
Fred Bergsten as an Early Architect of an International Regime for Foreign Direct Investment

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Of the many achievements of C. Fred Bergsten, one of the less heralded has been his role as an early advocate of an international regime for foreign direct investment (FDI) and his related efforts to launch the process that has resulted in at least some components of such a regime. The objective of this chapter is, first, to review Bergsten's role as an early advocate of an international investment regime and, second, to examine why a full-blown international investment regime does not yet exist despite the positive role it would serve.

An international regime in this context comprises both a set of rules for governments in the conduct of international commerce and a mechanism for enforcing these rules. The World Trade Organization (WTO) is an example of such a regime for international trade. Under the WTO rules, it is recognized that nations are sovereign and therefore cannot be compelled to obey the rules. Enforcement is therefore limited to dispute settlement procedures: If a WTO member nation believes it has suffered harm due to another nation's refusal to abide by the rules, the dispute can be settled by mutual consultation or, failing that, an arbitral procedure. In the end, however, "enforcement" depends on the noncompliant nation's voluntary implementation of remedial measures recommended by arbitral "panels," with the possibility of sanctions imposed by the aggrieved party if the vio-

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lator nation refuses to implement the measures. Bergsten has advocated a “regime” for FDI—a set of rules and an enforcement mechanism—along the lines of those now embodied in the WTO.

At the outset, it is useful to outline what an international regime for FDI would comprise and what use it would serve. FDI is, technically, the equity supplied by an investor to a foreign country where the investor exercises managerial control over the investment. In practice, such an investor is most often a firm rather than an individual, and the investment most often is also a firm (a subsidiary of the parent firm). The ensemble consisting of the investor firm and its overseas subsidiaries is variously termed a multinational corporation or multinational enterprise (MNE). The investor firm is considered the parent company, the country in which it is headquartered is the home country of the MNE, and the country in which the investment is located is the host country. Most of the world’s largest business enterprises can be classified as MNEs.

An international regime for investment would create a set of obligations for governments with respect to how they treat MNEs and their economically valuable output, especially the output created by their overseas subsidiaries. Thus, in this context, FDI is shorthand for various aspects of MNEs, including most importantly their operations outside their home countries. Bergsten recognized early on that an international investment regime would be more like the existing regime for international trade than the rules pertaining to international capital movements.

But his work in this area tends to be underappreciated for two reasons. First, efforts by governments to create such a regime have not met with full success, or at least not yet. Indeed, two major efforts to negotiate a fully developed international investment regime have been aborted: One at the Organization for Economic Cooperation and Development (OECD) was terminated in 1999, and another at the WTO was terminated in 2004. Second, Bergsten’s role was largely played out during the 1970s, when he was a scholar at the Brookings Institution and later assistant secretary of the US Treasury, well before the two efforts just noted were undertaken. Thus his role was that of pioneer, not architect of a final product. Nonetheless, some components of an international investment regime have been successfully implemented, one of which (the WTO Agreement on Trade-Related Investment Measures, or TRIMs) achieves some, but not all, of what Bergsten laid out as the priority goals of a policy regime for FDI.

Bergsten as Early Advocate of an International Regime for Investment

By the late 1960s and early 1970s it was widely recognized that production by overseas subsidiaries of multinational corporations had become an important component of international commerce. Indeed, during those years

a number of sometimes flamboyantly titled books, such as Jean-Jacques Servan-Schreiber's *Le Défi Américain* (*The American Challenge*), Raymond Vernon's more scholarly *Sovereignty at Bay*, and Richard Barnett and Ronald Müller's left-leaning *Global Reach*, addressed the growing spread of multinational business activity and the problems and benefits created by this activity. These books were widely read. Moreover, there were a number of calls by prominent international economists for new multilateral rules that would apply to FDI and to government policies affecting it; notable among these were Goldberg and Kindleberger (1970), Safarian and Bell (1973), and Bergsten (1974).

Goldberg and Kindleberger (1970) focused on whether there should be a multilateral approach to curbing the monopoly powers of MNEs. Concern over the market power of MNEs was common during the 1970s, especially in developing nations. One consequence was that two intergovernmental discussions were undertaken at the United Nations Conference on Trade and Development (UNCTAD) during the 1970s (and persisted into the 1980s). One of these centered on developing a code of conduct for MNEs and the other on developing a code—largely directed toward MNEs—to address restrictive business practices. But these discussions wound up producing very little, in large measure because neither the Carter nor the Reagan administrations would agree to codes that might be binding on states or US-based firms. Indeed, the sense in the US government was that any measures resulting from these discussions would likely be discriminatory against US-based firms because, at that time, the majority of MNEs were based in the United States.

