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International Investment Agreements and Their Impact on Foreign Direct Investment: Evidence from Four Emerging Central European Countries

Annie Tortian

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THESE

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Annie Zaven TORTIAN

**INTERNATIONAL INVESTMENT AGREEMENTS
AND THEIR IMPACT ON
FOREIGN DIRECT INVESTMENT:
EVIDENCE FROM FOUR EMERGING CENTRAL EUROPEAN COUNTRIES**

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The opinions expressed in this dissertation are those of the author and do not necessary reflect the views of the University of Paris 1 Panthéon-Sorbonne.

In memory of my father Zaven Tortian

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List of Abbreviations

ASEAN	Association of South East Asian Nations
BIS	Bank for International Settlement
BIT	Bilateral Investment Treaty
CEC4	Central European Four Countries: The Czech and Slovak Republics, Hungary, and Poland
CEEC	Central and Eastern European Countries
DSU	Dispute Settlement Undertaking (WTO)
EDT	External Debt Total
EU	European Union
FDI	Foreign Direct Investment
G7	Great Seven Countries or Group of Seven: United States, Canada, United Kingdom, France, Germany, Italy, and Japan
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tarrifs and Trade
GDP	Gross Domesic Product
GNI	Gross National Income
GNP	Gross National Product
ICC	International Chamber of Commerce
ICSID	International Centre for Settlement of Investment Disputes
IIA	International Investment Agreement
ILO	International Labour Organization
IMF	International Monetary Fund
M&As	Mergers and Acquisitions
MAI	Multilateral Agreement on Investment
MERCOSUR	Mercado Comun del Sur (Southern Common Market)
MFN	Most-favoured Nation

MGS	Imports of Goods and Services
MIGA	Multilateral Investment Guarantee Agency
MNC	Multinational Corporation
MNE	Multinational Enterprise
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
R&D	Research and Development
RES	Reserves
RULC	Relative Unit Labour Cost
SPS	Sanitary and Phytosanitary Standards
TDS	Total Debt Service
TNC	Transnational Corporation
TRIMs	Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UCFS	Understanding on Commitments in Financial Services
UK	United Kingdom
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
US	United States
USSR	Union of Soviet Socialist Republics
WB	World Bank
WIPO	World Intellectual Property Organization
WIR	World Investment Report
WTO	World Trade Organization
XGS	Exports of Goods and Services

Preface

The reason I chose the title “*International Investment Agreements and their Impact on Foreign Direct Investment: Evidence from Four Emerging Central European Countries*” for my doctoral dissertation stemmed from the fact that the 1990s has witnessed a major transformation in the structure and size of international capital flows parallel with an explosion in the number of international investment agreements (IIAs). Among the private capital flows foreign direct investment (FDI) has witnessed a dramatic increase in the world economy over the 1990s. This type of capital has emerged as the most important channel of external resources for emerging economies.

Coinciding with this is another fact that during the 1990s the four emerging economies of Central Europe - The Czech and Slovak Republics, Hungary, and Poland (CEC4) - have made tremendous progress in integrating with the world economy, and have attracted impressive amounts of private capital flows. Foreign investments were rare in these countries. They were ruled over decades by a centrally planned economic system, which maintained artificially for years, and led to serious economic crises. Political and market reforms introduced in the late 1980s changed the situation drastically. At that time an increasing financial openness by these countries, reflected by the signature of IIAs, led to a significant increase in private capital inflows, notably FDI. In addition, three reasons prompted the author to pursue this study.

First, the global financial system witnessed critical financial crises during the 1980s and the 1990s. Financial crises – banking crises, debt crises, currency crises, or

some combination of the three - have occurred with disturbing frequency and intensity over the last two decades of the twentieth century. In the past 20 years alone, more than 125 countries have experienced at least one serious bout of banking problems. In more than half of these episodes, a developing country's entire banking system essentially became insolvent. In more than a dozen cases, the cost of resolving the crisis was at least 10 percent of the crisis country's annual national output. For example, the US savings and loan crisis of late 1980s cost US taxpayers about 2-3 percent of their national income.

The debt crisis of the 1980s cost Latin America a "lost decade" of economic growth. Ten members of the European Exchange Rate Mechanism were forced to devalue their currencies in 1992 and 1993, despite spending upwards of \$150 billion to defend them. Mexico suffered its worst recession in six decades after the devaluation of the peso in 1994-95. And in the Asian/global financial crisis that first erupted in Thailand in July 1997, the most serious of these crises, economies accustomed to annual growth rates of 6-8 percent suffered severe depressions, with output falling 5-14 percent after the crisis. Many other emerging economies – from Latin America to Eastern Europe to South Africa – found their home grown economic problems exacerbated by the crises that began in Asia. Net private capital flows to emerging economies (as a group) collapsed to 70 percent below their peak in 1996. That decline in capital flows was particularly marked for portfolio capital flows (bonds and equities) and for bank lending. In the fall of 1998, after the Russian default and devaluation and following the near-collapse of Long Term Capital Management, a large hedge fund, the turmoil in international financial markets intensified to an almost unprecedented degree.

Financial crises can impose enormous costs and hardships on the countries involved. At their worst, these crises can destroy within a period of one or two years much of the economic progress that workers, savers, and businesses have achieved over several decades. It is therefore a matter of high priority for governments and private sectors alike to find ways both of reducing susceptibility to financial crises and of dealing with crises more effectively when and where they occur. Governments from

both the industrial countries and leading emerging economies in concert with international financial institutions (IMF, WB, BIS, and others) have been hard at work on plans for improving crises prevention and crises management. This collaborative international effort has come to be widely known as strengthening the “*international financial architecture*”. This body examined the factors that often give rise to financial crises and offered assessment of what parts of the existing architecture are most in need of repair.

One of the roots of financial crises and sources of vulnerability was high volatility in private capital flows to emerging economies. In recent years, private capital flows into emerging markets have been highly volatile. While some fluctuation in private capital flows to emerging economies is natural in light of the changing investment opportunities and the way investors react to new information, experience suggests that “boom and bust” cycles in such flows create serious problems. Turning to the “bust” side of the cycle, a sudden stop or reversal in private capital flows is often the forcing event that ushers in a crisis. This can turn liquidity problems into solvency problems, induce large cuts in spending that bring on recession, and spread crises considerably beyond their origin. The challenge, therefore, is to find ways to moderate the “boom-bust” cycle in private capital flows and to tilt the composition of such flows toward longer-term, less crisis-prone components, such as FDI, while still preserving most of the benefits associated with greater market access. Short-term capital flows carry a high risk because their short maturity makes it easier for investors to run at the first hint of trouble. On the other hand, flows of FDI to emerging economies record only a slight decline during crisis. Reversals in portfolio flows, and bank loans are much more pronounced. This seems to have tilted the composition of inflows towards less risky, longer-term components.

In this regard, an *Independent Task Force on the Future International Financial Architecture sponsored by the Council on U.S. Foreign Relations*, was formed, and set meetings focusing on what was “broken” in the existing architecture, and how to “fix” it. It made seven key recommendations. Recommendation 2 is concerned with capital flows and states: “*Recommendation 2: Capital Flows - Emerging economies with*

fragile financial systems should take transparent and non-discriminatory tax measures to discourage short-term capital inflows and encourage less crisis-prone, longer-term ones, such as foreign direct investment.”¹

Second, the emergence of new countries, such as the CEC4, to the international economic scene has been an important feature of the 1990s. Soon after the fall of the Berlin Wall in 1989, the CEC4 quickly established diplomatic and economic relations with the OECD countries. Since the late 1980s, the CEC4 have been very active in concluding bilateral investment treaties (BITs) with OECD members having concluded 93 BITs as of June 2006. The CEC4 completed the geographical coverage of their BIT network, having first signed treaties with their European neighbours. The striking feature is that all BITs signed between the CEC4 and OECD members have been ratified (entered into force) by the early 1990s. In addition, the CEC4 were invited to join the OECD² in 1995, and have accepted the *OECD Code of Liberalization of Capital Movements* - a regional investment agreement - that binds all OECD members to liberalize capital flows (EIU, 2003a, b, 2004a, OECD, 1995).

Third, since the early 1990s, the CEC4 have attracted impressive amounts of international private capital flows. The structure and size of capital inflows among and within each of these countries differed widely with FDI being an important component, indicative of a higher “quality”, “long-term stable capital” and “non-debt creating”. Investigating sources of FDI, led to the fact that they originate mainly from the OECD area. Moreover, during the 1990s, the CEC4 have been favourite targets for foreign investors within their region, attracting the bulk of FDI in CEEC. On a global scale, their share accounts for only 2-3 percent of World FDI inflows over the period 1990-2005 (UNCTAD, WIR 1998-2006).

Because of the three reasons discussed above, this study, first, will analyze the different types of capital inflows to CEC4: foreign direct investment (FDI), portfolio

¹ Extracted from “*Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture: Report of an Independent Task Force-Council on U.S. Foreign Relations*” by Hills, Peterson and Goldenstein, 1997, pp. 4.

² See Appendix F: Membership of CEC4 of International Organizations.

investment (PI), and “Other” investments (OI), as expressed in the *International Financial Statistics* published by the IMF. The analysis shows that FDI has been an important component of capital inflows. Second, it will examine empirically whether IIAs, particularly, BITs concluded between CEC4 and OECD countries have generated these major structural changes in capital inflows.

The Four Central European Countries (CEC4) in Focus

Looking at the list of BITs concluded by CEC4 as of 1 June 2006, one notices that these countries have started signing BITs since the late 1980s. More importantly, the list shows that the early treaties were concluded with OECD countries. One understands from the dates of signatures that they are related to the political and historical events. Hence, it becomes necessary to present an overview of the Central European region.

After the fall of communism in 1989, the Central European countries were left with the difficult task of creating free democratic states. The task was made more difficult as all their economies were suffering with debt (Economist Intelligence Unit 2001a, b, 2003a, b, c, d, e, and f). The speed of the communist collapse had caught policy makers in the West off guard and as a result limited work had been done on strategic policies to be adopted by the OECD in such an event. The result was a general scramble for policy ideas. An influential article during this uncertain time was Jeffrey Sachs’ article of 13 January 1990 in *The Economist*, entitled ‘*What is to be done?*’ His article focused predominantly on the economic aspects of transition, and argued for quick and total de-collectivization. Sachs’ ideas were based on neo-classical economics, and his own work in particular was referred to as “The Economic Theory of Transition”. Sachs’ main economic transition argument in 1990 was not only for privatization, but also for the West to supply large amounts of private investment into Central Europe (Sachs and Lipton, 1990, Sachs, 1997).

Sachs’ American-style developmental policies would later be adopted by the G7 countries. This was not because Sachs ideas were unique, but rather because his ideas conformed to the dominant paradigm of capitalism. Strict neo-classical policies were

supported by international financial institutions and G7 Governments. Moreover, Sachs played a visible role in the transferring of Western economic norms. He suggested that if Central European countries were to be truly integrated with the West they would have to seek membership of the IMF, WB, WTO, and OECD.³ All these international organizations are committed to the further liberalization of markets (Sachs, 1997, 2000, Sachs, Woo and Parker, 1997). It was expected therefore that Central Europe's transition countries would open their economies to foreign investment and international trade as well as making their national currencies fully convertible. The introduction of these policies, it was assumed, would lead to the establishment of private ownership as the "engine of growth" (Sachs, 1993, Sachs, Zinnes and Eilat, 2001).

On the other hand, from the point of view of the G7 leaders, the collapse of the Soviet Union had left a power vacuum (EIU, 2003g). Western aid and advice offered to Central Europe was designed to ensure its transition to Western capitalism and thereby ensure stability in the area (Baylis, 1994, EIU, 2003g). The European Community was concerned about the region of Central and Eastern Europe because it was their own economic backyard. Although the European Community was interested in the entire region, it was particularly interested in the Central European countries of Poland, the Czech Republic, and Hungary. The process was an attempt to integrate Central Europe into the West and capitalism (De Boer-Ashworth, 2000).

These Central European countries, in their transition phase, needed investment capital in order to maintain or introduce structural changes. Investment capital usually comes in the form of aid or loans from the West and this leads ultimately to the implementation of neo-classical economic development policies⁴. Basically Central European governments were told that they did not need a Marshall Aid package

³ See Appendix F: Membership of CEC4 of International Organizations.

⁴ Neo-classical economics is built on the theoretical foundations of classical liberal economics. The mainstay of this school of thought is that governments should not intervene in markets because free markets are assumed to be self-regulating. Countries involved in free trade need not benefit equally in order for a liberal market system to be a success. All that is required is that individual states accrue some benefit. The goal of this form of economics is that political impediments to the free movement of capital, goods and labour are eliminated.

because the transition would be financed by foreign capital. The claim that FDI was the only vehicle for technological change was only true to the extent that the G7 countries and the IMF told the Central European governments that this was the case, and pressured all countries to open their economies to FDI (De Boer-Ashworth, 2000).

The heavy concentration on the transmission of economic capitalism can be reflected somehow by the signature of IIAs, particularly, BITs. Since the late 1980s, the CEC4 concluded extensively BITs with the OECD countries. Also, in 1991, they signed with the EU bilateral “*Europe Agreement*” that came into effect in 1994. On the international scale, the CEC4 gained membership of the World Trade Organization (WTO) in 1995, and the OECD in 1995, and 1996 (EIU, 2003a, b, g, and 2004a). The stability created by these legislative changes and Central European access to the EU would act as a magnet for foreign investment, especially FDI. Regardless of the type of transition, whether fast or slow, the desired outcome by the West was to pull Central Europe into the wider global political economy. All these countries are now as dependent on the West as they were on the Soviet Union before 1989 (De Boer-Ashworth, 2000).

General Introduction

The last decade of the twentieth century witnessed a number of major events, including the fall of communism, a radical shift in economic and political regimes in many countries of Central and Eastern Europe, globalisation, financial crises in many emerging countries leading to voices calling for a reform of the international financial architecture, and an explosion in the number of international investment agreements (IIAs) between countries, especially, at the bilateral level.

The ongoing process of integration of the world economy, which gained momentum since the beginning of the 1990s, coinciding with the fall of the Berlin Wall in 1989, and the opening up of Central European countries to the world, has led to a significant change in the attitude of these countries with respect to international investment, and private capital flows, especially the FDI type. The four Central European countries – The Czech and Slovak Republics, Hungary and Poland have made tremendous efforts in integrating with the world economy. The financial openness of the CEC4 and their commitment to participate in the global economy is reflected by their extensive signature of bilateral investment treaties with OECD countries since the late 1980s, their membership of international organizations such as the OECD, IMF and WTO by the mid 1990s, and their attraction of impressive amounts of private capital flows during the 1990s. An analysis of the structure of capital inflows in CEC4 shows that FDI has been an important component.

The CEC4 have undertaken radical reforms to address administrative, regulatory, legal, and institutional barriers to investment, with the overarching objective of improving the “climate for investment” and private sector activity. Foreign investments were no longer regarded with suspicion by these emerging countries.

Controls and restrictions over entry and operations of foreign investors were replaced by policies aimed at encouraging FDI inflows (Shepherd, 2000, EIU, 2001a, b, 2003a, b, c, d, e, f, g, 2004 a, b, and c). Along with this, there has also emerged an extensive network of bilateral and regional investment agreements, which seek to promote and protect international investments, especially FDI, coming from the partner countries. The main provisions of these agreements whether bilateral or regional are linked with the gradual decrease or elimination of measures and restrictions on the entry and operations of foreign investors, the application of positive standards of treatment with a view to eliminate discrimination against foreign enterprises and international legal protection for foreign investments (UNCTAD, 1998a, b, and 2004b).

As a result of these developments, private capital flows, particularly FDI, surged in the 1990s to CEC4. According to the IMF, in 1989 there were some US\$ 455 million of FDI inflows in CEC4. In contrast, their total FDI inflows reached to about US\$ 29 billion in 2005. They have grown 50 fold during this period. Also, at the end of 2005, FDI inward stock in CEC4 were more than US\$ 229 billion compared to US\$ 1.5 billion in 1989, representing 70 to 83 percent of FDI stock in CEEC region during the period 1989-2005 (IMF, IFS, 1999-2007, UNCTAD, WIR 2006, and FDI/TNC database). Investigating sources of FDI led to fact that they originate mainly from the OECD area (OECD 2004a).

Research Question

Having explained the motivation and the reasons for deciding on this topic, the questions addressed by the study are:

1. Do IIAs increase FDI in CEC4?
2. Does the ratification of a BIT between source-host country pair increase bilateral inward FDI in CEC4?
3. Do BITs exert a different impact on FDI in an environment with well developed and efficient financial institutions?

