Chapter 11 establishes a dispute settlement process through which investors can sue host governments directly for alleged breaches of its investment provisions. The investor has the option to select the forum in which to sue the host government: the courts in the host country[36] or a variety of international arbitration bodies designated in Chapter 11.[37] The forum that most investors will select for expropriation claims will be the forum whose practice it is to interpret the expropriation and compensation rules in the most business-friendly manner. Thus, the practical effect of Chapter 11 will be to vest the authority to interpret its expropriation provisions in international arbitral panels. [38] Given the the lack of transparency in these institutions, FTAA negotiators should think carefully before conferring additional power to them, and consider

[35] This same concern also applies to other rules in the NAFTA investment chapter. Consider for example, Article 1105 of NAFTA which requires "fair and equitable treatment." Such a broad and vague requirement would leave an arbitral panel with great latitude to interpret its contours.

[36] While investors would have a choice of the courts of the host country and international arbitral panels, it is unlikely that the investor would choose the host country's court system as the forum in which to resolve a dispute with the host country's government.

[37] The arbitral bodies from which the investor-plaintiff may choose are bodies constituted under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, 4 I.L.M. 532 (1965)) (hereinafter ICSID Convention) , the ICSID Additional Facility Rules or the UNCITRAL Arbitration Rules. NAFTA, *supra* note 1, art. 1120, 1125.

[38] NAFTA, *supra* note 1, at Article 1123-24, providing that parties to a dispute submitted for arbitration must appoint three arbitrators - one by each of party, and the third by mutual agreement. In the event the parties are unable to appoint any such arbitrators, the Secretary-General shall select for them arbitrators from a list of 45 consensus-chosen arbitrators meeting the qualifications of the ICSID Convention (*see supra* Note 37) or if none are available, then from the approved ICSID Panel of Arbitrators. These judgements of arbitral panels must be enforced by host country courts: the New York Convention provides that arbitral awards made in any foreign state will be recognized and enforced in the domestic courts of the contracting states. United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, art. 3, 21 U.S.T. 251 251 (hereinafter New York Convention). The provisions of the Convention do not affect the validity of other multilateral or bilateral agreements concerning the recognition and enforcement of arbitral awards that contracting states may enter into. New York Convention at art. 7.1

alternative ways of structuring dispute resolution proceedings.

B. Specific Concerns about the Appropriateness of the NAFTA's Dispute Resolution Provisions

The recent expropriation cases under the NAFTA raise serious concerns about whether and to what extent expropriation, technology transfer provisions might evolve in the future to strip States of traditional powers. Yet the investor-to-State dispute resolution mechanism established by the NAFTA does not create independent and impartial dispute settlement bodies that ensure that members of civil society, including local and indigenous people, are able to participate and to hold investors accountable. They are structurally biased: the arbitrators are selected for their understanding of international business, and the main clients of the arbitral institutions are multinational corporations. Moreover, the arbitrations take place in secret and do not allow all interested parties to express their views or to participate in the proceedings.

1. *The arbitrations take place in secret*

The arbitral bodies listed in Chapter 11 are not required to, nor is it their practice to, conduct investor-to-State arbitrations in public, and the records of the proceedings are not publicly accessible.[39] Indeed, the institutions conducting the arbitrations are not even required to make publicly known the initiation of a claim, even when the claim involves an important public policy issue such as the validity of an environmental regulation.[40]

Thus, it is extremely difficult for the public to track or influence evolving interpretations of regulatory expropriation, performance requirements, and other substantive provisions that could profoundly affect important public policies.

2. *The arbitrations take place without the participation of all interested parties.*

While Chapter 11 confers "private legal standing" on investors to challenge measures taken by local and state governments, it fails to provide sub-national governments, or the individuals meant to be protected by such measures, the right to defend these measures. State and local governments, even if they are intimately involved in matters giving rise to a controversy, must depend on the representation provided by their

[39] See, *eg* ICSID, *supra* note 37, at section 1.6.23 (1) (archives inviolable).