Moreover, the US position was that any international rules that pertained to MNEs and were binding on governments should be centered on a principle of nondiscrimination. This principle, sometimes called the principle of national treatment for foreign-owned enterprises, can be succinctly stated as follows: Government measures should in general not act to discriminate against foreign-owned business activity, subject to a limited and specific set of exceptions (e.g., measures undertaken to protect national security).

Whereas the Goldberg and Kindleberger proposal was for an international regime that would restrict the power of the MNE, both the Safarian and Bell and the Bergsten proposals called for new rules that would restrict government measures to promote the establishment of MNE activities in the government's jurisdiction, especially if such measures might cause harm to other nations. Thus, these proposals were more along the lines of the existing GATT rules pertaining to trade than was the Goldberg and Kindleberger proposal. Safarian and Bell believed that measures such as government tax incentives granted to an MNE in exchange for the enterprise locating plants or other economic activity in the jurisdiction of the government might have distorting effects on domestic and international commerce. They also worried that measures such as value-added require-

ments imposed by governments on local operations, or requirements that a certain amount or percent of output be exported, would be tantamount to import restrictions or export subsidies.

Bergsten, employing an approach he would use to address other issues as well as FDI, went further, arguing that proliferation of such measures was leading the world toward investment wars that would not be unlike the devastating trade wars of the 1930s. He was not the only person raising such fears. John Dunning (1974), who arguably was the “dean” of scholars of FDI and the activities of MNEs,¹ worried along similar lines, as did a student of his, David Robertson (1975). Although the concerns of Bergsten and Dunning in retrospect were exaggerated in the sense that no investment wars came about, they were nonetheless justifiable. Studies done for the US Treasury Department during the late 1970s indicated that measures such as investment incentives (including tax incentives) or performance requirements (including most especially value-added, or “local-content,” requirements and export requirements) were proliferating and that this proliferation could generate welfare-reducing economic distortions. Thus, Bergsten was right to believe that negotiated rules to restrict the use of such measures were warranted.²

Unlike other analysts who had written on these issues, Bergsten was soon in a position actually to do something about them. He became assistant secretary for international affairs at the US Treasury in 1977, where one agenda he pursued was an effort to launch a US government initiative to negotiate and implement rules limiting the use of investment incentives and performance requirements. It was an uphill battle. Other US government agencies involved in international economic affairs were not convinced that negotiating such rules should be a US priority, and it is safe to say that during his first three years in the position, one of the only things that Bergsten was able to do was to keep the issue alive.³ However, during his final year, some progress was made.

The Task Force on International Direct Investment

In the fall of 1979 a Task Force on International Direct Investment was formed under the aegis of the Joint Development Committee of the Inter-

1. Dunning (1974) is considered to be the first major, seminal work on these issues.

2. This view was most strongly stated in a book that Bergsten coauthored with Thomas Horst and Theodore Moran (Bergsten, Horst, and Moran 1978), written prior to but published more than two years after Bergsten became assistant secretary for international affairs at the US Treasury Department.

3. After leaving the Treasury Department, in 1981 Bergsten talked about these issues and the progress made on them (but not about the uphill nature of the battle) in testimony before the US Senate Committee on Foreign Relations, Subcommittee on International Economic Policy, reprinted as Bergsten (1983).

national Monetary Fund and the World Bank. As official representative of the United States, Bergsten chaired the task force, which included representatives of the governments of Australia, Brazil, France, Germany, Mexico, and the United Kingdom. The mission of this task force was to determine whether any new rules pertaining to FDI would serve global economic interests and, if so, the nature of those rules and in what institution they would be sited. Bergsten was able to convince the other representatives that the task force should seriously investigate the desirability of rules to restrict governments from either imposing performance requirements or granting investment incentives or other subsidy-like measures. He did not, however, convince all the members of the task force that they should *endorse* such rules.