Purpose of the Dissertation

The purpose of this dissertation is to examine empirically the impact of international investment agreements (IIAs) on FDI through the capital flow experience of the Central European four countries - The Czech and Slovak Republics, Hungary, and Poland (CEC4) - during the period 1992 to 2003. Statistical figures show that these countries have been experiencing sizeable capital flows, notably FDI, since the early 1990s, coinciding with their signature of bilateral investment treaties (BITs) with OECD countries (UNCTAD *investment instruments online database*: www.unctad.org/iia).

Since the late 1980s, the CEC4 have been very active in concluding BITs with OECD countries having concluded 93 BITs as of June 2006. Most of these treaties were entered into force by the early 1990s. In 1991, the CEC4 signed with the EU bilateral “*Europe Agreement*” that came into effect in 1994. By the mid 1990s the CEC4 joined international organizations: a) the OECD, accepting the *OECD Code of Liberalization of Capital Movements* - a regional investment agreement; b) the WTO - accepting all its investment related provisions as a multilateral investment agreement; and c) accepted the *IMF Articles of Agreement: Article VIII* – concerning current account convertibility. All the international agreements (bilateral, regional, and multilateral) concluded between the CEC4 on one hand, and OECD and WTO on the other, include investment clauses reflecting the priorities of international economic relations of both parties. The investment-related clauses cover a wide range of issues, reflecting the depth of economic integration between the two parties.

In particular, BITs are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each others’ territories by companies based in either country. The signature of BITs reflects the fact that establishing international economic relations was a priority concern for the CEC4, and confirms their strong commitment for external liberalisation, economic and financial integration with the global economy. It signals that these countries’ attitude towards foreign investors has changed, and its “investment climate” is improving. What is of interest is the international legal protection and change in property rights introduced

with a BIT. All offer guarantees for transfer, and international legal protection for investments. Foreign investors consider BITs as part of a “good” investment environment.

The researcher seeks to demonstrate that BITs have a significant positive impact on FDI inflows. Beside, the author claims that host country “institutions” have a crucial role in attracting FDI to a country. The study focuses on “financial institutions” and argues that level of development and efficiency of financial institutions is crucial for the “investment environment” in a host country. Foreign investors’ decisions are strongly influenced by the level of development, quality and efficiency of financial institutions of a host country. The main purpose of the study is to examine empirically whether or not the existence of BITs attracts FDI, and how BITs interact with financial institutions. Achieving the objective of this study requires the examination of the link among international investment agreements (IIAs), foreign direct investment (FDI), and financial institutions.

Other Studies

The existing literature on capital flows to the emerging economies of Central Europe has concentrated on the analysis of the “traditional” determinants of FDI and the “transition economies” as a whole. The two main approaches have been survey-type studies and formal quantitative analyses. Examples of the former are found in Lankes and Venables (1996). Quantitative studies are based on a number of different empirical models, the gravitational approach being the most commonly adopted. Among the quantitative studies in the literature one can mention the works by Wang and Swain (1995), Lansbury, Paine and Smidkova (1996), Holland and Pain (1998), Claessens, Oks and Polastri (1998), Resmini (2000), Ramcharran (2000), Bevan (2000), Bevan, Estrin and Meyer (2000, and 2004), Bevan, Estrin and Grabbe (2001), Di Mauro (2001), Garibaldi, Mora, Sahay and Zettlemeyer (2002), Bandelj (2002), Campos and Kinoshita (2003), Bevan and Estrin (2004), Carstensen and Toubal (2004), and Brzozowski (2006). All the mentioned studies have used “traditional” variables, such as market size, growth prospects, macroeconomic factors (inflation, exchange rate levels and volatility, and fiscal deficit), labour cost, availability of

skilled labour, geopolitical considerations, distance, common border, trade linkages, etc.; and “transition-specific” variables, such as the speed and method of privatisation. Some have used country credit ratings, and the impact of EU accession announcements.

Lansbury, Pain and Smidkova (1996), using panel data technique, identified the determinants of FDI from 14 OECD countries to the Czech and Slovak Republics, Hungary, and Poland, from 1991 to 1993. Their study focused on the privatisation process, and on the trade linkages between host and investor countries. The set of explanatory variables included country risk, labour costs, trade, privatisation, expense in energy consumption, and the relative stock of patents in the host country. Their result suggested that FDI patterns are positively affected by the privatisation schedule, the research base (reflected by the number of patents), and trade links. Holland and Pain (1998), also using a panel data technique, focused on variables such as the privatisation method, overall risk, relative labour costs, and common border. They studied FDI inflows to 11 transition economies over the period 1992-1996. The authors concluded that the privatisation method is an important determinant of FDI. Bevan and Estrin (2004) explicitly took host countries' risk into account. Risk is associated to credit rating, which is explained by macroeconomic, transition and environmental factors. Their analysis is based on a gravity-type model, and the data sample contains FDI flows from 18 market economies to 11 transition economies, over the period 1994-1998. They explored the impact of EU membership announcements on FDI inflows. Their econometric model revealed that, country risk, market size, labour costs, distance, and announcements concerning EU membership have affected FDI directly.

Other researchers have also put considerable effort on the analysis of foreign investment in CEEC and transition economies since the late 1980s. In this respect, one can mention the works by Sachs (1990, 1993, 1997, and 2000), Blanchard, Dornbusch, Krugman, Layard and Summers (1991), Gross and Steinherr (1995, and 2004), Lavigne (1995), Dabrowski (1996), De Melo, Denizer and Gelb (1996), The World Bank (1996, and 2002), De Melo, Denizer, Gelb and Tenev (1997), Frydman,

Rapaczynski and Turkewitz (1997), Michalet (1997), Sachs, Woo and Parker (1997), Meyer (1998, 2001, and 2006), Berg, Borenztein, Sahay and Zettlemeier (1999), Kaminski (1999a, b, and 2001), Michalopoulos (1999a, and b), Stiglitz (1999), Altomonte (2000), Bartlet (2000), De Boer-Ashworth (2000), Elteto (2000), Fischer and Sahay (2000), Gross and Suhrcke (2000), IMF (2000, and 2003a), Kaminski and Riboud (2000), Mihalyi (2000), Roland (2000), UN/ECE (2000a, b, 2001, 2003a, b), Balaz and Williams (2001), Kaminski and Smarzynska (2001), Reininger, Schardax and Summer (2001), Sachs, Zinnes and Eilat (2001), Weder (2001), Berglof and Bolton (2002), Ebbers and Todeva (2002), Lane, Lipschitz and Mourmouras (2002), Jensen, Hougaard, Rasmussen and Rutherford (2002), Popov (2002), Gorg and Greenway (2003), Sass (2003), Andreff (2004), Meyer and Estrin (2004), Pournarakis and Varsakelis (2004), Meyer and Peng (2005), Meyer and Jensen (2005), and Andreff and Andreff (2006).

Within the economic literature BITs have generated very little attention. The role of BITs has received some discussion in law journals. There the focus has been on the issue of providing a commitment device to overcome the dynamic inconsistency problem (Vandeveld, 1998 and 2000). It is most astonishing that despite the rising number of BITs since the early 1990s, there are only few serious studies examining the effect of such treaties on the location of FDI. UNCTAD sponsored one of the first analyses in 1998 (UNCTAD, 1998b). It studied the impact of 200 BITs on bilateral FDI data, examining years prior to and after their conclusion. It found a weak correlation between the signing of BITs and changes in FDI flows, but used minimal control variables in generating this result and did not control for the strong upward trend in FDI over time. Its cross-section analysis of 133 host countries in 1995 concluded that BITs do not play a primary role in increasing FDI, and that a larger number of BITs ratified by a host country would not necessarily bring higher inflows.

The first serious study has been undertaken by Hallward-Driemeier (2003), looking at a panel dataset of bilateral FDI outflows from 20 OECD countries to 31 developing countries over the period 1980 to 2000. Using source-host country fixed effects estimations she finds little evidence that the existence of a BIT between two

countries does stimulate additional investment from the developed to the developing signatory country. Those countries with weak domestic institutions, including protection of property, have not gotten significant additional benefits; a BIT has not acted as a substitute for broader domestic reform. Rather, those countries that are reforming and already have reasonably strong domestic institutions are most likely to gain from ratifying a treaty. That BITs act as more of a complement than a substitute for domestic institutions means that those that are benefiting from them are arguably the least in need of a BIT to signal the quality of their property rights.

The second study, Banga (2003) examines the impact of BITs on aggregate FDI inflows to 15 developing countries of South, East and South East Asia for the period 1980-81 to 1999-2000. She undertakes a separate analyses for FDI inflows from developed and developing countries using a panel data for ten developing countries for the period 1986-87 to 1996-97. She finds that BITs have a significant impact on aggregate FDI. But it is BITs with developed countries rather than developing countries that are found to have a significant impact on FDI inflows to developing countries.

The third study, Egger and Pfaffermayr (2004a) use the largest available panel of outward FDI stocks provided by OECD, which contains FDI of OECD countries into both OECD and non-OECD economies to evaluate the impact of BITs. They restrict their study to the period from 1982 to 1997. They find that BITs exert a significant positive effect on outward FDI, if they actually are implemented. Moreover, even signing a treaty has a positive, although lower and in most specifications insignificant effect on FDI.

The fourth study, Tobin and Rose-Ackerman (2005) analyse the impact of BITs from developed to developing countries from 1984 to 2000, with data averaged over five – year periods, covering 63 countries. In a fixed effects model, Tobin and Rose-Ackerman find that a higher number of BITs signed with a high income country raises the FDI a country receives as a share of global FDI flows only at low levels of political risk. It is only once a country achieves some minimally low level of political risk that

BITs may become important for host countries to attract FDI. In an additional bilateral analysis, they fail to find any statistically significant effect of BITs signed with the US on FDI flows from the US to developing countries.

The fifth study by Salacuse and Sullivan (2005) provides three cross-sectional analyses of FDI inflows to up to 99 developing countries in the years 1998, 1999 and 2000, respectively, as well as a fixed effects estimation of the bilateral flow of FDI from the US to 31 developing countries over the period 1991 to 2000. They find the signature of a BIT with the US to be associated with higher FDI inflows in both types of estimations, whereas the number of BITs with other OECD countries is statistically insignificant.

The sixth study by Neumayer and Spess (2005) finds that the more BITs a country signs, the greater the FDI flows to that country. Their study includes 119 countries over the period 1970 to 2001.

The seventh study by Desbordes and Vicard (2006) investigates whether the quality of diplomatic relations between a country and the rest of the world influences the volume of FDI that it receives. Their sample of study includes 88 developing countries over the period 1991-2000. The econometric results indicate that the quality of diplomatic relations and the existence of an armed conflict on a host country territory strongly influence the location choice of multinational enterprises. One of the channels through which the quality of diplomatic relations influences FDI is their contribution to the number of BITs signed by a host country. Furthermore, the signature of BITs corresponds to an important channel through which good diplomatic relations exert a positive impact on the volume of FDI received by a host country.

Need for this Study

The effects of IIAs on FDI remain unexplored despite the proliferation of IIA and FDI during the 1990s. To the researcher's knowledge, the literature is lacking studies on the impact of IIAs on FDI activity in CEC4. Despite the proliferation of the number of BITs concluded by the CEC4 since the late 1980s and their attraction of impressive

amounts of FDI during the 1990s, the impact of BITs on FDI in CEC4 is unexplored. The question of whether BITs actually do affect FDI in CEC4 has not been addressed in available literature. A question which is not yet addressed also is whether or not CEC4 membership of OECD and WTO and their acceptance of regional and multilateral investment agreements have any significant impact on FDI in CEC4. Another issue is the role of “financial institutions” in attracting FDI into CEC4. The CEC4 governments applied serious financial sector reforms in order to adhere to the EU standards and the *acquis communautaire*. Financial institutions’ level of development, quality and efficiency, whether BITs exert a different impact on FDI in well developed and efficient financial institutions, have not been given due attention in available literature. Therefore, there is a gap in the literature and a need for this study.

Contribution of the Dissertation

This study will make a major contribution to the literature on capital flows and FDI into CEC4, by verifying the significant positive impact of IIAs and financial institutions’ level of development and efficiency on FDI.

a. Impact of IIAs on FDI in CEC4

The present study adds to the existing literature on the determinants of FDI in CEC4 by empirically examining the response of FDI (inflows and stock) to IIAs concluded by the CEC4. It is the first attempt to test empirically the significance of BITs, *OECD Code of Liberalization of Capital Movements* as a regional investment agreement, *IMF Article VIII* as an international monetary, and *WTO* investment related provisions as a multilateral investment agreement in attracting FDI to CEC4. Whether or not international investment treaties actually attract FDI to CEC4 has not been addressed. This study aims to empirically verify the extent international investment rules influence the flow of FDI to CEC4. The author focuses on BITs and expects investment activity between source–host country pairs to change positively as a consequence of BIT ratification.

The CEC4 signed BITs during their early stages of transition, in the late 1980s and early 1990s. They needed foreign capital and foreign investment, especially FDI, to help them grow and develop at a time when they had weak markets and institutions. For that purpose they opted to signing investment treaties extensively with the developed countries of OECD, since most FDI in the world originates from the OECD area. They hoped and believed that the existence of an investment treaty will influence foreign investors' choice for their country. From foreign investors' point of view, investment treaties provide international legal protection and hedge against political risk. The striking feature is that all the early BITs of the CEC4 were concluded with the OECD countries. These treaties had been ratified by the early 1990s, and FDI flows from OECD to CEC4 were covered by BITs. Clearly, a BIT is not a necessary condition to receive FDI. There are many source-host country pairs with substantial FDI that do not have a BIT. Japan, for example, the second largest source of FDI in the world has only concluded twelve BITs, as of June 2006, and does not have any BIT with the CEC4. Also, the US does not have a BIT with Hungary. In addition, there are also numerous examples of countries that have concluded many BITs and yet have received only moderate inflows.

b. Impact of financial institutions' level of development and efficiency on FDI, and the relationship between BITs and financial institutions vis-à-vis FDI.

Despite the crucial role financial institutions play in an economy, the literature on FDI seems to have ignored the importance of financial institutions' level of development and efficiency with respect to FDI. This study adds to the existing literature by testing empirically whether or not the level of development and efficiency of financial institutions have a significant role in attracting FDI into CEC4, and whether or not ratified BITs exert a different impact on FDI in well developed and efficient financial institutions.

While it may seem natural to argue that BITs serve as commitment device, and that foreign investors regard BITs as improving the "investment environment", a country's capacity to take advantage of FDI spillovers and externalities might be

limited by the “quality” of local institutions. In an effort to further examine the impact of BITs on FDI the study takes its cue from the recent emphasis on the role of “institutions” in the capital flows literature, especially FDI. It emphasizes on the role of “financial institutions” and argues that the lack of development of local financial institutions and their efficiency can limit a country’s ability to take advantage of FDI spillovers.

Although most FDI by its very nature relies on capital from abroad, it is important to recognise that foreign investors’ decisions might crucially depend on the extent of the level of development and efficiency of domestic financial institutions. Progress in establishing financial infrastructure and capital markets is important for foreign investors because it facilitates access to local capital markets. Well developed and efficient financial institutions encourage foreign investors to set up operations, as they can have access to complementary local finance more easily, and face lower transaction costs for local financial services, such as the payment system. Moreover, their customers too, are more likely to have access to bank credit, which should accelerate the demand for their products that are often bought on credit.

The importance of the role played by the financial system for the real economy has been frequently pointed in the economic literature. It has a key function in the allocation of resources by channelling funds from households to enterprises, it provides risk-sharing opportunities for households and firms and it helps agents economize on transaction and information costs. A developed and efficient financial system is therefore an important part of the “investment environment” in an economy. Schumpeter recognized the importance of well-developed financial intermediaries in enhancing technological innovation, capital accumulation, and economic growth almost a century ago. The argument goes on that well-functioning financial institutions, by lowering costs of conducting transactions, ensure capital is allocated to the projects that yield the highest returns, and therefore, enhance FDI activity.

Research Hypotheses

In this study the researcher hypothesizes that:

HYPOTHESIS 1: Foreign investment inflows will be positively related to bilateral investment treaties (BITs) concluded between a foreign investor's home country and a host country.

HYPOTHESIS 2: Foreign investment inflows will be positively related to regional and multilateral investment agreements concluded by a host country.

HYPOTHESIS 3: The lower the "country risk" of a host country, the higher the foreign investment inflows.

HYPOTHESIS 4: The lower the "macroeconomic risk" of a host country, the higher the foreign investment inflows.

Economic Performance (GDP, and Growth Prospects)

H: The higher the economic performance of a host country indicated by GDP and growth, the higher the foreign investment inflows. GDP indicates also market size, therefore, the larger the market size of a host country, the higher the foreign investment inflows.

Price Stability (Inflation Rate)

H: The higher the price instability of a host country reflected by high inflation rate, the lower the foreign investment inflows.