[40] No requirements for public notice or participation appear as to disputes involving only two arbitrants (e.g. a Party to NAFTA and an investor of another Party), NAFTA, *supra* note 1, at Articles 1119-1125. However, the rules differ when disputes are consolidated due to common questions of law or fact. In connection with such consolidated arbitrations, the Secretary-General is required to maintain a public register of requests for arbitration, the names of the disputing parties or investors, the nature of the order sought, *and the grounds on which the order is sought.* The Secretary-General also must publicly maintain its notices of arbitration. See NAFTA *supra* note 1, at Article 1126, Section 13. This publication requirement addresses concerns about the notification of non-arbitrants as to proceedings that may affect their rights, but does not open the arbitration process itself to public view and civil society participation. Under reservations made at the time NAFTA was signed, Canada and the United States reserve their respective rights to make public arbitration awards whenever they are parties, and reserve the same right on behalf of disputing investors whenever Canada or the U.S. is party. See NAFTA, *supra* note 1, at Annex 1137.4 Clearly this discretionary, post-hoc publication right means little in terms of the transparency and openness of dispute resolution processes themselves.

respective federal governments to defend their laws and regulations. Private individuals, even those with direct interests in the controversy, have no right to present their views during the arbitration or even to know that a claim has been brought.

Consequently, in cases such as Metalclad, the investor benefits from conflict between the state and federal governments. The state of San Luis Potosi does not have the right to represent and defend itself against Metalclad's claim. Since the Mexican federal government has granted permission to Metalclad to commence operations, it is doubtful that San Luis Potosi will receive as vigorous a defense as it would have had had it been allowed to defend itself.

Moreover, because the government of Mexico must defend this claim against a foreign corporation from Mexico's largest trading partner and source of foreign aid, this very local issue suddenly becomes entangled in broader foreign affairs concerns. As the Metalclad claim highlights, the federal government may not always understand the need for, or have sympathy for, the sub-federal government's position, but it is under no obligation to involve the local or state government in the dispute settlement process.[41]

As designed, the investor-to-State dispute settlement mechanism undermines the authority of sub-national levels of government. Shifting the balance of power between various levels of government has broad implications for all sorts of policy issues; international agreements that privilege national governments over local and state governments may threaten efforts to promote sustainable development, which often rely upon locally-based solutions to environmental problems.

In addition, while investors are granted legal standing to defend their property interests, individuals whose very lives may be irrevocably harmed should an unregulated industry prove dangerous to public health are not allowed to represent their point of view during the dispute resolution process. The investor-to-State arbitration proceedings make no provisions for public participation in the legal proceedings. Even *amicus curiae* briefs are not accepted, despite the pervasive practice of accepting them in legal systems throughout the world; third party intervenors are not permitted. The arbitration panels can, therefore, easily reach a final decision on the merits of an investor's claim without having granted hearings to all interested parties.

This practice sets a dangerous precedent because it establishes an international adjudicatory body that affords a special interest group—investors—the right to be heard, yet provides no mechanism to ensure that all other stakeholders to a dispute are consulted. In contrast to international human rights law, which recognizes the right of all individuals under

[41] It is also not clear that all federal governments can bring sub-federal governments into compliance after the ruling. The NAFTA obliges federal governments to "ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments." (NAFTA, *supra* note 1,, Article 105). However, the extent to which national governments are able to dictate or influence the policies of sub-national governments varies from country to country. Regardless of the ability of the national government to influence the policies of sub-national government, the national government may be held liable for damages caused by such policies. The enforcement of judgments or awards involving sub-national measures may thus be problematic and lack uniformity across parties to the agreement.

international law, Chapter 11 has created international legal rights for a special interest class—investors—without creating concomitant rights for the general public. This situation raises concern that corporations will be better able to promote their special interests than will individuals and groups committed to promoting the public interest on an issue.

A multilateral investment agreement should not create a dispute settlement mechanism to resolve conflicts arising out of the rules governing foreign investment that is inaccessible to parties with direct interests in the controversy. To the contrary, investment agreements should foster an appropriate balance between private property rights and public health and safety rights, both of which are of paramount importance to society.