A senior member of the World Bank staff, Dale Weigel, was assigned to work more or less full time on the task force and to draft its final report. I participated in the project as a US Treasury Department economist. The task force representatives, all of whom were quite senior representatives of their respective governments,⁴ eventually gave Weigel and me considerable latitude to explore the economic case for and against rules of the sort proposed by Bergsten and to identify the political factors that influence bringing such rules to fruition. We commissioned studies of these issues by John Dunning and Steven Guisinger, both acknowledged experts in the field of MNEs and FDI. The Australian representative to the task force, David Robertson, had been an academic researcher prior to his government service and was also a recognized expert in this field. Consequently, he effectively became a consultant to the task force, as well as a member of it, and helped draft the final report.

This team of experts soon became convinced that there were different cases to be made for international rules to restrict investment incentives and to restrict performance requirements.

First, for investment incentives, it quickly became clear that the economic case against these incentives was not unequivocal. The counter case based on empirical evidence accumulated during the 1970s indicated that FDI, via the local subsidiaries of MNEs, can create positive externalities in host nations.⁵ These externalities (also called positive spillovers into the local economy) create a positive economic rationale for subsidies to the activity that generates them. But the evidence for such externalities was ambiguous—while some studies suggested that they do exist, others did not.

4. The representative of Mexico, Bernardo Sepúlveda, for example, would become finance minister of that country a few years later, and the French representative, Michel Camdessus, later became managing director of the International Monetary Fund.

5. The relevant literature, including studies conducted since the 1970s, is reviewed in Lipsey and Sjöholm (2005). The positive case for public subsidies to FDI to stimulate externalities is laid out in some detail in Blalock and Gertler (2005).

The consultants to the task force thus were asked to determine if there was evidence that investment incentives to MNEs increased their activity in the countries in which they operated. They found that investment incentives did not seem to cause direct investors to undertake more activity internationally than they would have in the absence of the incentives. However, there was considerable evidence that investment incentives could affect the specific location of a direct investment. For example, if an MNE based outside the United States decided to create a US subsidiary, the availability of investment incentives from particular states might influence the choice of location for the subsidiary. Thus it could be worthwhile for state governments to offer incentives, although for all states to do so would be a negative-sum game,⁶ resulting in a “bidding war” that would improve the lot of the MNE’s shareholders at the expense of taxpayers in the states offering the subsidies.⁷

The above considerations would also hold for nations competing for investments by MNEs. Indeed, the consultants found that investment incentives were quite commonly offered to MNEs by state or provincial governments as well as by national governments. A clear implication was that any rules restricting the use of government incentives would be effective only if they applied to subnational as well as national governments.

Alas, enthusiasm for such rules among government officials and political leaders, including most members of the task force, was meager.⁸ Rather, the view was that national and subnational governments should retain the option of granting investment incentives. Behind this view was considerable skepticism that, if rules were established, they would be followed. It would be difficult to sanction governments that offered incentives in violation of the rules. (It must be remembered that these discussions took place in 1979, when the dispute settlement procedures in the GATT were quite weak.) Moreover, for obvious reasons, MNEs themselves had no enthusiasm for international rules to limit investment incentives.

Thus, whatever the substantive case for international rules to limit investment incentives, there simply was no constituency in favor of such rules—and there were constituencies against them. Accordingly, it is no surprise that the task force members could not agree to language in the final report recommending new rules to curb investment incentives. They did agree, however, that incentives represented bad policy and that further study of the issue was needed. At its September 1980 meeting, the task force remanded the issue to the World Bank Executive Board, which

6. States sought to attract FDI during the 1970s and, indeed, state officials seemed to understand that positive externalities could be generated by such investment, although it is doubtful that many of these officials could have articulated this understanding.

7. This outcome is easily modeled using the “prisoner’s dilemma” from game theory.

8. This sentiment was held particularly strongly among the US state government officials that we contacted.

took no action. Indeed, although there have since been a number of agreements or rules established that pertain to international investment at both multilateral and regional levels, they do not cover investment incentives (with the exception of TRIMs).⁹

Rules to limit performance requirements were a different matter, on which action would prove feasible. The difference reflects an important economic reality. In the case of investment incentives, subsidies can create net costs for the global economy, but these are borne by the community (nation or regional unit) that grants the subsidy. Thus the only constituency that might be expected to favor international rules to limit the subsidy should be the community that grants them. If there is no real enthusiasm among subsidy-granting communities for such rules, the negotiation of such rules is a nonstarter. But in the case of performance requirements (or at least some of them), the costs they generate can extend beyond the community served by the government entity imposing the requirements. Thus constituencies may favor rules to limit them.