Financial Institutions' Development and Efficiency

H: The better developed and efficient are the financial institutions of a host country, the higher the foreign investment inflows.

External Debt Position

H: The lower a host country's external debt obligations relative to its output or export revenues, the higher is its creditworthiness, the higher the foreign investment inflows.

H: The lower a host country's payments of debt service (interest and principal) relative to export revenues, the higher is its creditworthiness, the higher the foreign investment inflows.

International Liquidity Position

H: The higher a host country's reserve levels relative to its imports of goods and services and / or its external debt obligations, the higher is its creditworthiness, the higher the foreign investment inflows.

HYPOTHESIS 5: The higher a host country's international competitiveness indicated by low relative unit labour cost adjusted for productivity, the higher the foreign investment inflows.

Research Methodology

Econometric Estimation Method

The impact of IIAs - *BITs*, *OECD Code of Liberalization of Capital Movements*, *IMF Article VIII*, and *WTO membership* - on bilateral FDI inward activity (inflows and stock) from 22 OECD countries to CEC4 is estimated for the period from 1992 to 2003 included. This is the period for which data are available. The study estimates also the impact of CEC4 core economic fundamentals, such as, market size, growth prospects and macroeconomic stability; the level of development and efficiency of financial institutions; country creditworthiness indicated by both international liquidity position and external debt management ability; and international competitiveness, indicated by the relative unit labour cost and quality of labour force, on bilateral inward FDI in CEC4.

The scarcity of data concerning FDI in CEC4 creates important constraints to the development of an econometric analysis. One strategy to minor this problem is to use *panel data methodology* in the estimation process. The econometric specifications use country-pair specific effects to capture time invariant *unobservable* effects that might affect bilateral inward FDI. The country-pair specific effects are taken into consideration because one might suspect that there are factors making the host CEC4 attractive to OECD foreign investors that are not captured by the explanatory variables, and that are time invariant, such as historical ties, culture, language, common border, knowledge of mentality of host country people. Both fixed-effects and random-effects methods are used in the estimations. The Hausman test (1978) is applied to detect the efficiency of the estimation method, and to test whether there is a correlation between the country-pair specific effects and the explanatory variables.

Data

Data are originally collected by the researcher. A wide range of data is collected from the IMF *International Financial Statistics*, The World Bank *World Development Indicators*, and *Global Development Finance*, OECD *International Direct Investment Statistics*, and *OECD FACTBOOK 2006*, UNCTAD *World Investment Reports*, *FDI/TNC*, and *international investment instruments online (electronic) database*.

Structure of the Dissertation

In terms of format this dissertation consists of the following seven chapters:

Chapter one elaborates the concept of FDI and presents definitions according to the IMF and the OECD recommendations. It explains the role of FDI in international capital flows, its characteristics and behaviour with respect to other financial flows. Next, it describes the various types of FDI, both from home country and host country perspectives. It discusses also the relationship between globalization and FDI. Finally, it looks at the global trend of FDI inflows during the period 1985-2005.

Chapter two presents facts about the structure and size of capital inflows to CEC4 from late 1980s till 2005. It examines the composition, size and pattern of the different

types of capital inflows. First, the chapter compares the three important types of capital inflows: FDI, portfolio investments and “other” investments in each country over the period under study. Data available suggest that FDI is an important component in the capital structure of CEC4. These countries have attracted impressive amounts of FDI since the early stages of their transition to a market economy. Thus, attention of the chapter shifts to FDI type of capital inflows in CEC4. It looks at the evolution of FDI in each country. Then it compares the size of FDI (inflows and stock) among the four countries, with respect to the CEEC region, and the World. Next, it presents and analyses the different indicators of FDI penetration in CEC4. A serious effort is made by the chapter by investigating the geographical allocation of FDI to and from CEC4 (inward and outward FDI). The chapter investigates the sources (countries of origin) of FDI in CEC4. Data suggest that the majority of FDI activity in CEC4 originates from the OECD area. Concerning outward FDI from CEC4, available data suggest that outward FDI from CEC4 is not yet remarkable and seems to be weak.

Chapter three elaborates the international legal framework for FDI and focuses on international agreements that directly concern and affect FDI. This framework includes bilateral, regional and multilateral investment agreements, which constitute the “sources” of international FDI law. With the ascendancy of FDI as one of the main factors driving international economic relations in the era of globalization, international investment rulemaking has come to the forefront of economic diplomacy. The chapter starts first, by discussing the sources and principles of international investment law and presents a historical overview of the growth of IIAs. Next, it elaborates the methods and instruments in use: BITs, regional and multilateral investment agreements. It explains the notion of BITs, how and why they started to develop and grow in number during the 1990s, and the importance of the entry into force of BITs. Then, it discusses regional economic agreements focusing on the *OECD Code of Liberalization of Capital Movements* as a regional investment agreements. In relation to the OECD Code, the chapter mentions the *IMF Article VIII*, concerning current account convertibility, and its relevance to FDI. The WTO investment related provisions are discussed within the framework of multilateral investment agreement. The core of the chapter is the section which discusses the key issues and provisions

included in BITs. It discusses the characteristics of IIA at different levels, and analyses the advantages and disadvantages of BITs, regional and multilateral investment agreements. Finally, the chapter presents a list of BITs concluded by the CEC4 till June 2006.

Chapter four reviews the international literature on the determinants of FDI. The different theories of the determinants of FDI are discussed by dividing them under four major headings: Theories assuming perfect markets, theories assuming imperfect markets, other theories, and theories based on other factors. Furthermore, the different theories under each subheading are discussed in turn. Theories assuming perfect markets discuss: (1) *The Differential Rates of Return Theory*, (2) *The Portfolio Diversification Theory*, (3) *The Market Size Theory* and (4) *The Growth Prospects Theory*. Theories assuming imperfect markets discuss: (1) *The Industrial Organization Theory*, (2) *The Internalization Theory*, (3) *The Location Theory*, (4) *Dunning's Eclectic Theory*, (5) *The Investment Development Path Theory*, (6) *The Product life Cycle Theory* and (7) *The Oligopolistic Reaction Theory*. Other theories of FDI include: (1) *The Internal Financing Theory*, (2) *The Currency Area and the Effect of Exchange Rates*, (3) *The Theory of Diversification with Barriers to International Capital Flows*, and (4) *The Kojima's Theory*. The chapter discusses also theories which are based on other factors, such as: (1) *Political Risk and Country Risk*, (2) *Tax Policies*, (3) *Trade Policies*, (4) *Government Policies and Regulations*, (6) *Agglomeration Economies*, (7) *Institutions*, and (8) *Strategic and Long-Term Factors*. Finally, the chapter elaborates theories of FDI entry modes by differentiating between exporting, licensing and FDI.

Chapter five presents the conceptual (theoretical) framework of the study. It elaborates the proposed "integrated" theory upon which the theoretical model of the study is based. In order to examine the impact of IIAs on FDI in CEC4, the study proposes to adopt an "integrated" theory, integrating Dunning's "eclectic" theory (OLI Paradigm) with "country risk" theory, because these two theories have been the most successful and powerful in explaining FDI. Beside, the factors of these two

theories can be utilized also as “location-specific” “pull-factors” within the “pull-and-push approach” that has been widely used and adopted in the capital flow literature. Thus, the theoretical framework is based mainly on location-specific “pull-factors”. Dunning’s “eclectic” theory (OLI Paradigm) integrates three theories: the ownership, location, and internalization theories. The theory of “country risk”, in its turn, consists of two major components: “macroeconomic risk” and “political risk” factors. Risk – macroeconomic and political - constitutes a crucial element for foreign investment decisions. The chapter elaborates in detail the two theories. Next, it explains the integration mechanism of the two theories, that is, how the two theories can be integrated. Then, it analyses the way the “integrated” theory can be utilized to explain the impact of IIAs on FDI in CEC4. Finally, the chapter formulates the research hypotheses that the study aims to test in chapter six which is devoted to the empirical analysis.

Chapter six presents the empirical analysis of the study. It specifies the econometric model which is based on the factors of the “integrated” theory, discusses the variables with their expected relationships and presents the data sources. The empirical analysis adopts *panel data methodology* for the estimation process. The econometric specification uses country-pair specific effects to take into consideration all time invariant *unobservable* effects and factors that might affect bilateral inward FDI activity between source and host country that are not captured by the explanatory variables. Both fixed effects and random effects are used for the estimations. A Hausman Test (1978) is applied to detect whether there is a correlation between the country-pair specific effects and the explanatory variables. Next, the chapter presents the estimation results under different specifications. It runs also various regressions under several specifications to check the robustness of the findings. Finally, it discusses in detail the empirical results.

Chapter seven presents the policy implications of the major findings of the study. Finally, a general conclusion presents the uniqueness of the study, summarizes the dissertation, and discusses possible extensions of the topic and fields for further research.

1 The Concept of FDI and Role in International Capital Flows

1.1 Introduction

The 1990s was marked by the increasing role of FDI in international capital flows. It has accounted for about a quarter of total international capital outflows in the 1990s and appears to have grown, relative to other forms of international investment, since the 1970s (Lipsey, 1999). This change in the composition of capital flows has been synchronous with a shift in emphasis among policymakers to attract more FDI, especially following the 1980s debt crisis and the recent turmoil in emerging economies. The rationale for increased efforts to attract more FDI stems from the fact that FDI has been the least volatile source of international investment for most countries (Hausman and Fernandez-Arias, 2000a, b, Carlson and Hernandez, 2002, Lane and Milesi-Ferretti, 2001). Particularly, for emerging economies, direct investment has been the most dependable source of foreign investment (Lipsey, 1999, 2001a, b, 2002, and IMF, 2003b). In addition, FDI has several positive effects which include technology transfers and diffusion (Borenstein *et al.* 1998), productivity gains, the introduction of new processes, managerial skills, and know-how in the domestic market, employee training, international production networks, and access to markets. For instance, Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through a “contagion” effect from the more advanced technology and management practices used by foreign firms. This “contagion” or knowledge diffusion often referred to as externalities or efficiency “spillovers”, can lead to improvements in productivity and efficiency in host country firms. These benefits, in addition to the direct capital financing it generates, suggest that FDI can

play an important role in modernizing the national economy and promoting growth (Lipsev, 2002, Alfaro *et al.* 2004, and 2005, Djankov and Hoekman, 1999, Dunning, 1998, Fernandez-Arias, 1996, Hunya, 2000, Lim, 2001, Zebrags, 1999, Kaminski and Riboud, 2000, and OECD, 2001c).

The aim of this chapter is to provide some theoretical background to the concept of FDI, its definition and measurement according to the IMF, and the OECD recommendations. It presents also the role of FDI in international capital flows, and discusses the differences in the behaviour of FDI with respect to other financial flows. Finally, the chapter presents a brief description of the global trend of FDI inflows during the period 1985-2005.

1.2 The Concept of FDI: Definitions

International flows of capital perform a variety of functions in the world economy. The International Monetary Fund (IMF) provides the most comprehensive and comparable data on capital flows. According to the IMF *Balance of Payments Manual, fifth edition (BPM5)*, capital flows are disaggregated into five categories:

1. *Foreign Direct Investment*
2. *Portfolio Investment*
3. *“Other” Investment*
4. *Use of IMF Credit and Loans*
5. *Exceptional Financing*

The internationally accepted method for classifying and recording cross-border foreign investment flows for Balance-of-Payments Statistics set by the IMF divides them into:

1. *Foreign Direct Investment*
2. *Portfolio Investment*
3. *Financial Derivatives, and*
4. *“Other” Investment*

- *Portfolio Investment*: Includes equity up to or below 10% ownership (shares, stocks, preferred shares and preferred stock and depository receipts) and debt securities not included under direct investment (bonds, debentures, notes and money market instruments).
- *Financial Derivatives*: Include options (on currencies, interest rates, commodities, indices and the like), traded financial futures, warrants and arrangements such as currency and interest rate swaps.
- *“Other” Investments*: Include trade credits, loans (including financial leases and repurchase agreements), currency (notes and coins in circulation), deposits and other assets and liabilities (such as accounts payable and receivable).

As to the concept of FDI, it is a specific form of international investment and capital flows, more long-term, more company-related than portfolio investment, more stable, least volatile source of international investment for most countries, responds less to financial shocks, and there is risk-sharing between the investor and the host country (Lipsey 2001a, b, IMF, 2003b, Albuquerque, 2003).

The IMF *Balance of Payments Manual (5th edition) (BPM5)* and the OECD *Benchmark Definition of Foreign Direct Investment (3rd edition)*, which are fully consistent with each other, present international guidelines for the compilation of balance of payments and international investment position statistics. This body of recommendations provides comprehensive and detailed international standards for recording both positions and flows related to FDI (Falzoni, 2000).

The OECD *Benchmark Definition of Foreign Direct Investment*, 3rd edition, 1996, pp.7 - 8 defines the main concepts as follows:

“Foreign Direct Investment”

“Foreign direct investment reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an

economy other than that of the investor (“direct investment enterprise”). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.”

“Foreign Direct Investor”

“A foreign direct investor is an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise – that is, a subsidiary, associate or branch – operating in a country other than the country or countries of residence of foreign direct investor or investors.”

“Direct Investment Enterprise”

“OECD recommends that a direct investment enterprise be defined as an incorporated or unincorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise.

The numerical guideline of ownership of 10 per cent of ordinary shares or voting stock determines the existence of a direct investment relationship. An effective voice in the management, as evidenced by an ownership of at least 10 per cent, implies that the direct investor is able to influence or participate in the management of an enterprise; it does not require absolute control by the foreign investor.”

“Subsidiaries, associates and branches”

“A direct investment enterprise may be an incorporated enterprise – a subsidiary or associate company – or an unincorporated enterprise (branch). Direct investors

may have direct investment enterprises which have subsidiaries, associates and branches in one country or in several countries.

*A **Subsidiary** is an incorporated enterprise in which:*

- (i) The foreign investor controls directly or indirectly (through another subsidiary) more than 50% of the shareholders' voting power, or*
- (ii) The foreign investor has the right to appoint or remove a majority of the members of this enterprise's administrative, management or supervisory body.*

*An **Associate** is an enterprise where the direct investor and its subsidiaries control between 10% and 50% of the voting shares.*

*A **branch** is an unincorporated enterprise that:*

- (i) is a permanent establishment or office of a foreign direct investor*
- (ii) is an unincorporated partnership or a joint venture between a foreign direct investor and third parties*
- (iii) is land, structures and immovable equipment and objects directly owned by a foreign resident*
- (iv) is mobile equipment operating within an economy for at least one year if accounted for separately by the operator (e.g., ships, aircraft, oil rigs).*

“Foreign Direct Investment flows” are made up of three basic components:

- **Equity Capital:** Comprising equity in branches, all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and are included under other direct investment capital) and other capital contributions such as provisions of machinery etc...
- **Reinvested Earnings:** Comprise the direct investor's share of earnings not distributed, as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. Such retained profits by subsidiaries are reinvested.

- ***Other Direct Investment Capital***: Cover the short – or long-term borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investor.

Foreign direct investment can be expressed by the following relationship:

$$\text{Direct Investment} = \text{Equity Capital} + \text{Reinvested Earnings} + \text{Other Capital}$$

1.3 Role of FDI in International Capital Flows

Different types of capital flows have different implications for a host economy. FDI are long-term flows not normally prone to quick reversals or to speculative movements. Some other types of financial flows consist of highly liquid flows that can easily be reversed and cause financial crises. The major features of FDI with respect to other international financial flows are:

- (i) *Low Volatility*
- (ii) *Share of Ownership*
- (iii) *Behaviour in Financial Markets*
- (iv) *The Importance of Retained Earnings*
- (v) *Relationship between FDI and the Balance of Payments*

(i) ***Low Volatility***

Different types of financial flows can perform quite different functions for both investing and receiving countries (Lipsey, 1999). One difference among the types of flows that affects their functions, especially for the recipients, is in their *volatility*, a subject that has received increased attention since the Asian financial crisis began. Different types of international financial flows can be compared by asking how often net flows to or from a country change signs. That is, how often do inflows turn into

outflows and outflows turn into inflows. FDI are in general less volatile than portfolio flows as they normally tend to be driven by long term considerations (Lipsey, 2001a, b, Alfaro *et al.* 2004). Portfolio (debt and security) and “other” investment type of flows have higher volatility relative to FDI.

(ii) *Share of Ownership*

In conceptual terms, FDI and portfolio investment are distinct. Direct investment involves both a long-term interest in, and a significant management influence over a foreign affiliate. Portfolio investment may include a long-term interest, but it seldom involves managerial control. For statistical purposes, a threshold of 10% share of ownership has been established to differentiate equity holdings of direct and portfolio investors (Lipsey, 1999).