3. *The arbitration system lacks adequate safeguards to ensure that arbitrators are well trained and free from conflicts of interest.*

Compounding the concern over the lack of openness in the arbitration proceedings is the fact that the panels generally are composed of business experts who have no proficiency in environmental law or science. Environmental and other public interest organizations are concerned that the arbitrators selected by claimants will tend to be experts in international business law and practice who lack experience evaluating social costs and benefits. Without experience evaluating public policy, these persons may tend to understand and sympathize more readily with business perspectives.[42] Were the issues before the panels certain to be fully and fairly presented, this deficiency would not be as troublesome. However, as it stands, panels composed of experts who understand the needs of business much better than the risks to human health and the environment posed by inadequate regulation will not be presented with the full range of perspectives on issues on which they are being asked to make binding decisions. This process is structured to produce biased decisions that do not balance the interests of investors with the interests of broader society. [43]

[42] Another issue raising questions about the appropriateness of this dispute resolution mechanism is that some arbitrators work for private, profit-making arbitration institutions. The main clients of these institutions are multinational corporations. The lion's share of the revenue earned by these private arbitral institutions comes from adjudicating disputes between multinational corporations. Moreover, under Chapter 11, the arbitral institutions compete with each other to attract NAFTA disputes. Under the investor-to-State dispute resolution mechanism, the investor selects the forum because the investor brings the complaint against the host country. Thus, these institutions have a powerful incentive to interpret the expropriation provisions in a manner that favors investors. The more disputes investors decide to bring before an institution, the more money the institution will make.

[43] A binding investor responsibility and citizen's suit subchapter would provide a counter weight to the precedent-setting corporate rights granted by the agreement by establishing a minimal set of environmental obligations which a foreign investor would have to meet, perhaps in order to qualify for the protections granted in the rest of the investment agreement. An investor responsibility and citizen's suit Chapter would also provide citizens that have been or stand to be affected by the activities of a foreign investor with a forum in which to obtain redress for environmental harms.

The environmental responsibilities of foreign investors written into a draft investor responsibility and citizen suit Chapter could include a host of requirements to ensure that the imbalance of bargaining power between multinationals and developing countries does not result in unnecessary environmental damage. For example, the draft Chapter might include a requirement that environmentally progressive technology be employed in new undertakings and that the investor build the host country's internal capacity to use this

C. An Investment Agreement within a Comprehensive Trade Agreement for the Western Hemisphere Is Qualitatively Different than a Bi-Lateral Agreement.

A common response to the forgoing discussion about the dangers inherent in the investor-to-State dispute settlement process is to observe that such provisions are a standard part of numerous bilateral treaties between countries throughout the hemisphere. Why is an investor-to-State dispute settlement mechanism suddenly so dangerous as part of an FTAA? The answer to this question lies in the overarching significance of free trade agreements to the economic development of many countries. Including an investment chapter in a comprehensive trade agreement will pressure countries to accept multilateral investment rules even when doing so is against their interests. The superior strength of a regional trade agreement relative to a bilateral trade agreement thus triggers special concern.

Moreover, once investment rules are sequestered within a comprehensive package of trading rights and obligations, it will be, as a political matter, almost impossible for a country to extricate itself from the investment portion of the deal. The country would have to repudiate not only the investment agreement, but also all the benefits of being part of the agreement on tariffs and trade. For a contracting party to extricate itself from the investment provisions of the NAFTA, for example, the government would have to renounce the entire agreement.[44] The trade-related benefits that will be tied to an FTAA will be even greater. Therefore, it would be even more difficult for a country to renounce the FTAA because of dissatisfaction with the investment provisions.

The investor-to-State dispute settlement mechanism of Chapter 11 allows anentity with a strong financial dependence on the business community to resolve disputes between foreign investors and governments. Knowledge of the high cost to countries of pulling out of the FTAA could embolden such bodies to succumb to incentives to favor multinational corporations. Distrust of this dispute settlement mechanism amplifies all the substantive concerns about multilateral investment rules.

VI. Constructing an Environmentally Sound Investment Agreement

The deregulatory model for international investment rules contains no requirement that corporations operate in an environmentally or socially responsible manner. In this sense, such agreements represent an opportunity lost. This section offers suggestions for developing an environmentally sound investment agreement that gives corporations incentives to promote sustainable development rather than pursue short-term gain. It begins by reviewing the risks posed by the deregulatory model for international investment rules

technology. Finally, an investor responsibility and citizen's suit Chapter would direct the international community down the road (that it must take eventually) which leads to the rational international control of multinational corporate power.

[44] See NAFTA *supra* note 1, at Articles 2201-2205. NAFTA provides that any party may, upon six months notice, withdraw from the agreement. Amendment requires the consent of all parties. While the reservations of the parties made prior to executing NAFTA are made part of the overall agreement, no provision is made for partial reservation or withdrawal from individual obligations after execution.

discussed above, and then proceeds to suggest ways to improve upon this model and to produce an investment agreement that would be fair to all members of global society.