The typical example is a value-added (or local content) requirement, which obligates an MNE subsidiary to substitute locally produced inputs for imported ones. The locally produced inputs might be supplied internally by the subsidiary or, in most cases, by locally owned, unrelated suppliers. The effect of the requirement is equivalent to the combination of a protective tariff and a production subsidy (Graham and Krugman 1990). There might be some positive rationale for such a performance requirement from the point of view of the host government, such as appropriation of some of the MNE's excess return. (MNEs necessarily operate in imperfect markets that enable excess returns.) However, even if there is a potential gain to be had from such an appropriation, if all nations seek such gain, the collective result will be distortions that are globally welfare reducing. Moreover, rational calculation of potential national gain in practice does not seem to be the main motivation behind value-added requirements; rather, the motivation is of the standard mercantilist sort—that is, to reduce imports and substitute local production, even if there is a net cost to the economy of doing so. The main international objection to such a performance requirement is also typically mercantilist: Other nations oppose local-content requirements because they lose exports, not because they expect a global welfare loss. Nevertheless, economic analysis indicates that there usually is an overall welfare loss, and the countries whose mercantilist thinking leads them to believe that there are net losses form a potential constituency to support international rules to restrict value-added requirements.

9. The most comprehensive investment agreement currently in place is that of chapter 11 of the North American Free Trade Agreement, and trade policy experts believe that this chapter might serve as a model for a multilateral agreement. But chapter 11 does not provide disciplines on investment incentives and, to the best of my knowledge, no bilateral investment treaty or agreement does. The only such disciplines in existence are in the WTO's Agreement on TRIMs but, as discussed later in the chapter, they are very limited in scope.

Moreover, MNEs themselves can be expected to oppose value-added requirements; from their point of view, unlike an investment incentive, which grants them a subsidy, a value-added requirement effectively imposes a tax.¹⁰

Other types of performance requirements raise issues similar to those raised by value-added requirements. For example, host countries have imposed export performance requirements on local MNE subsidiaries that call for the export of a specified amount of the subsidiary's output. Such a requirement is tantamount to an export subsidy, except that the subsidy is financed by the MNE itself rather than by the host government. Host governments favor these requirements for reasons that are largely mercantilistic. As is the case for value-added requirements, export performance requirements are all of the following: (a) collectively world welfare reducing; (b) likely to be opposed by countries other than that which imposes the requirement, which it likely does for mercantilist reasons; and (c) opposed by the MNEs themselves.

Thus in considering the feasibility of a negotiated set of rules to regulate or eliminate performance requirements, it is important to recognize that two potentially strong constituencies would favor such rules: governments of nations that are adversely affected by these requirements (even if in the mercantilist sense) and MNEs.

As with investment incentives, the final report of the task force indicated that performance requirements can have adverse consequences but did not recommend what action, if any, might remedy them. Rather, again, the report remanded the issue to the executive board of World Bank. However, unlike the case of investment incentives, the issue did not stop there. In 1981, at the behest of the Treasury Department, the US government, represented by the US trade representative (USTR), formally introduced the subject of possible trade-distorting effects of government measures on FDI at a meeting of the GATT Consultative Group of 18. In doing so, government representatives drew on the task force's finding that performance requirements can have trade-distorting effects and recommended that the GATT Secretariat compile a list of investment measures that might distort trade, with a focus on performance requirements. Developing countries at the meeting did not support this recommendation, and while representatives of the European Community and Japan supported the recommendation in principle, they also indicated that the GATT Secretariat had higher priorities at the time than the recommended compilation. Consequently, the GATT Secretariat did not act on the recommendation. That would change, however, the following year.

10. Why then have MNEs often accepted value-added requirements imposed by host nations without raising objections? As Bergsten (1974) himself noted, most often value-added or other performance requirements are imposed as a condition for receipt of investment incentives. Clearly then, in many instances, the firms have calculated that the value of the incentives exceeds the cost of the performance requirements.

Action in the GATT

In 1982, the United States launched a complaint in the GATT against the government of Canada, arguing that performance requirements imposed by the Canadian Foreign Investment Review Agency (FIRA, an agency that no longer exists) on Canadian subsidiaries of US firms were in violation of a number of GATT obligations. A GATT panel subsequently ruled that one type of performance requirement (value-added or local-content requirement) was indeed in violation of a GATT article (on national treatment) but other types were not. The panel muddied the water by noting that a value-added requirement might not be in violation of the GATT if it were used “to promote economic development” in conformity with GATT Article XVIII, section C.