(iii) *Behaviour in Financial Markets*

A possible way to explain the difference of FDI is that direct and portfolio investments are related differently to the financial markets in home and host countries. In the markets for bank loans, government securities, and private company bonds and equity, many buyers and sellers are competing with each other to supply and acquire fairly standardized types of assets with fairly well defined prices in identifiable markets. Changes in flows can presumably be associated with changes in various interest rates in markets for these types of securities.

FDI flows do not enter any general financial market. They are internal to each firm, and an inflow is not simply offset by an outflow. Each flow brings something different to a country because it is attached to a specific firm (Lipsey, 1999, 2001b, 2002). This contrast should not be drawn too sharply. Portfolio investment may also flow in two directions at any given time. Investors in country 1 make portfolio investments in country 2 while investors in country 2 are making such investments in country 1. They may be seeking country or industry diversification in their portfolios even if their preferences and attitudes towards risk are the same. If they are not the same, investors in one country may be indulging a greater appetite for political risk or industry instability combined with higher returns (Lipsey, 1999).

(iv) *The Importance of Retained Earnings in Direct Investment*

Another important feature of FDI that distinguishes it from other forms of investment is that it can be, and often is, financed from the retained earnings of affiliates. The IMF and the OECD recommend that direct investment flows include “...*the direct investor’s share of the company’s reinvested earnings*” (OECD, *Benchmark Definition of Foreign Direct Investment*, 1996, p. 16).

(v) *Relationship between FDI and the Balance of Payments*

FDI is regarded as having a considerable and immediate positive impact on host countries’ external financial positions and, thus, on their development prospects. Such flows can be particularly beneficial when access to other types of foreign capital is limited. The financial aspect of FDI complements its potential technological, management and restructuring impact (IMF, 2000, OECD, 2001c, and IIF, 2004). More recently, and especially among countries accelerating economic reforms, “privatisation-related” FDI inflows help to boost foreign exchange and / or reduce external debt (i.e. net debt reduction). Such revenues have often been counted on as a means of financing current account (and fiscal) deficits and boosting official reserves (EBRD, *Transition Reports*, 1998-2004, UN/ECE, 2000a, b, 2001, and 2003a, b).

FDI contributes to a loosening of balance of payments constraints. The growth of FDI helps to finance increasing current account deficits. This means of finance is generally viewed favourably since it is considered more stable than other financial flows, because investments in fixed assets may be more difficult to liquidate (compared with other financial investments) and because direct investors tend to make long-term commitments. Also, it often promotes exports, and is “non-debt creating” (IMF, 2000). Four items in the balance of payments accounts deal specifically with the transactions of FDI: (a) In the current account: interest on inter-company debt, repatriated profits, and reinvested earnings from direct (equity) investment; (b) In the financial (capital) account: FDI flows, including reinvested earnings.

These generally positive features of FDI, and its association with dynamic export growth, may improve foreign perceptions of the host country’s creditworthiness. Thus

FDI may contribute to the creation of a virtuous circle, involving a reduction in borrowing costs, access to a broader range of financial instruments, and a more stable capital flows (Montiel and Reinhart, 1999a, b, and IMF, 2003b).

1.4 Types of FDI

FDI can be classified from the perspective of the source country (investor) and from the perspective of the host country.

1.4.1 FDI from Source Country Perspective

From the perspective of the investor, Caves (1971) distinguishes between horizontal, vertical, and conglomerate FDI.

i. Horizontal FDI

Horizontal FDI is undertaken for the purpose of horizontal expansion to produce the same or similar kinds of goods abroad as in the home country. Hence, product differentiation is the critical element of market structure for horizontal FDI. Generally, horizontal FDI is undertaken to exploit certain monopolistic or oligopolistic advantages, such as patents or differentiated products, particularly if expansion at home were to violate anti-trust laws.

ii. Vertical FDI

Vertical FDI is undertaken for the purpose of exploiting raw materials (backward vertical FDI) or to be nearer to the consumers through the acquisition of distribution outlets (forward vertical FDI).

iii. Conglomerate FDI

This type involves both horizontal and vertical FDI.

1.4.2 FDI from Host Country Perspective

From the perspective of the host country, FDI can be classified into:

i. Import-substituting FDI

This type involves the production of goods previously imported by the host country, necessarily implying that imports by the host country and exports by the investing country will decline. It is likely to be determined by the size of the host country's market size, transportation costs and trade barriers.

ii. Export-increasing FDI

This type is motivated by the desire to seek new sources of inputs, such as raw materials and intermediate goods. This kind of FDI is export-increasing in the sense that the host country will increase its exports of raw materials and intermediate products to the investing country and other countries.

iii. Government-initiated FDI

This type refers to when a government offers incentives to foreign investors in an attempt to eliminate a balance of payments deficit. A similar, trade-related classification of FDI is adopted by Kojima (1973, 1975, and 1985). According to Kojima's classification, FDI is either trade-oriented FDI (which generates an excess demand for imports and excess supply of exports at the original terms of trade) or anti-trade-oriented FDI, which has an adverse effect on trade.

1.5 Globalization and FDI

FDI has been one of the defining features of the world economy and globalisation over the last two decades of the twentieth century (Bordo, Taylor and Williamson, 2003). More firms, and in more industries and countries, than ever before have expanded abroad through direct investment. At the microeconomic level, far reaching organisational changes have taken place as a result of e-business and new technology, which have transformed the value chain of many industries (OECD, 2001c).

FDI and globalisation tend to reinforce one another. While globalisation has led to higher FDI flows to a number of emerging countries, the benefits of FDI and the opportunity of receiving a greater share of global FDI flows has, among other things,

motivated a number of countries to undertake further liberalization. Investments in certain sectors that were long closed to foreign participation in many emerging economies are now open to foreign investors. At the same time, other impediments to FDI, including restrictions on the forms of investment and the level of foreign ownership, have been gradually eased (IMF, 2003b).

FDI facilitates the international integration of markets for goods and services. By selling directly to residents within the host economy, foreign direct investors may overcome natural or policy-induced barriers to market access and hence substitute for trade. This is referred to as “market-seeking FDI”. By contrast, so-called “efficiency-seeking FDI” has facilitated the international division of labour, and hence stimulated the expansion of trade. On the other hand, “asset-seeking FDI” has been attracted by the new opportunities created in some regions relative to others, such as the Central European region relative to other regions. Also, “strategic assets” such as technological and innovative assets e.g. brand names – have become important determinants in the location decision of MNEs (UNCTAD, 1998a).

In addition to generating relatively large multiplier effects for the economy, FDI typically facilitates the transfer of technology and promotes sound employment and corporate governance practices (OECD, 2001c). For example, FDI in the financial sector is commonly credited with raising the efficiency of financial intermediation and the quality of supervision through importing higher prudential standards (IMF, 2003b). Besides increasing the integration of financial markets, FDI can serve as a source of stability at times of emerging pressures in the balance of payments (UN/ECE, 2000a). That is, compared with other forms of private capital flows – e.g. portfolio equity and debt flows - FDI flows appear to be more stable, because the long time horizon of FDI allows the forbearance of investors to short-run economic upheavals. Also, unlike debt capital, FDI entails an element of risk sharing between the investors and the host country since the rate of return is designed to be “state contingent” – the cost of servicing the investment moves in step with the recipient’s economic fortunes (IIF, 2004).

1.6 Trends in Global FDI Inflows

FDI has accounted for about a quarter of total international capital flows in the 1990s and appears to have grown, relative to other forms of international investment, since the 1970s (Lipsey, 1999). Table 1-1 presents the global trend of FDI inflows during the period 1985-2005. It suggests that there has been a tremendous increase in global FDI inflows in the last two decades. During the period 1985-1990, the global FDI inflows recorded an annual average amount of US\$ 142 billion. During the 1990s, FDI grew dramatically in the world economy, with the exception of few years due to the effects of economic recession (UNCTAD, *FDI database* and *WIR 1997-2006*). The world FDI inflows have expanded from US\$ 159 billion in 1991 to US\$ 916 billion in 2005. The overall inflows of FDI have grown by about 6 times of its 1991 value. Within the global FDI inflows, the developed countries – the European Union, United States and Japan - accounted for 60 per cent of world FDI inflows in 2005; developing countries share amounted to 36 percent, whereas CEEC showed a marginal share.

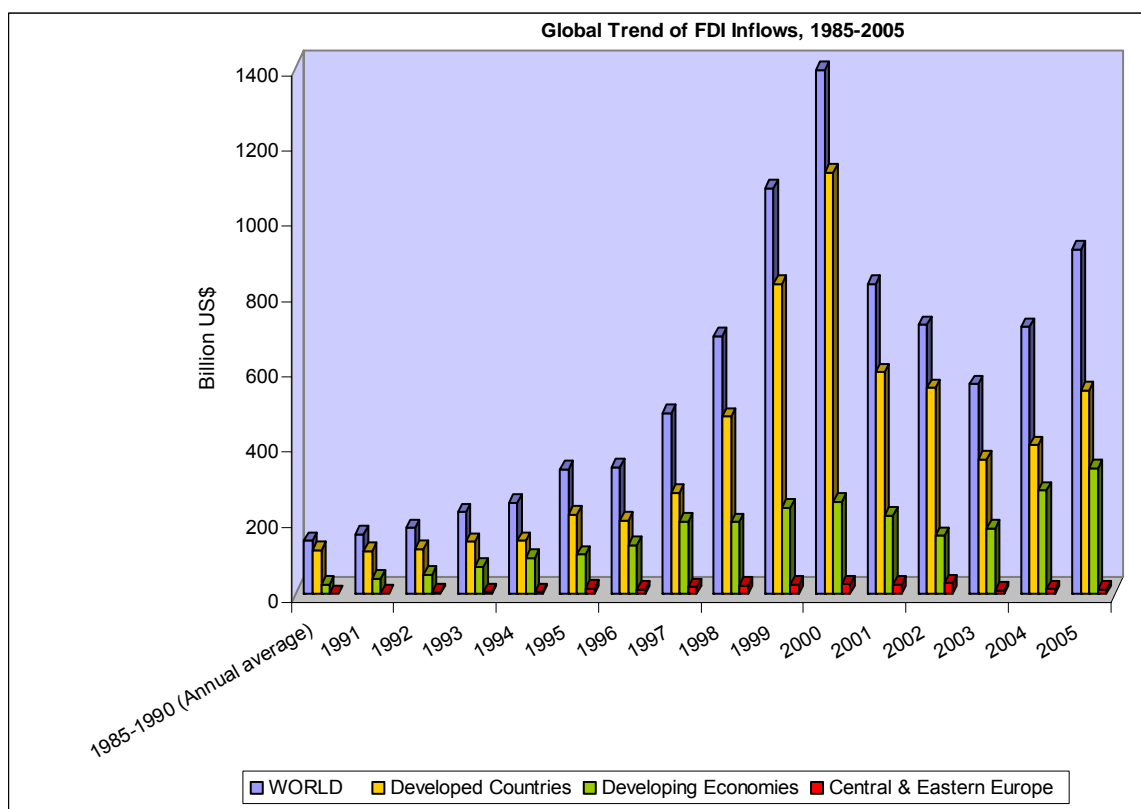
Table 1-1: Global Trend of FDI Inflows, 1985-2005

Global FDI Inflows by Host Region, 1985- 2005 (Billion US\$)

Host Region	1985-1990 (Annual average)	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
WORLD	142	159	176	218	243	331	338	482	686	1079	1393	824	716	558	711	916
Developed Countries	117	115	120	139	142	211	195	270	472	825	1121	589	548	358	396	542
<i>Western Europe</i>	56	82	86	84	78	123	100	139	263	496	710	401	428	274	218	434
<i>European Union</i>	53	79	84	81	72	117	92	128	250	476	684	389	420	254	213	422
<i>United States</i>	49	23	19	44	45	59	76	103	174	283	314	144	71	54	122	99
Developing Economies	25	42	51	73	96	106	130	193	191	229	246	209	156	175	275	334
<i>Africa</i>	3	3	3	4	6	5	5	11	9	12	8	19	13	18	17	31
<i>Latin America & Caribbean</i>	8	15	18	17	29	32	44	73	82	108	95	84	50	46	100	104
<i>Asia & Pacific</i>	14	23	30	51	61	67	80	109	100	109	142	107	92	110	157	200
Central & Eastern Europe	0.4	2	4	6	6	14	12	19	22	25	26	25	29	9	13	12

Source: UNCTAD, FDI/TNC Database and *World Investment Reports, Issues* 1997- 2006.

Figure 1-1: Global Trend of FDI Inflows, 1985-2005



1.7 Conclusion

This chapter presented the importance of FDI relative to other international financial flows because this type of capital has grown since the 1970s. It followed the OECD *Benchmark Definition of Foreign Direct Investment* to state a definition for FDI, which emphasizes on the notion of “lasting interest” and a “significant” influence on management. In the balance of payments data, FDI is divided up statistically among owners of shares of 10 per cent or more. The different forms of international investment flows not only vary in importance among regions but have different characteristics in other ways. Direct investment flows have been the least volatile among different types in most countries. One reason for the relative stability of direct investment flows may be the importance within them of retained earnings. These do fluctuate, of course, with profits, but they rarely shift sharply into the negative once firms are well established. It discussed the relation between FDI and globalization. Finally, it presented the global trend of FDI inflows since the mid 1980s.

2 Capital Flows to CEC4: Structure and Trends

2.1 Introduction

The 1990s were a new period in the history of capital mobility in Central Europe. Capital flows surged into these economies to levels matching those to other emerging economies (Balaz and Williams, 2001). The aim of this chapter is to provide the main facts regarding the structure, size, and trends of capital inflows into each CEC4 country since their transition to a market economy, that is, from the late 1980s till 2005. As a first step, the chapter analyzes the three important types of capital inflows – FDI, Portfolio and “Other” investments. It compares each type of capital with respect to the total. The analysis reveals that FDI is an important component of the capital structure in each CEC4 country. Thus, as a second step, attention shifts on the evolution of FDI in CEC4 since the late 1980s. It provides also a regional and an international comparison of FDI in CEC4. Next, it discusses the different indicators of FDI penetration. Furthermore, it investigates both the origins of FDI in CEC4 and the destination (outward) of FDI from CEC4. Comparative tables, figures and charts complement the information for individual countries by the geographical breakdown for inward and outward FDI flows and stocks to and from the OECD area. Data available suggest that most FDI in CEC4 originates from the OECD area.

2.2 Structure of Capital Inflows to CEC4

As a first step, the study attempts to analyse the structure, and size of capital inflows in CEC4 over the period 1990-2005. By capital inflows it is meant all recorded inflows that lead to a *liability vis-à-vis foreign residents*. This includes all capital

inflows, both official and private, except those based on current transactions, transfers, and unrecorded flows (which would be classified as “errors and omissions”).

Tables and figures are provided to describe the size and composition of capital inflows into each CEC4 during the period 1990–2005. They compare the size of each type of capital – FDI, Portfolio Investments and “Other” Investments - relative to the total. The ratios at the bottom of each table reflect that the long-term trend, if there is one, seems to have been an increase in the share of FDI in total investment flows from 1990 through 2005.

Table 2-1: Czech Republic: Size and Composition of Capital Inflows, 1993-2005

Czech Rep.: Size and Composition of Capital Inflows, 1993 - 2005 (US\$ Million)

Category of Inflow	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
FDI Inflows	654	878	2568	1435	1286	3700	6313	4987	5641	8497	2021	4978	10973
Portfolio Inv. Liabilities	1840	893	1695	771	1152	1146	499	482	798	814	1753	4795	79
<i>Equity Securities</i>	1125	497	1236	601	378	1096	120	619	616	-265	1104	738	-1540
<i>Debt Securities</i>	715	396	460	170	774	49	380	-137	181	1079	649	4057	1619
Other Inv. Liabilities	3738	5333	6816	4571	3298	-217	927	-300	-544	9	2565	2325	3010
Use of IMF Credit & Loans	-3	-1117	-	-	-	-	-	-	-	-	-	-	-
Exceptional Financing	...	...	...	...	...	...	...	...	...	-	-	-	-
TOTAL (FDI+PI+OI)	6232	7104	11079	6777	5736	4629	7739	5169	5895	9320	6339	12098	14062
FDI/Total (%)	0.10	0.12	0.23	0.21	0.22	0.80	0.82	0.96	0.96	0.91	0.32	0.41	0.78
Portfolio /Total (%)	0.30	0.13	0.15	0.11	0.20	0.25	0.06	0.09	0.14	0.09	0.28	0.40	0.01
Other Inv./ Total (%)	0.60	0.75	0.62	0.67	0.57	-0.05	0.12	-0.06	-0.09	0.00	0.40	0.19	0.21

Source: IMF, *International Financial Statistics Yearbooks*, 1999 - 2007 (February issue).