Under terms such as those of the NAFTA or the draft Multilateral Agreement on Investment, multinationals would be free to deplete the resources of and pollute with impunity a country which has yet to create or has only nascent environmental protection laws and/or which lacks the resources to monitor and enforce fully what environmental regulation it has. If the host country were to respond by enacting an environmental measure aimed at curbing the damaging effects of the economic activity, the corporation could threaten the country with an expropriation challenge. This threat will be exacerbated by the fact that some countries rely on foreign investment for most large-scale investment activity.

Unless we are careful, international investment rules risk creating a class of institutions (multinational corporations) that will largely be able to dictate the terms on which their economic activity will occur. The NAFTA inhibits the ability of countries to use access to their natural resources as a bargaining tool to establish the terms under which multinational corporations will operate in their countries and thereby enhance their ability to develop sustainably. Instead, the NAFTA, implementing multinational corporate interests, would dictate the terms on which these powerful institutions obtain access to the wealth of the South. If our regional political structures further increase what is already an imbalance of bargaining power, the ability of developing countries to protect their environment and environmental wealth and to develop in a sustainable manner will be seriously impaired.

NAFTA's Chapter 11 is structured along the same lines as many bilateral investment treaties between the United States and other countries in the hemisphere. But as part of a multi-State treaty governing tariffs, trade and investment, Chapter 11 creates a much more durable set of international rules. The political strength of an investment agreement that constitutes one chapter within an indivisible multi-issue economic agreement among three major trading partners is far greater than the political strength of a bilateral investment treaty. When it is part of an FTAA, it is stronger still.

An environmentally sound hemispheric investment agreement is not inconceivable. However, the NAFTA model should not be used as its template. While it is not the purpose of this section to fully develop an alternative model, a few conclusions can be drawn from the ideas elaborated here:

1) An investment agreement should not be linked to a free trade agreement. Investment is a separate subject, which the international community has explored extensively for only a couple of decades. Multilateral trade rules have been developed over more than half a decade and in the experimental years were part of an agreement with very weak dispute settlement oversight. It is premature to bind an entire region to investment rules as securely as the region is bound to its trade rules.

2) The clear goal of negotiators for a regional investment agreement should be to develop investment

rules that promote sustainable development. Too often governments negotiating economic agreements treat sustainable development as a mere platitude. Yet as far back as 1972 these same governments recognized that "[Mankind] bears a solemn responsibility to protect and improve the environment for present and future generations."[45]

3) To ensure that multilateral investment rules are directed toward sustainable development, governments should assess existing foreign direct investment and proposed multilateral rules to determine past and potential impacts on environmental and social policy and economic security before these governments design a new investment agreement.[46]

4) Expropriation provisions should explicitly note that they do not apply to regulation that falls within traditional government powers to protect public health and safety and to protect the environment. The burden is on proponents of a broader rule to devise language that clearly protects the traditional regulatory functions of national and sub-national governments. International investment agreements should not override national policies that serve to balance investors' property rights with the public's right to a safe environment.

5) Investor-to-State dispute settlement fora should employ legal experts who are trained in public policy, not merely business practice and should be transparent and open to the participation of all interested parties. They should be balanced by mechanisms that permit civil society to hold investors responsible for their actions.

6) Performance requirements should be allowed, and technology transfer should be encouraged. Governments should be free to negotiate with investors to obtain whatever benefits they can in exchange for the privilege of investing within the country's borders.

7) Negotiations for a hemispheric set of investment rules presents an opportunity to increase regional environmental protection by imposing regional environmental requirements on multinational corporations that have environmentally sound technologies and can afford to operate according to the highest environmental standard. This opportunity should not be lost. Regional rules governing foreign direct investment should not encourage or allow one-sided economic development that extracts the wealth of a country to the benefit of foreign companies and at the expense of future generations.

[45] Stockholm Declaration on the Human Environment, See *supra* note 17, principle 1.

[46] As noted in the introduction, an investment agreement should also contain a number of proactive environmental provisions to ensure the goal of sustainable development can be achieved. While not central to the topics covered in this paper, such provisions are crucial to the design of an environmentally acceptable investment agreement. Examples include, environmental impact assessment requirements, prohibitions on lowering or not enforcing environmental standards to attract investment, citizen access to information and civil society rights to challenge socially or environmentally harmful investments.