The United States then argued for the next three years that its 1981 proposal should be accepted and urged the GATT to examine an enlarged set of investment-related measures for possible trade distortions. In 1986, these efforts bore fruit in the preparatory meetings for the launching of what was to become known as the Uruguay Round of multilateral trade negotiations. The ministerial declaration of the meeting at which this round was launched included language establishing a Negotiating Group on TRIMs. This group was to consider the possible trade-distorting effects of such measures, to identify violations of existing GATT articles that might be created by such measures, and to negotiate “further provisions that may be necessary to avoid such adverse effects on trade.”¹¹

During the negotiations that ensued (and lasted for nine years), the United States enumerated eight types of performance requirements that might have trade-distorting effects: (1) value-added or local-content requirements, (2) export performance requirements, (3) local manufacturing requirements, (4) trade balancing requirements, (5) production mandates, (6) mandatory technology transfer, (7) foreign exchange balancing requirements, and (8) limits on equity participation and remittances. In the end, the negotiating group agreed that items (1), (4), and (7) were both trade distorting and in violation of existing GATT articles but could not agree that this was true of any of the remaining items. The negotiating group went on to produce the TRIMs agreement, which effectively banned value-added or local-content requirements, trade balancing requirements, and foreign exchange balancing requirements, and required GATT contracting parties (now known as WTO member countries) first to list such requirements as they might have in place and subsequently to phase them out. Developed countries were given two years to phase out these requirements, and developing countries were given five years.

11. Quoted wording is from the Ministerial Declaration of the Punta del Este meeting of the GATT establishing the Uruguay Round, as quoted in Graham and Krugman (1990).

The United States also succeeded in persuading the Uruguay Round Negotiating Group on Subsidies and Countervailing Measures to consider as “actionable” subsidies to direct investment (i.e., investment incentives) that are granted on condition that the recipient agree to performance requirements of types (1), (4), or (7).

Thus, the Uruguay Round eventually brought about implementation of a partial set of rules to limit government measures directed at MNEs that might have trade-distorting effects, as Fred Bergsten had proposed early on and toward which he worked very hard during his tenure as assistant secretary of the US Treasury. But this implementation hardly represented a towering victory for Bergsten. Rather, in the words of trade policy expert Jeffrey Schott, “the Uruguay Round accord on TRIMs represents only a small first step toward international discipline on the nexus of trade and investment issues” (Schott 1994, 113). However, Bergsten did succeed in planting a seed that sprouted and grew at least into a sapling.

Bergsten and the Early Days of the Committee on Foreign Investment in the United States

As assistant secretary of the Treasury from early 1977 to early 1981, Fred Bergsten acted as working chairman of the Committee on Foreign Investment in the United States (CFIUS). The secretary of the Treasury formally chairs the CFIUS, but in practice the working chairman oversees most of the committee’s activity. The CFIUS was established in 1975, during the administration of Gerald Ford, in response to growing concern about foreign investment, especially from OPEC nations, in the United States. Original members of the committee included the secretaries of the Treasury (chair), Commerce, Defense, and State departments, the US attorney general, the chairman of the Council of Economic Advisers, the USTR, and the director of the Office of Management and Budget. Later, representatives of other federal agencies (most recently, the secretary of Homeland Defense) were added. In practice, the cabinet and subcabinet officers themselves attend CFIUS meetings only under exceptional circumstances (e.g., to recommend a block of a foreign takeover of a US firm); instead, their designated representatives attend on their behalf.

The mission of the CFIUS, according to the executive order that established it, was to monitor the impact of foreign investment in the United States and to coordinate the implementation of policy on such investment. In particular, the CFIUS was to (1) analyze trends and significant developments in foreign investment in the United States; (2) provide guidance on arrangements with foreign governments with respect to any investment these governments might hold in the United States; (3) review particular investments in the United States that, in the judgment of the committee, might have major implications for US national interests; and (4) consider

proposals for new legislation or regulation relating to foreign investment in the United States, as necessary. However, the Ford administration left office before the CFIUS had much time to function or to define its role beyond the parameters established by the executive order. Thus defining the specifics of the role of the CFIUS fell largely to the incoming Carter administration.