FDI Inflow : line 78bed (Dir. Invest. In Reporting Economy)

Portfolio Investment Liabilities : line 78bgd.

Portfolio Equity Securities : line 78bmd (Equity Securities under Portfolio Investment Liabilities)

Debt Securities : line 78bnd (Debt Securities under Portfolio Investment Liabilities)

Other Investment Inflow : line 78bid (Other Investment Liabilities)

The sign (...) indicates a lack of statistical data that can be reported or calculated from underlying observations.

The sign (-) indicates that a figure is zero or less than half of a significant digit or that data do not exist.

Figure 2-1: Czech Republic: Size and Composition of Capital Inflows, 1993-2005

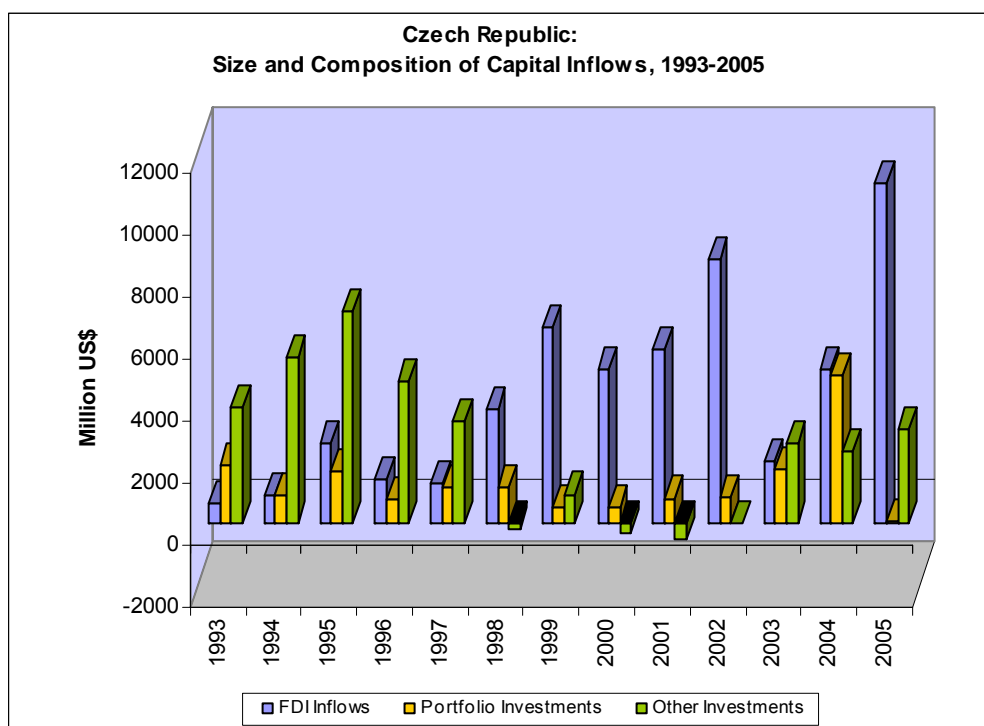


Chart 2-1: Czech Republic: Pattern of Capital Inflows, 1993-2005

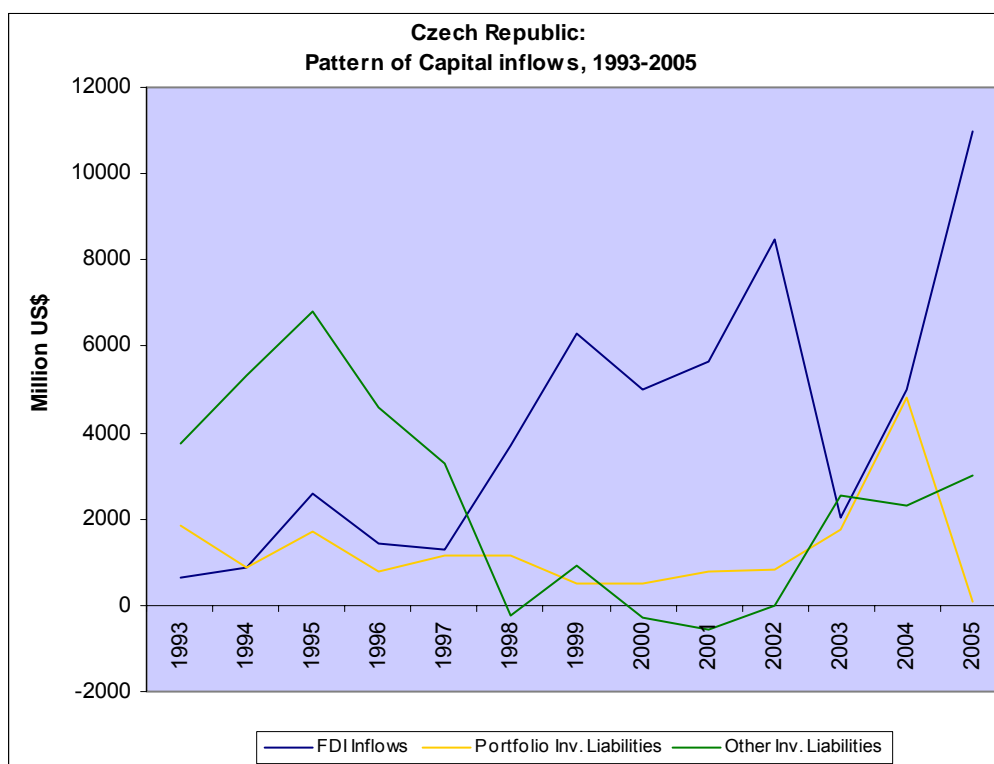


Table 2-2: Hungary: Size and Composition of Capital Inflows, 1990-2005

Hungary: Size and Composition of Capital Inflows, 1990 - 2005 (US\$ Millions)

Category of Inflow	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
FDI Inflows	311	1462	1479	2350	1144	4519	2274	4155	3343	3308	2770	3944	3013	2177	4670	6436
Portfolio Inv. Liabilities	-	-	-	3927	2458	2213	-851	-919	1925	2065	-141	1523	1844	2902	7353	5774
<i>Equity Securities</i>	-	-	-	46	224	...	359	979	556	1191	-369	134	-137	269	1491	-16
<i>Debt Securities</i>	-	-	-	3881	2234	2213	-851	-1918	1369	874	229	1389	1982	2633	5862	5790
Other Inv. Liabilities	-278	25	-642	-1055	-551	-199	-1294	549	-13	2046	2232	465	-517	6000	2977	6529
Use of IMF Credit & Loans	-145	905	-7	30	-165	-785	-203	0	-160	-	-	-	-	-	-	-
Exceptional Financing	...	...	...	...	...	...	...	...	-	-	-	-	-	-	-	-
Total (FDI+PI+OI)	-	-	-	5222	3051	6533	129	3785	5255	7419	4861	5932	4340	11079	15000	18739
FDI/Total (%)	-	-	-	0.45	0.37	0.69	17.63	1.10	0.64	0.45	0.57	0.66	0.69	0.20	0.31	0.34
Portfolio/ Total (%)	-	-	-	0.75	0.81	0.34	-6.60	-0.24	0.37	0.28	-0.03	0.26	0.42	0.26	0.49	0.31
Other/ Total (%)	-	-	-	-0.20	-0.18	-0.03	-10.03	0.15	0.00	0.28	0.46	0.08	-0.12	0.54	0.20	0.35

Source: IMF, *International Financial Statistics Yearbooks*, 1999 - 2007 (February issue).

FDI Inflow : line 78bed (Dir. Invest. In Reporting Economy)

Portfolio Investment Liabilities : line 78bgd.

Portfolio Equity Securities : line 78bmd (Equity Securities under Portfolio Investment Liabilities)

Debt Securities : line 78bnd (Debt Securities under Portfolio Investment Liabilities)

Other Investment Inflow : line 78bid (Other Investment Liabilities)

The sign (...) indicates a lack of statistical data that can be reported or calculated from underlying observations.

The sign (-) indicates that a figure is zero or less than half of a significant digit or that data do not exist.

Figure 2-2: Hungary: Size and Composition of Capital Inflows, 1990-2005

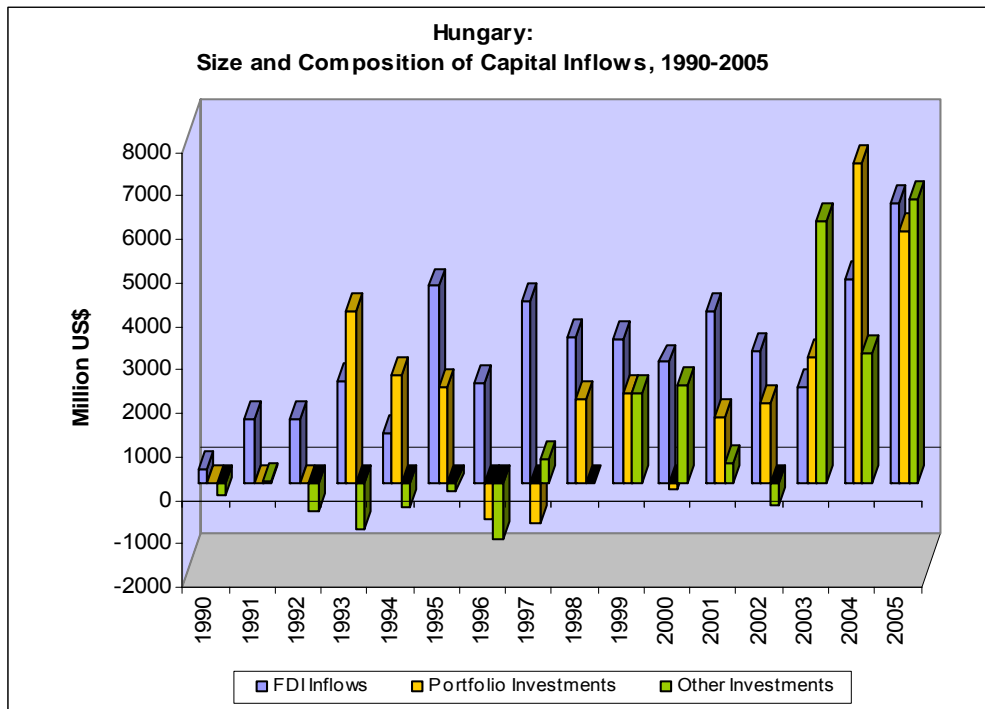


Chart 2-2: Hungary: Pattern of Capital Inflows, 1990-2005

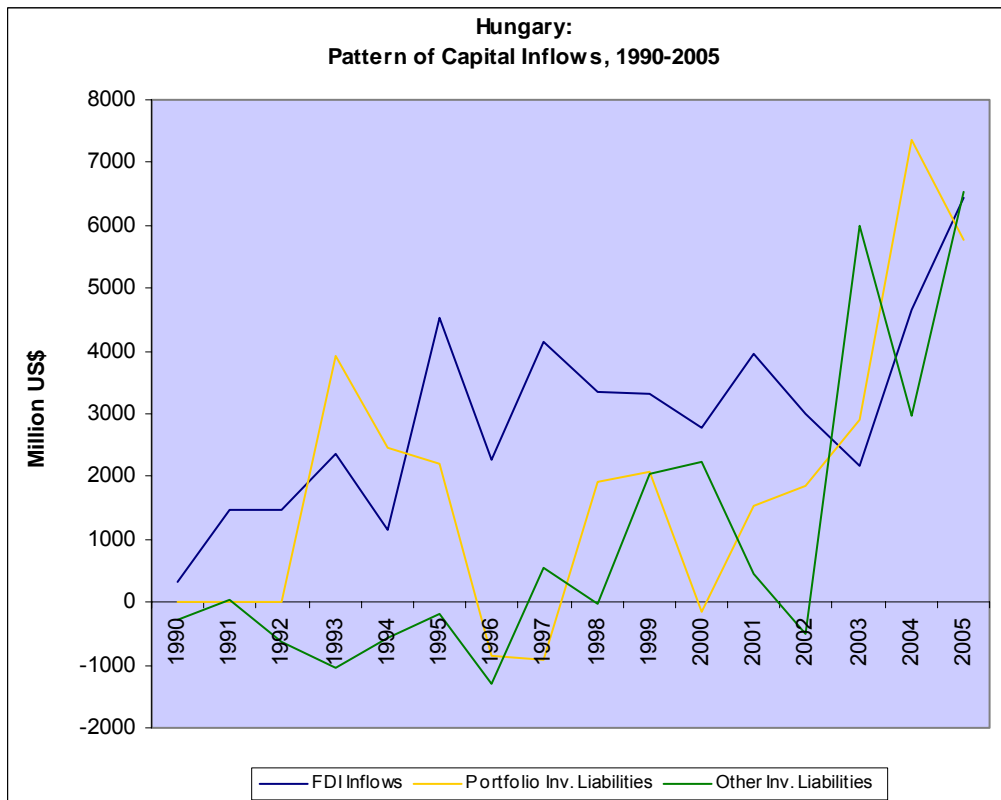


Table 2-3: Poland: Size and Composition of Capital Inflows, 1990-2005

Poland: Size and Composition of Capital Inflows, 1990 - 2005 (US\$ Millions)

Category of Inflow	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
FDI Inflows	89	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4589	12890	9602
Portfolio Inv. Liabilities	-	-	-	-	-	1176	19	1283	1827	691	3423	1067	3051	3740	10612	15139
<i>Equity Securities</i>	-	-	-	-	-	219	749	599	1734	14	447	-307	-545	-837	1660	1341
<i>Debt Securities</i>	-	-	-	-	-	957	-727	686	93	677	2976	1374	3596	4577	8952	13798
Other Inv. Liabilities	-4316	-2984	-752	-204	-8446	1110	-4264	1203	3429	5850	1156	662	396	3321	-1351	-2105
Use of IMF Credit & Loans	479	323	-	-138	603	-1408	-	-	-	-	-	-	-	-	-	-
Exceptional Financing	7440	5921	4946	3466	-96	4	4	3	2	-	-	-	-	-	-	-
Total (FDI+PI+OI)	-	-	-	-	-	5945	253	7394	11621	13811	13922	7443	7578	11650	22151	22636
FDI / Total (%)	-	-	-	-	-	0.62	17.78	0.66	0.55	0.53	0.67	0.77	0.55	0.39	0.58	0.42
Portfolio / Total (%)	-	-	-	-	-	0.20	0.08	0.17	0.16	0.05	0.25	0.14	0.40	0.32	0.48	0.67
Other / Total (%)	-	-	-	-	-	0.19	-16.85	0.16	0.30	0.42	0.08	0.09	0.05	0.29	-0.06	-0.09

Source: IMF, *International Financial Statistics Yearbooks*, 1999 - 2007 (February issue).

FDI Inflow : line 78bed (Dir. Invest. In Reporting Economy)

Portfolio Investment Liabilities : line 78bgd.