In 1977, shortly after the Carter administration took office, the Economic Policy Group, the administration's top officials involved in setting economic policy, conducted a formal review of US policy on inward investment. The group subsequently did something that had never been done before: It issued a formal statement articulating US policy concerning inward investment. The statement included the following language:

The fundamental policy of the U.S. Government toward international investment is to neither promote nor discourage inward or outward flows or activities. . . . The Government therefore should normally avoid measures that would give special incentives or disincentives to investment flows or activities and should normally not intervene in the activities of individual companies regarding international investment. Whenever such measures are under consideration, the burden of proof is on those advocating intervention to demonstrate that it would be beneficial to the national interest. . . . [The Government] should not discriminate against established firms on the basis of nationality or deprive such firms of their rights under international law.¹²

In other words, the US government should grant national treatment to US subsidiaries of foreign-owned firms and should grant to both these subsidiaries and their parent organizations all protections afforded to international investors under international law. Such protections include an assurance that investments will not be nationalized or subjected to measures tantamount to nationalization, except for a public purpose (e.g., national security), in which case nationalization will be executed under due process of law and subject to rapid and full compensation. National treatment and rights accorded under international law should form the core principles of an international regime for FDI, and the Economic Policy Group's statement in effect expressed the United States' willingness to abide by these core principles.

During most of Bergsten's tenure as working chairman of the CFIUS, the committee was not highly active, in part because the major reasons for its creation—OPEC investment in the United States and fear and suspicion of this investment among members of Congress—diminished after 1976. But in 1979 the committee, under Bergsten's leadership, did act to address concerns about the acquisition of American Motors by the French firm Renault. Because Renault was partly owned by the French government, the committee worried that, as a subsidiary of Renault, American Motors might somehow be used by the French government to advance

12. Reprinted in Bergsten (1983).

French national objectives of a noneconomic nature. That concern was mitigated when the CFIUS sought and received an assurance from the French government that Renault would operate American Motors purely as a commercial entity.¹³ This case established the precedent for the CFIUS to undertake a formal review, if the chairman deemed it advisable, of any investment in the United States in which a foreign government had a stake. If the CFIUS determined that the investment might have a major adverse implication for US national interests, the committee would convey its finding to the Economic Policy Group and the National Security Council; then if these bodies concurred, the relevant government would be asked either to refrain from making the investment or to modify it to make it acceptable to the CFIUS.

In the wake of the 1979 oil price increase, there was renewed suspicion and fear of OPEC investment in the United States and, with it, calls from Congress for a more activist role for the CFIUS, as well as new powers congressionally granted to the president to regulate foreign investment in the United States. In official testimony before the House of Representatives Subcommittee on Commerce, Consumer, and Monetary Affairs in late July of that year, Bergsten argued against new legislative authority, claiming that it could discourage foreign investment in the United States. He argued that such investment, and international investment on the whole, “will generally result in the most efficient allocation of economic resources if it is allowed to flow according to market forces” (Bergsten 1979). He further argued that there was no basis for concluding that FDI harmed US national interests.

No legislation to create a more activist CFIUS was passed at that time. However, nine years later, in the wake of renewed fears of FDI (from Japan rather than OPEC), new legislation was passed, the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988. This amendment, later made part of permanent law, authorized the president to block foreign acquisition of a US firm if the president determined that the acquisition “impaired or threatened to impair” US national security. The president subsequently delegated to the CFIUS implementation of so-called Exon-Florio reviews of acquisitions of US firms by foreign investors. Under current procedure, the CFIUS need not fully review every such acquisition but may review any acquisition. A 1992 amendment to the law makes such reviews mandatory if the foreign investor is a foreign government (or an entity under the control of a foreign government) and if the CFIUS determines in a preliminary review that there may be a connection between the acquisition and US national security. The outcome of a review is that the CFIUS recommends to the president whether or not to

13. This matter is recalled in C. Fred Bergsten, “Avoiding Another Dubai,” *The Washington Post*, February 26, 2006.

block a particular acquisition; to date, the president has followed the CFIUS recommendations.

In practice, since the passage of the Exon-Florio amendment, the CFIUS has recommended blocking only one foreign acquisition of a US firm for national security reasons. However, about a dozen proposed acquisitions have been cancelled because of an investor's expectation that the acquisition likely would be blocked (for details, see Graham and Marchick 2006). The small number (13 or 14) of formal or de facto blocks by the CFIUS must be compared with the number of successful foreign acquisitions of US firms, which total more than 3,000 since enactment of the Exon-Florio authority.

At the time of this writing, bills are pending in both the US Senate and the House of Representatives to modify the Exon-Florio authority to make it more likely that any acquisition of a US firm by a foreign investor will be subject to an Exon-Florio review or for the CFIUS to recommend to block the acquisition. Fervor in the Congress to "tighten" Exon-Florio was fomented first by the (failed) effort of the China National Offshore Oil Corporation (CNOOC) to acquire the US oil firm Unocal and subsequently by the acquisition of US port operations (via takeover of a British firm that operated certain US port facilities) by Dubai Ports World, a firm under the control of the Emir of Dubai. However, it is not clear that either bill will actually be acted upon.

Since the furor in 2006 over Dubai Ports World, a number of other countries—most prominently, China and Russia (for details, see Graham and Marchick 2006)—have enacted or are considering measures that could restrict FDI activity. These developments come after 15 years during which numerous countries took significant steps to liberalize law and policy for foreign investment in their economies.¹⁴ Given that this trend toward liberalization might be reversing itself, it is worth reconsidering whether Bergsten was correct in calling for some sort of international rules pertaining to government treatment and regulation of international investment and MNEs.

Does the Case for an International Regime for Investment Still Stand?

In order to answer this question in the affirmative, we should be able to demonstrate two things: (1) FDI yields a net gain for the global economy,

14. Developments in international law and policy pertaining to FDI have been documented since 1991 in the *World Investment Report*, published annually by the United Nations Conference on Trade and Development (UNCTAD); since that year, about 80 percent of the reported changes have been in the direction of liberalization of treatment for foreign investors.

and (2) international rules pertaining to such investment would enable even greater gains. While it is not possible to unequivocally demonstrate either of these conclusions, I would argue that both are likely true.

The first point—that FDI yields a net gain for the global economy—is easier to argue. Operations enabled by FDI generate positive externalities that can be empirically measured, and although empirical evidence is mixed as to whether these externalities actually exist, recent evidence tilts in their favor. Moreover, if FDI does generate gains of this sort, it should also raise the overall rate of growth of the economy (through, for example, more rapid transfer and diffusion of technology). A number of studies attempt to measure the effect of FDI on growth, and all but one concludes that FDI is positively and robustly associated with growth. Among these are results reported by Blomström, Lipsey, and Zejan (1994), who find that FDI positively affects growth if and only if a national wealth threshold is reached. By their finding, FDI does not positively affect growth if a country is quite poor. Balasubramanyam, Salisu, and Sapsford (1996) also find a positive relationship but only if the country is open to international trade. This result is not inconsistent with Blomström, Lipsey, and Zejan because, in recent history, poorer countries have tended to be less open to trade than richer countries. Borzenstein, de Gregorio, and Lee (1998) also find a positive relationship but only if a country meets a threshold level of education. Again, this finding is generally consistent with the earlier results, because poorer countries tend to have less well-educated populations than do richer ones. It should be noted, however, that Blomström, Lipsey, and Zejan did consider education as a conditioning variable but found it not to be significant. Alfaro et al. (2003) again find a positive relationship but only in countries with well-developed financial markets; this is (roughly) consistent with earlier findings, because richer countries have better developed financial markets than do poorer ones. Finally Blonigen and Wang (2005) find, using a later and larger dataset than Blomström, Lipsey, and Zejan, that FDI affects growth more strongly in developing (poorer) countries than in rich ones. This lattermost finding is of course not consistent with the other and earlier ones and might be explained by a number of factors, including that the data is more recent and hence affected strongly by growth in China. Moreover, it is possible that because a majority of FDI in rich countries in recent years has been created by cross border merger and acquisition, as opposed to “greenfield” FDI, the former type of FDI simply generates less growth than the latter.¹⁵ By contrast, the majority of FDI in certain developing countries, most especially China, has been of the “greenfield” variety. Kumar and Pradhan (2005) use instead of an ordinary

15. “Greenfield” FDI occurs when the foreign investor creates an affiliate, which then creates plant and equipment, as opposed to the foreign investor acquiring an extant, ongoing operation from local investors.

least squares (OLS) estimator an “Arellano-Bond” (modified General Method of Moments) estimator to test whether FDI in south Asia has had a positive impact on growth. They conclude in the affirmative. This study is notable because an Arellano-Bond estimator is now accepted as a more appropriate tool with which to analyze panel data than the more commonly used OLS estimator.