Portfolio Equity Securities : line 78bmd (Equity Securities under Portfolio Investment Liabilities)

Debt Securities : line 78bnd (Debt Securities under Portfolio Investment Liabilities)

Other Investment Inflow : line 78bid (Other Investment Liabilities)

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Figure 2-3: Poland: Size and Composition of Capital Inflows, 1990-2005

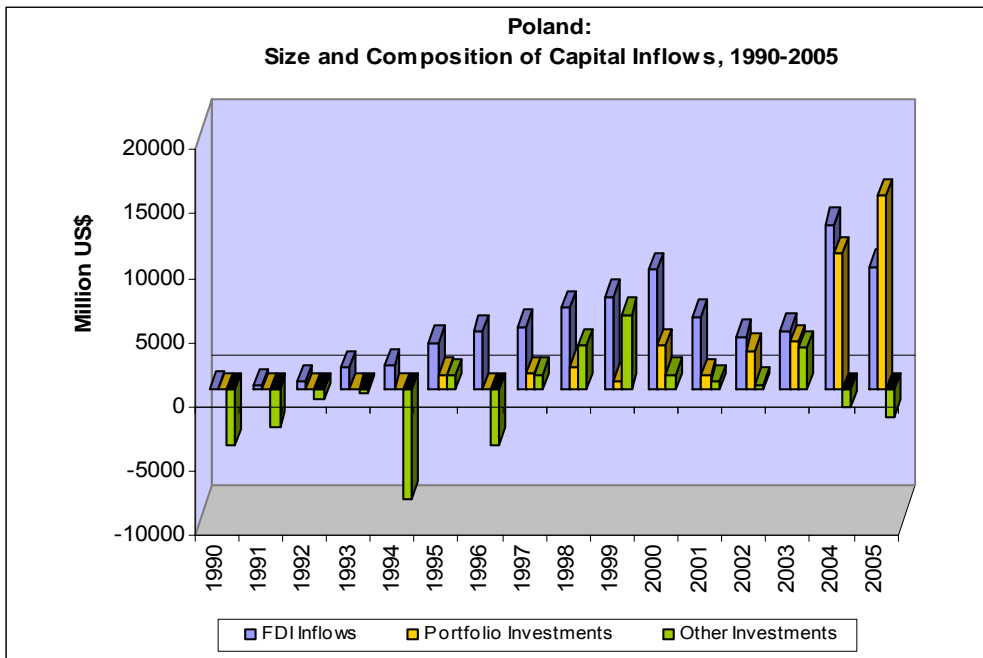


Chart 2-3: Poland: Pattern of Capital Inflows, 1990-2005

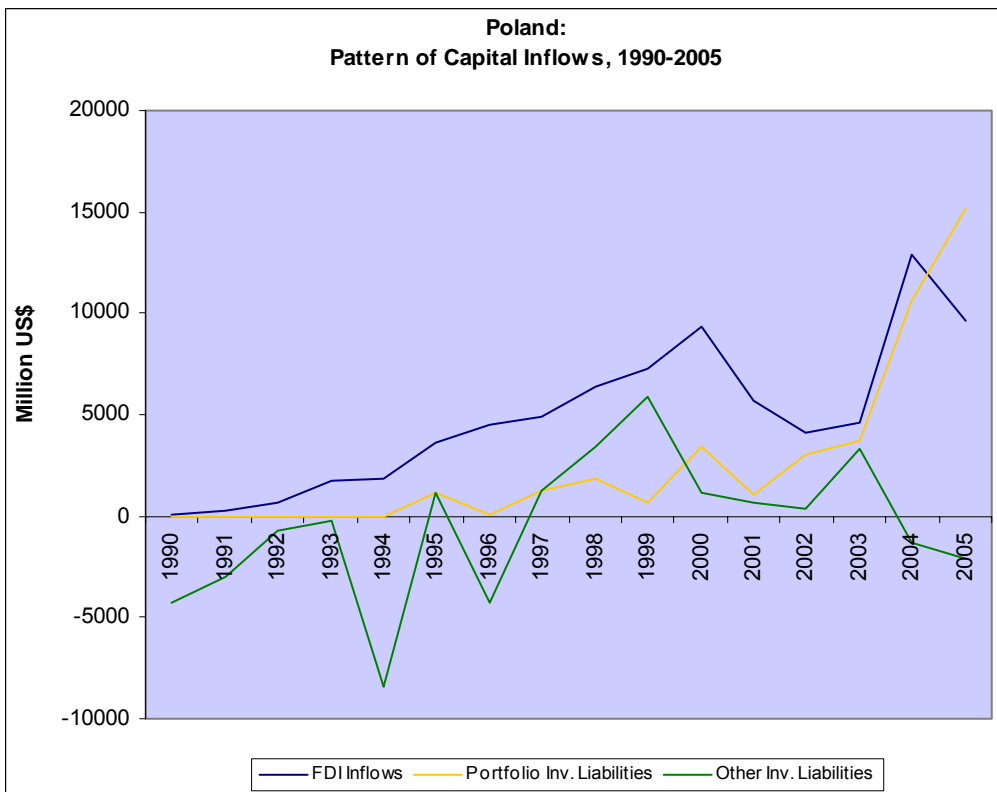


Table 2-4: Slovak Republic: Size and Composition of Capital Inflows, 1992 -2005

Slovak Republic: Size and Composition of Capital Inflows, 1992 - 2005 (US\$ Millions)

Category of Inflow	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
FDI Inflows	...	199	203	183	281	165	562	354	2052	...	4104	559	...	...
Portfolio Inv. Liabilities	...	465	304	53	29	96	841	405	1016	...	289	168	...	...
<i>Equity Securities</i>	...	465	111	-16	28	102	-35	47	-53	...	10	59	...	...
<i>Debt Securities</i>	193	69	1	-6	876	358	1069	...	279	109	...	...
Other Inv. Liabilities	...	430	84	891	2282	2715	520	-1307	-407	...	-165	1703	...	...
Use of IMF Credit & Loans	...	89	51	-201	-125	-52	-67	-52	-125	...	-	-	...	...
Exceptional Financing	-
TOTAL (FDI+PI+OI)	...	1094	591	1127	2592	2976	1923	-548	2661	...	4228	2430	...	...
FDI/Total (%)		0.18	0.34	0.16	0.11	0.06	0.29	-0.65	0.77	...	0.97	0.23	...	...
Portfolio /Total (%)		0.43	0.51	0.05	0.01	0.03	0.44	-0.74	0.38	...	0.07	0.07	...	...
Other Inv. /Total (%)		0.39	0.14	0.79	0.88	0.91	0.27	2.39	-0.15	...	-0.04	0.70	...	...

Source: IMF, *International Financial Statistics Yearbooks*, 1999 - 2007 (February issue).

FDI Inflow : line 78bed (Dir. Invest. In Reporting Economy)

Portfolio Investment Liabilities : line 78bgd.

Portfolio Equity Securities : line 78bmd (Equity Securities under Portfolio Investment Liabilities)

Debt Securities : line 78bnd (Debt Securities under Portfolio Investment Liabilities)

Other Investment Inflow : line 78bid (Other Investment Liabilities)

The sign (...) indicates a lack of statistical data that can be reported or calculated from underlying observations.

The sign (-) indicates that a figure is zero or less than half of a significant digit or that data do not exist.

Figure 2-4: Slovak Republic: Size and Composition of Capital Inflows, 1993-2005

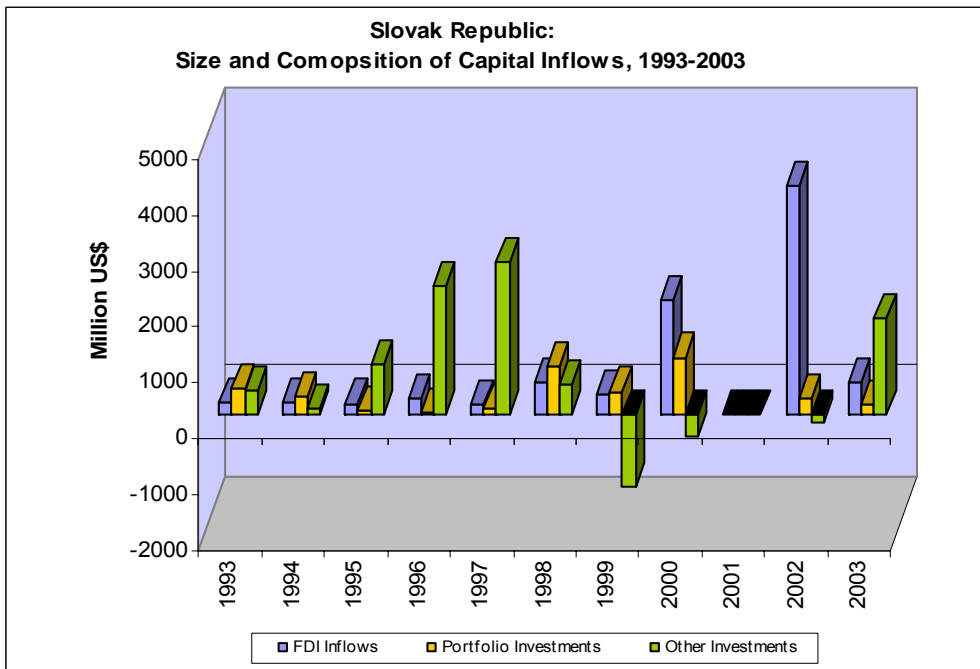
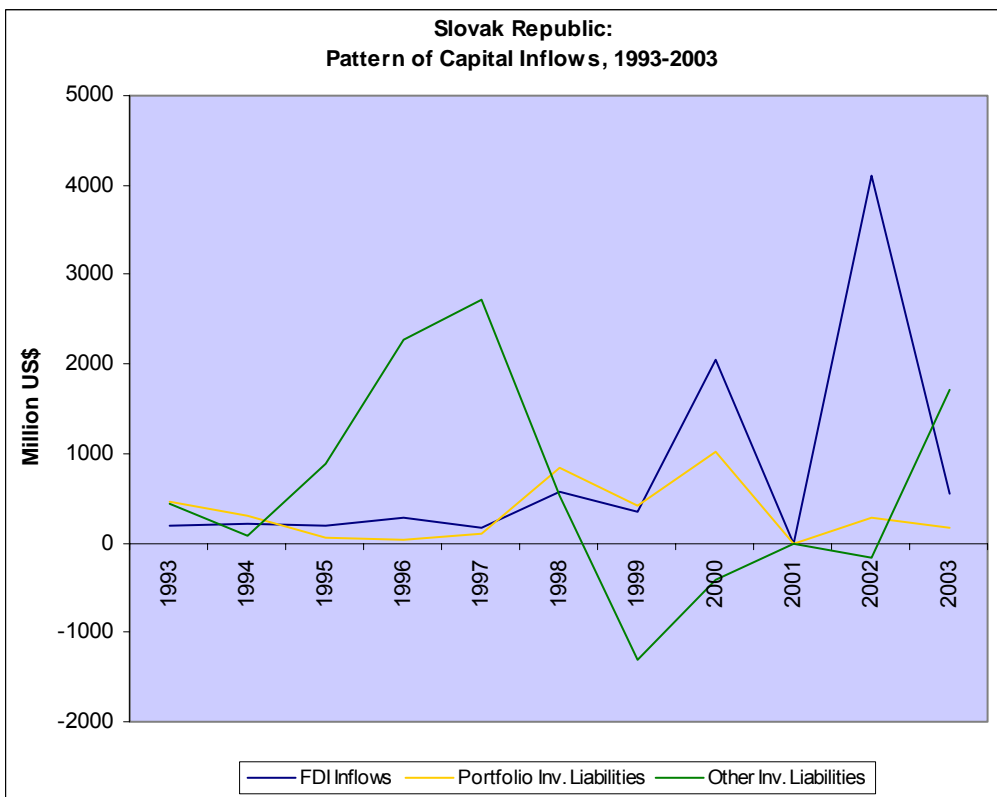


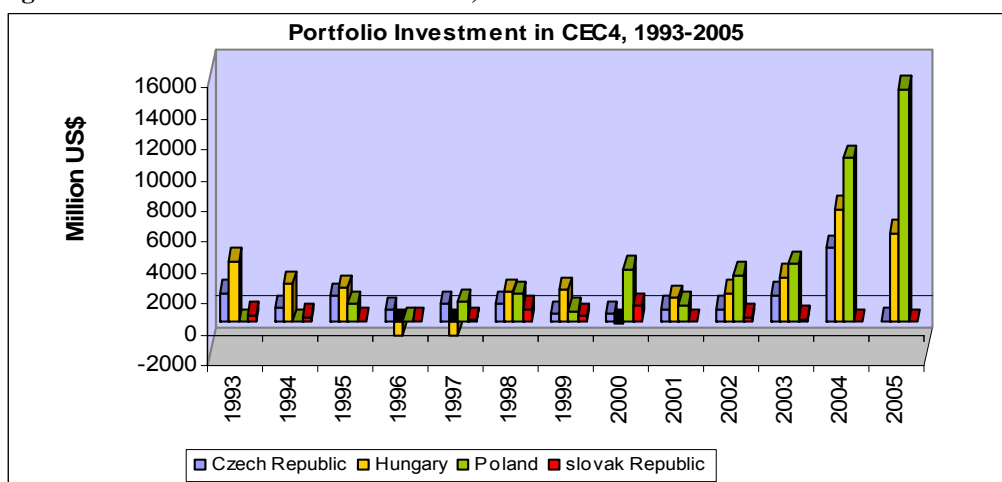
Chart 2-4: Slovak Republic: Pattern of Capital Inflows, 1993-2005



2.2.1 Portfolio Investments in CEC4

While portfolio flows traditionally tended to be more volatile than FDI, they were not insignificant. Large international institutional investors sought alternative investments in the face of decreasing interest rates in developed economies in the wake of EMU preparations (Gibson and Tsakalatos, 2004). This had profound implications for the development of financial markets in the Central European emerging economies: increased liquidity levels in local capital markets, and the introduction of a new market culture (Reininger, Schardax and Summer, 2001). In the Czech Republic foreign investors were mainly interested in shares in the early 1990s (because of the Coupon Privatisation scheme), but their interests gradually shifted to the debentures. Several leading Czech companies launched international issues (Claessens, Oks, and Polastri, 1998). In Hungary, portfolio investment has developed since 1993. The main targets were government bonds, T-bills and other debentures. The interest of foreign portfolio investors in Polish securities was moderate throughout the 1990s, despite Poland having one of the earliest and best regulated capital markets in the Central and Eastern Europe. Since 2000 Poland became the largest receiver of portfolio investment among the four countries (Credit Suisse, 2002, EIU, 2001a, b, PricewaterhouseCoopers, Pyszna and Vida, 2002).

Figure 2-5: Portfolio Investment in CEC4, 1993-2005

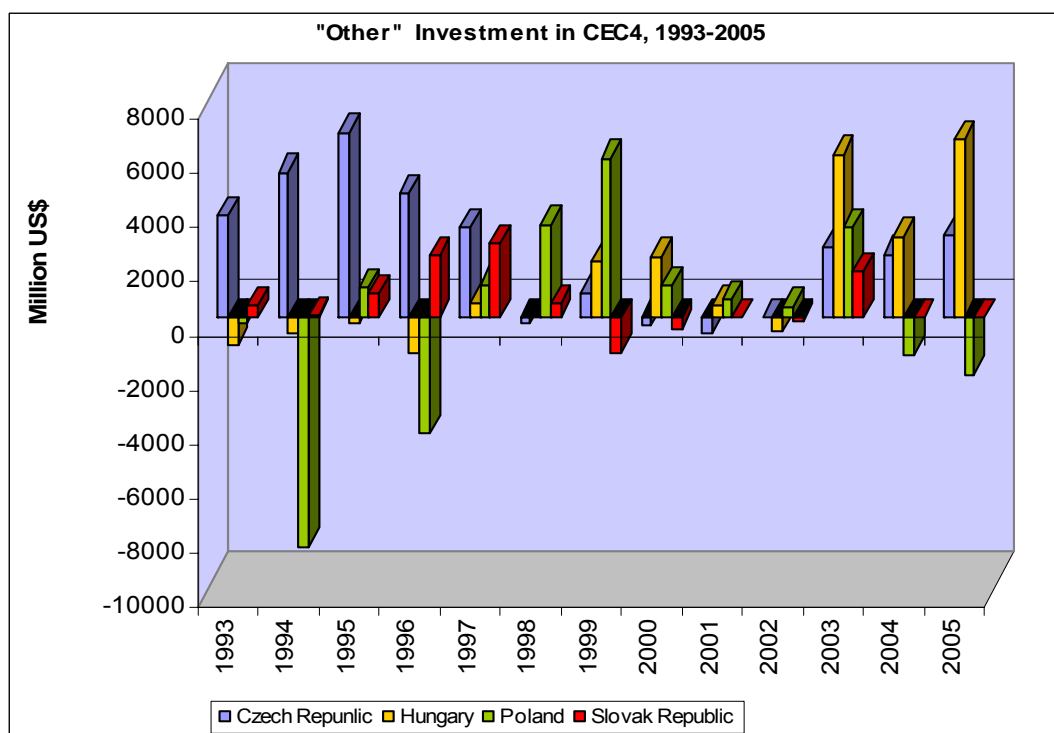


2.2.2 “Other” Investments in CEC4

In terms of “other” investment flows, the experiences of the CEC4 were similar to those in most emerging markets: currency attacks, volatile speculative flows attracted by interest rates differentials (Balaz and Williams, 2001). Speculative capital was attracted by interest rate differences between the region and world money and capital markets. In these circumstances, it would be reasonable for Central Banks to impose capital controls, limit the foreign exchange exposure of domestic banks and steer foreign capital towards financial instruments with longer maturity dates. However, the CEC4 sought early membership to the OECD which required the removal of capital controls. Governments and Central Banks in CEC4 therefore decided on different solutions (OECD, 2001).

In the Czech Republic, during the 1990s, Czech banks and enterprises started to borrow abroad, adding to the economy’s foreign debt. By the end of 2004, a large part of the Czech government’s, and private sector’s debt in short-term commitments included the “other investment” category (Brada and Kutan, 2000). In the state socialist period, Hungary obtained foreign capital almost exclusively via bank loans and the central government was the main recipient of these. Most of the funds were not directed to the production sector, but were used to offset a negative trade balance and, in fact, mainly funded purchases of consumer goods (Lavigne, 1995, Gross and Steinherr, 1995). Poland, also, had been heavily indebted since the early 1980s and its economy was burdened with high levels of interest and principal repayment (Balcerowicz, Blaszczyk, and dabrowski, 1997). Its position was weaker than Hungary’s, and this was reflected in larger inflows of speculative capital. Hungary and Poland repaid large amounts of their debts in the early nineties. This is reflected by the negative “other investment” figures till the mid 1990s (OECD, *Economic Surveys* 2001b, 2002, 2003, and Doyle, Kiujs, and Jiang, 2001).