In addition to studies based on panel data, there have been studies of individual nations based on time series. We note an unpublished study in particular (Dayal-Gulati and Husain 2001) focusing on China. Comparisons of regions within China reveal that, in the years subsequent to China becoming more open to FDI in 2001, there was an acceleration of economic growth in those regions that received significant amounts of FDI. By contrast, this acceleration in economic growth was not observed in those regions where such FDI did flow. The findings thus are consistent with a claim that FDI does accelerate economic growth. Carkovic and Levine’s analysis (2005), which includes a critical review of other studies, does not support this claim. Carkovic and Levine’s analysis indicates that there is a positive relationship between FDI and growth but that it is not robust. The authors also find that FDI is positively and robustly associated with growth unless a variable for trade openness is included in the specification, in which case the association between FDI and growth becomes non-robust. In a commentary on Carkovic and Levine, Melitz (2005) concludes that their finding should be reinterpreted as follows: Trade openness and FDI jointly are positively and robustly associated with growth.

As with the empirical evidence regarding FDI and growth, there is an empirical literature on FDI and externalities, and the reported results are mixed. A recent survey of the rather extensive literature (Lipsey and Sjöholm 2005), however, notes a curious fact: Whereas older studies tend both to support and not support the hypothesis that FDI does create positive externalities, newer studies more consistently find in favor of this hypothesis than do the older ones. The authors conclude that one of two possibilities is correct: Either, in recent times, the externalities themselves are more prevalent and perhaps stronger than in earlier times, or methodologies have improved such that externalities that have long existed but once escaped detection are now more readily discerned than in the past. Either way, the recent evidence does seem to point towards the likely existence of positive, and mostly technology-based, externalities being generated by FDI.

Despite the fact that the studies just cited do not unequivocally support that FDI creates gains to the host or world economies, the evidence is quite strong that such gains do occur. Moreover, there is no empirical evidence whatsoever that FDI does harm. Thus, I would argue that the case for FDI is quite strong. But is this case supportive of a call for new international rules on investment? Would such rules increase gains from FDI?

In the absence of such rules, it is difficult to answer this last question. The closest thing to a comprehensive set of such rules is chapter 11 of the North American Free Trade Agreement (NAFTA). With respect to this agreement, Hufbauer and Schott (2005, 30) argue that, since NAFTA came into effect, Mexico has realized “an FDI boom,” which presumably has benefited Mexico, although the authors do not attempt to quantify this benefit. But, assuming that Mexico does benefit from accepting the rules on investment of NAFTA chapter 11, would similar benefits be realized by other countries from a multilateral version of these rules? In the absence of experience, it is difficult to answer “yes”—but equally or more difficult to claim that the answer is “no.”

Subject to such qualification as offered in the previous paragraph, let me nonetheless offer an opinion with respect to this last question: Bergsten and others noted earlier in this chapter, who called for such rules more than 30 years ago, were right then and remain right now. Government measures certainly can have the effect of diminishing the gains from investment or creating “beggar thy neighbor” outcomes whereby some nations are advantaged by investment at the expense of others and to the likely detriment of global economic welfare.

Having said this, my own view is that Bergsten might only have gotten the priorities wrong when he stressed as a first priority to develop rules to regulate investment incentives and performance requirements. He was right in stressing that certain government measures can lead to distortions that reduce global economic welfare. But surely the worst such distortions are not caused by incentives and performance requirements but rather by measures that discourage FDI altogether. Thus NAFTA provides for rules ensuring the right of entry of multinational firms to the three NAFTA nations (subject to a number of reservations) and for postestablishment national treatment of operations of foreign investors. And the same priority was at the heart of the (failed) Multilateral Agreement on Investment. Moreover, as recognized by practitioners of trade policy and trade negotiations, international rules on any aspect of commerce are useful only if they are enforceable; thus NAFTA created a dispute settlement procedure meant to increase enforceability of the chapter 11 rules, and such a procedure would be an important element of any effective multilateral rules on investment.

But maybe the big question is not whether international rules pertaining to investment would be a good idea, but rather will such rules ever come into being? At the moment, the picture is not encouraging. In the Cancun meeting of the WTO, the “trade and investment” negotiations were taken off the table. Thus, whatever the case for such rules, they are unlikely to come about in the near future. History will judge whether this proves to be a major or simply a minor failing of whatever comes out of the Doha Round. But, in any event, Bergsten surely was right to begin; a full set of these rules does need to come into existence.

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