Figure 2-6: “Other” Investment in CEC4, 1993-2005



2.2.3 “Use of IMF Financing” and “Exceptional Financing”

IMF financing was actually negative over the period, reflecting the repayment of loans prior to 1993, and there was almost no “exceptional financing”.

2.3 Evolution of FDI in CEC4

Given the importance and size of FDI relative to other types of capital inflows, the remaining part of the study focuses on FDI in CEC4. This section provides detailed tables and figures to describe the size, and pattern of FDI inflows in each CEC4 country over the period 1989-2005. Next, it compares the levels of FDI inflows and inward stock among the four countries, with respect to the CEEC region, and the World FDI inflows. Data used in the tables and figures are from the IMF *International Financial Statistics*, and UNCTAD *FD/TNC database*, and *World Investment Reports*.

2.3.1 FDI in CEC4

Table 2-5 and figures 2-7, 8, 9, 10, 11, and 2-12 describe the evolution of FDI in each CEC4 country – The Czech and Slovak Republics, Hungary and Poland - and compares the levels of FDI among the four countries over the period 1989-2005. They suggest that, in the late 1980s, FDI inflows were rare in these countries. Since the early nineties, FDI inflows witnessed a dramatic increase.

Table 2-5: Evolution of FDI Inflows in CEC4, 1989-2005

Evolution of FDI Inflows in CEC4, 1989-2005 (US\$ Million)

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech	257	72	393	983	654	878	2568	1435	1286	3700	6313	4987	5641	8497	2021	4987	10973
Hungary	187	311	1462	1480	2350	1144	4519	2274	4155	3343	3308	2770	3944	3013	2177	4670	6436
Poland	11	89	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4589	12890	9602
Slovak	..	93	81	100	166	255	300	301	220	684	390	1925	1579	4094	756	1261	1908
CEC4	455	565	2227	3241	4885	4152	11046	8508	10569	14092	17281	19025	16878	19735	9543	23808	28919
CEEC	467	640	2637	4681	7086	6304	14811	13576	19033	22479	25145	26373	25015	28709	20970	10778	13283
World	192492	208664	158859	167007	225580	255939	333818	384960	481911	686028	1079083	1392957	823825	651188	557869	710755	916277
CEC4/ CEEC %	0.97	0.88	0.84	0.69	0.69	0.66	0.75	0.63	0.56	0.63	0.69	0.72	0.67	0.69	0.46	2.21	2.18
CEC4/ World %	0.00	0.00	0.01	0.02	0.02	0.02	0.03	0.02	0.02	0.02	0.02	0.01	0.02	0.03	0.02	0.03	0.03

Sources: (1) IMF, *International Financial Statistics Yearbooks*, 1999-2007, Line 78bed. (2) UNCTAD FDI/TNC database and WIR available via internet at http://www.unctad.org/en/doc/wir2006_en.pdf

Figure 2-7: Czech Republic: Evolution of FDI, 1989-2005

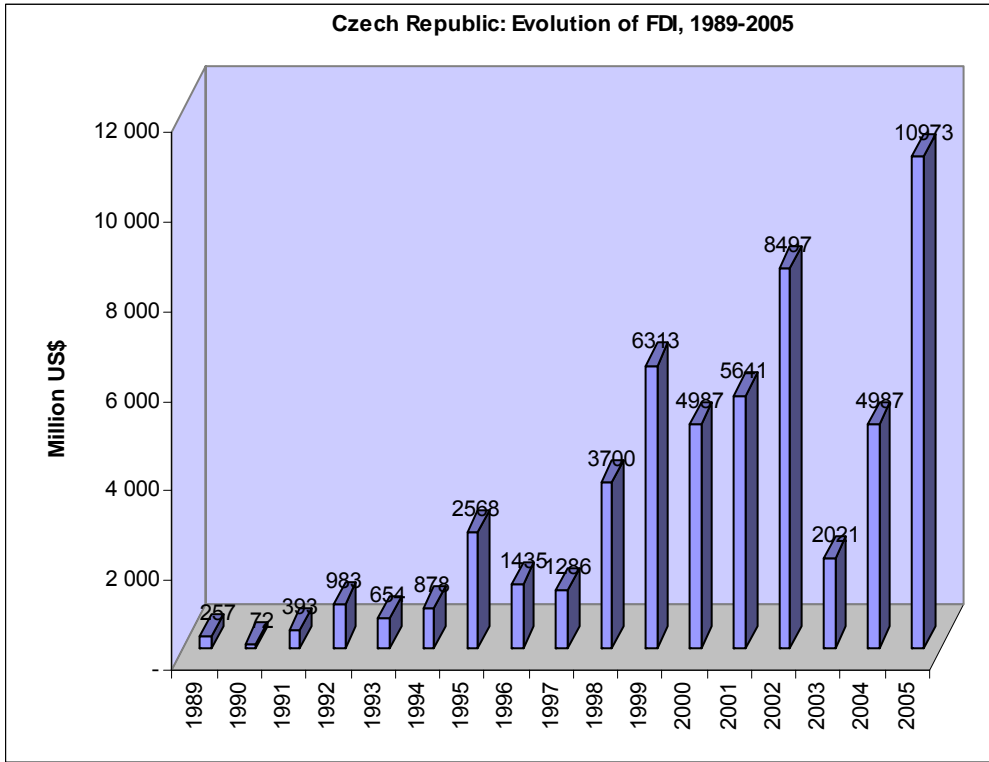


Figure 2-8: Hungary: Evolution of FDI, 1989-2005

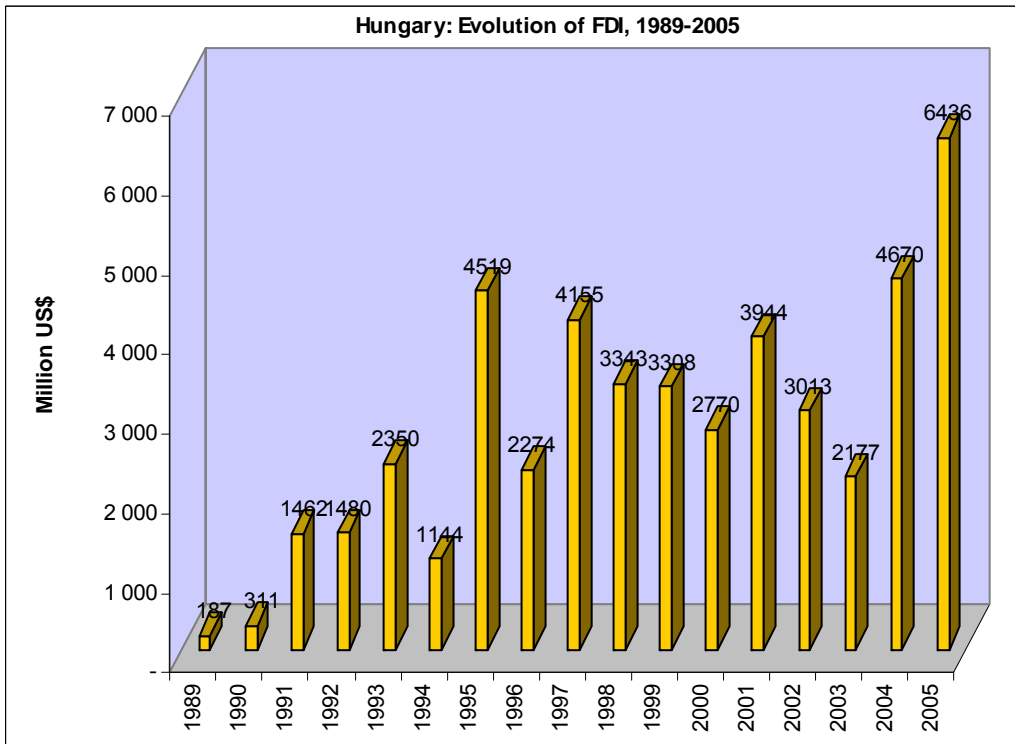


Figure 2-9: Poland: Evolution of FDI, 1989-2005

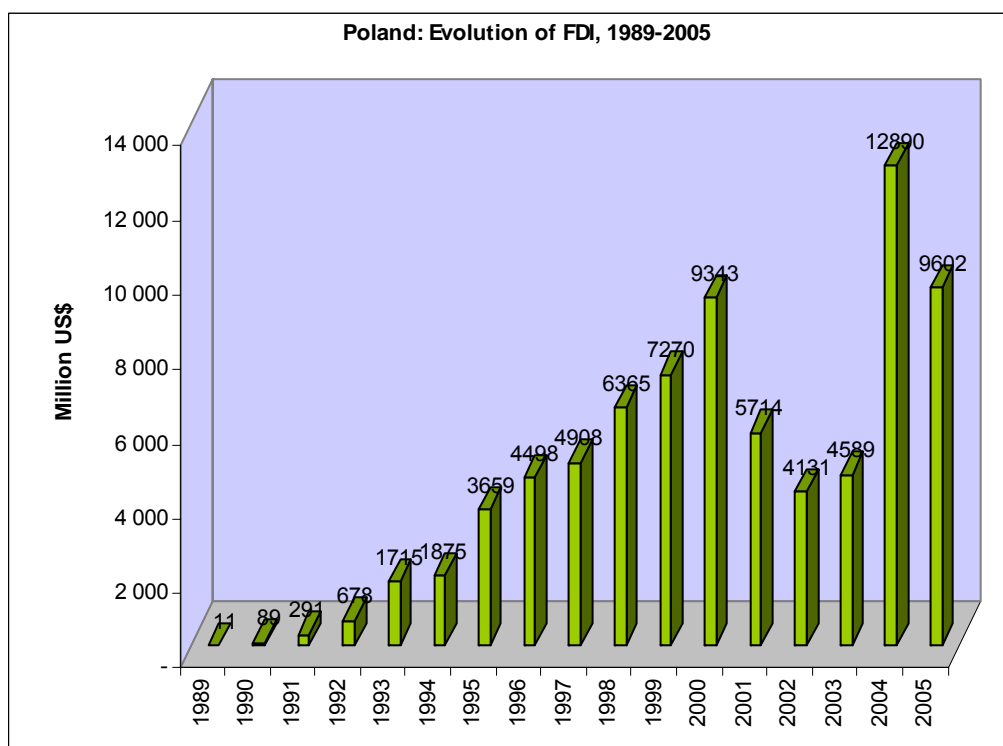


Figure 2-10: Slovak Republic: Evolution of FDI, 1990-2005

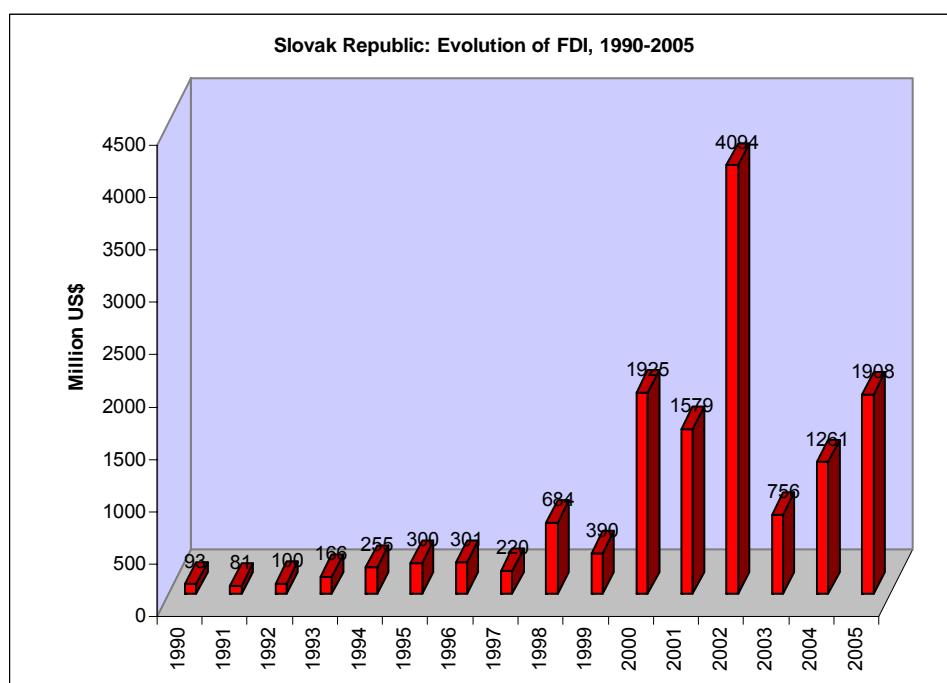


Figure 2-11: A Comparative Perspective: Evolution of FDI in CEC4, 1990-2005

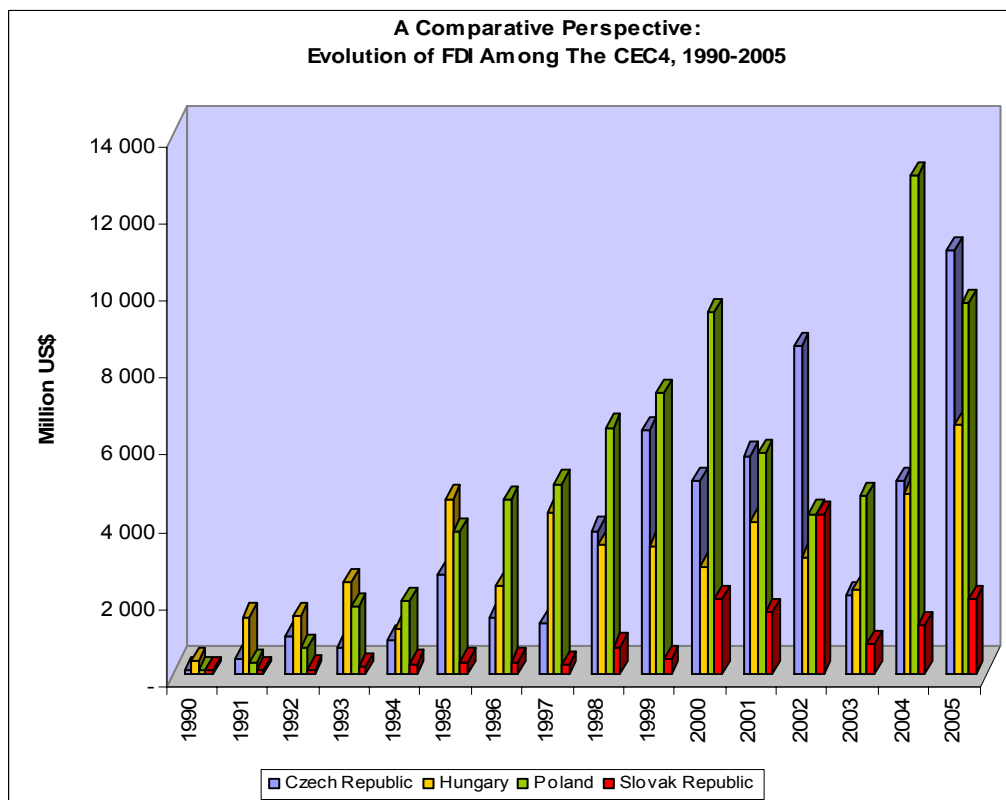


Figure 2-11 provides a comparative perspective of the evolution of FDI inflows among the four countries over the period 1990-2005. The levels and patterns of FDI inflows in each of the four countries reflect the special nature of the economic developments in these countries (Table 2-5 and Figure 2-11). Each CEC4 country adopted a different economic policy to attract FDI. Among the analysed countries, between 1990 and 1995, Hungary was in the leading position concerning FDI inflows. This was due to the privatisation programme in Hungary. Starting from 1995, Poland caught up, and then became the first in the region in terms of attracting FDI. This can be explained by the fact that mass privatisation was postponed until 1995 in Poland. Since 1998, the Czech Republic is on the second place after Poland in that respect. In 2002 Czech Republic attracted the highest amount of inflows among the four countries attracting an amount of around US\$ 9 billion. In 2003 and 2004 Poland gained the first rank having attracted FDI inflows of more than US\$ 12 billion in 2004. In 2005 The Czech Republic caught up and attracted the highest amount of FDI among the four countries (US\$ 11 billion). These changes can be explained by the fact that

governments in CEC4 adopted different policies to attract foreign investors into their economies.

Figure 2-12: Evolution of FDI in Total CEC4, 1989-2005

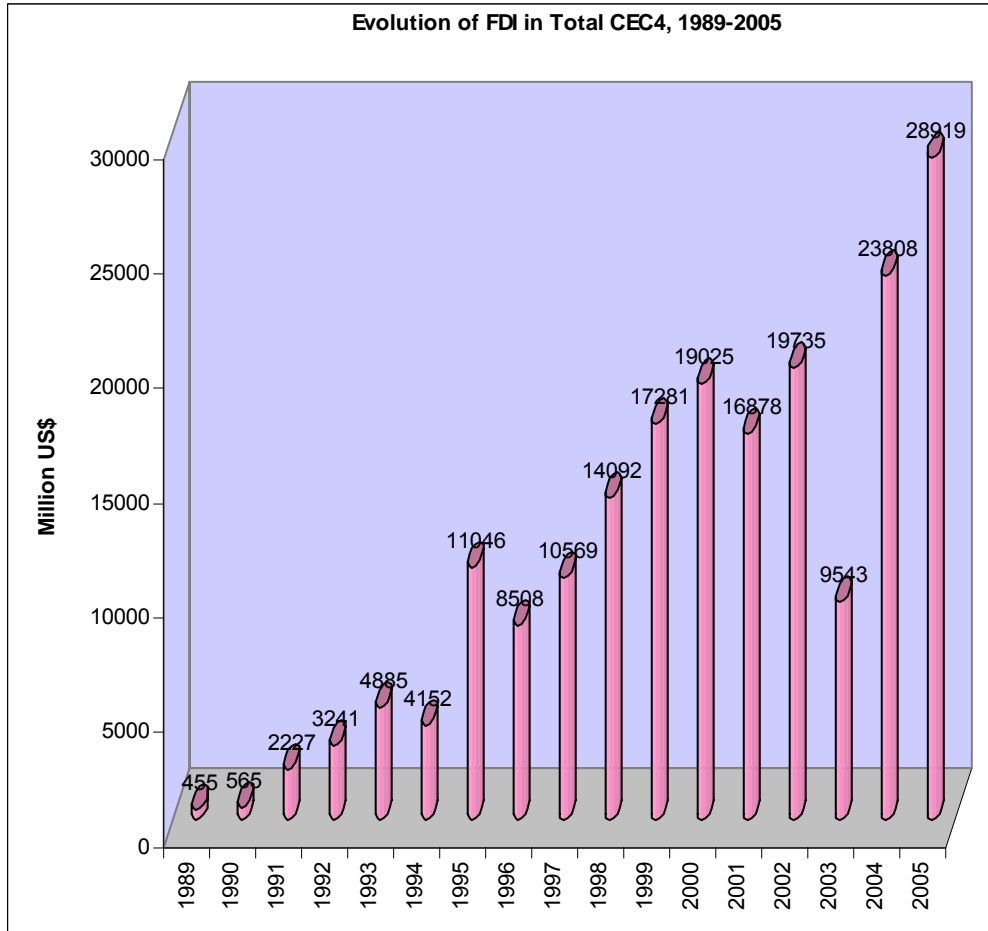


Figure 2-12 describes the evolution of FDI inflows in total CEC4 over the period 1989-2005. The figure above suggests that FDI was rare in the former state socialist economies. According to the IMF, in 1989, there were some US\$ 455 million of FDI inflows into the former Czechoslovakia, Hungary, and Poland (Table 2-5). In contrast, their total FDI inflow reached to about US\$ 29 billion in 2005. While the increase was striking, it was by no means exceptional. They have grown 50 fold during the period 1989-2005.

2.3.2 Regional Comparison: CEC4 versus CEEC

According to data provided by the IMF and UNCTAD, since 1989 the CEC4 have attracted the bulk of FDI in CEEC region – ranging from 97 percent in 1989 to 50 percent in 2003 of total annual inflows (Table 2-5 and Figures 2-13 and 2-14). After other countries appeared in the region in competition for FDI, the share of CEC4 diminished in total regional inflow. Concerning to data for 2004 and 2005, one can notice that FDI inflows in CEC4 are much higher than the CEEC region (Table 2-5). In fact this study uses data published by UNCTAD. According to UNCTAD, WIR 2006, data for CEEC in 2004 and 2005 represent FDI inflows to South-East European countries (UNCTAD, *WIR* 2006).⁵ The Central European countries joined the European Union in May 2004, and since then they are included under data representing the EU.

The CEC4 countries have received the bulk of FDI in CEEC region for several reasons. The initial conditions of CEC4 were different than those of other countries in the region. They were early reformers, and most advanced among CEEC. These countries were among the first to achieve macroeconomic stabilization and their economic reforms have been the most advanced of all CEEC region. Although there have been considerable policy differences between them, a key element of the reforms has been the privatisation of state assets with the involvement of foreign strategic investors (Lavigne, 1995, Beigelbauer, 2000, and EIU 2003a, b). These acquisitions, the timing of which has been determined by the political process and national timetables for the sale of specific assets, have accounted for a considerable share of total FDI inflows (UN/ECE, *Economic Survey of Europe*, 2001, No. 1, p.188).

⁵ The four Central European countries joined the European Union in May 2004, and since then, all statistical data relevant to CEC4 are provided under the European Union section. UNCTAD started to publish data for South East European countries and CIS countries under a separate section, excluding the four Central European countries.

The early investment promotion efforts of these countries not only signalled that foreign investment was welcome in the former state run economies, but they also capitalized on the enthusiasm of western investors. At various times, investment incentives have been introduced which still seem to retain their attractiveness for individual countries competing for FDI (Hunya, 2000, Sass, 2003). All in all, the CEC4 were able to attract the bulk of FDI into the CEEC region for the following reasons:

1. They were the first to open up their economies to foreign investors.
2. They have been the earliest to begin liberalisation and the most advanced reformers.
3. They had more favourable initial conditions because of government policies and pre-transition efforts mostly owing to pre-1989 efforts.
4. These were the largest transition economies. At face value this might imply that considerations of market size have indeed dominated investment decisions.

Figure 2-13: A Comparative Perspective: CEC4 vs. CEEC, 1989-2005

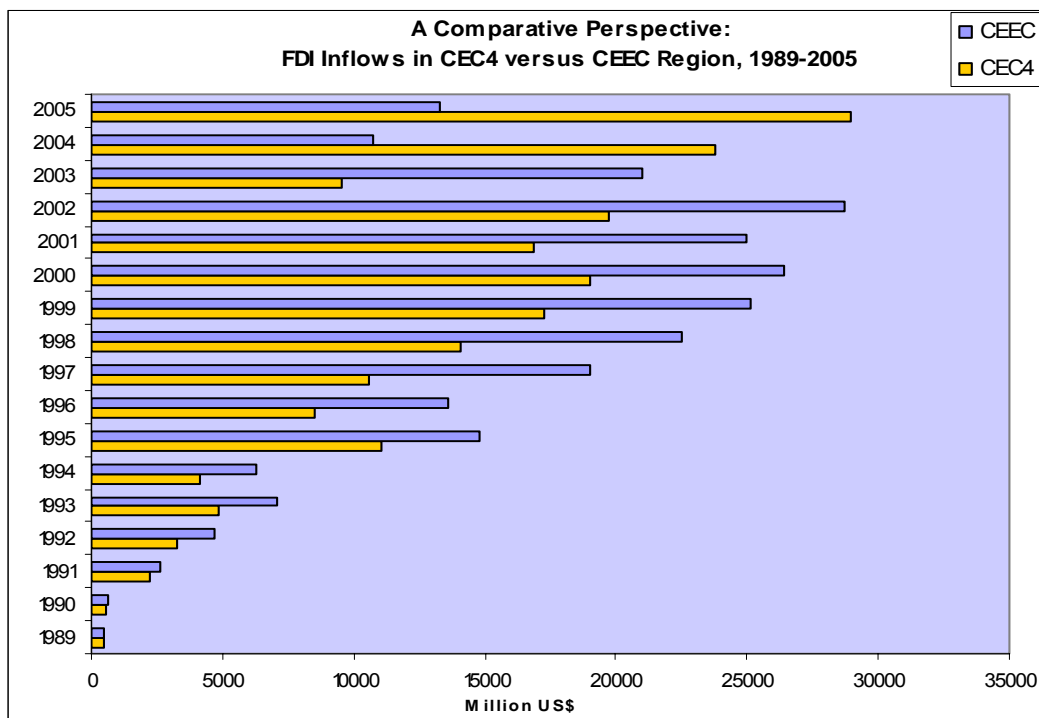
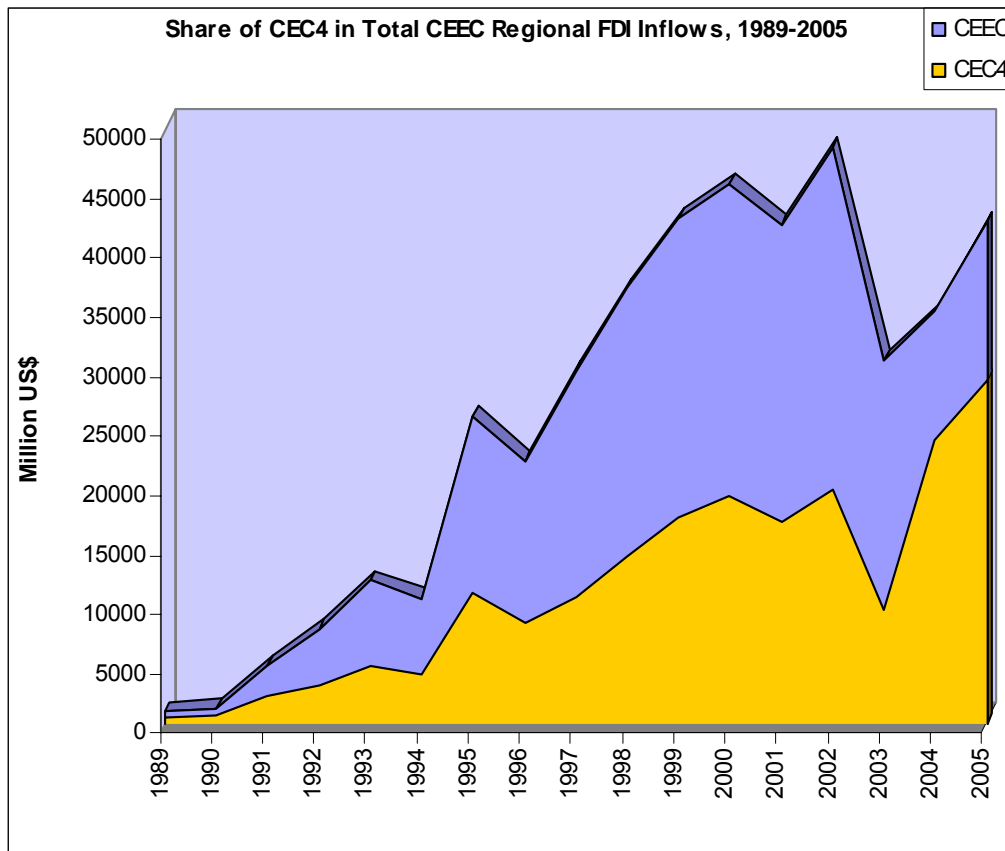


Figure 2-14: Share of CEC4 in Total CEEC FDI Inflows, 1989-2005



2.3.3 International Comparison: CEC4 versus World FDI

From a global perspective, during the 1990s, the CEC4 have become strong competitors for FDI. Even though these countries began to open up to foreign investment only in the beginning of 1990s, by the mid 1990s, the CEC4 absorbed around 3 percent of World FDI inflows (Table 2-5), which represented a relatively high share after only 4-5 years of their opening up to FDI. Their share has maintained the same level over the decade. The total share of CEC4 has accounted for 3 percent of global FDI inflows in 2005. Concerning FDI inward stock, the share of CEC4 of global FDI inward stock has increased from 0.9 percent in 1989 to about 2.3 percent in 2005 (Table 2-6).

Figure 2-15: A Comparative Perspective: CEC4 vs. World FDI Inflows, 1989-2005

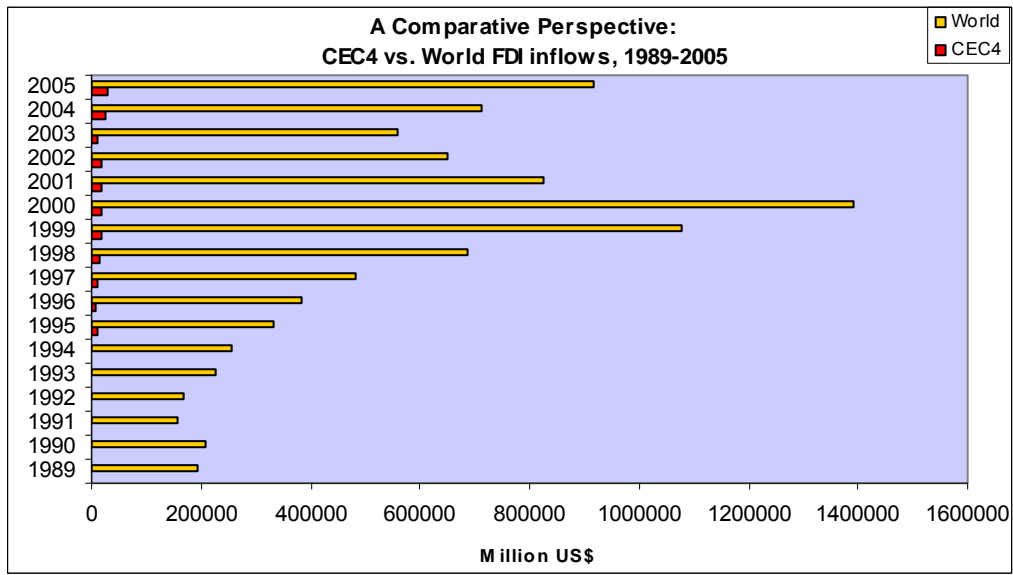
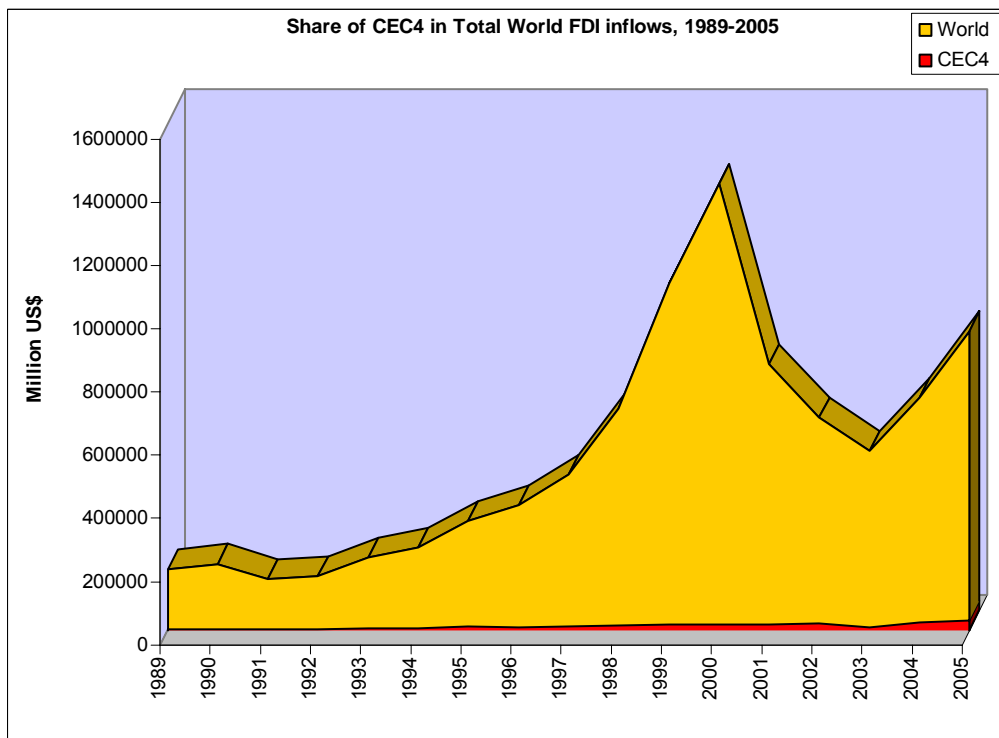


Figure 2-16: Share of CEC4 in Total World FDI Inflows, 1989-2005



2.4 Indicators of FDI Penetration: Relative Indices of FDI

The trend of FDI can be analysed from various viewpoints and can be compared to other indices. Different types of ratios are used in the analysis of inward FDI. All are measures of the penetration of FDI in the economy and give some idea of the potential economic impact of foreign investment. The various indices of FDI are presented respectively.

2.4.1 FDI Inward Stock

Table 2-6 describes FDI inward stock in CEC4, CEEC region and the world over the period 1989-2005. Among the four countries, at the end of 2005, on the basis of stock of FDI, Poland was the most important FDI target with a stock of US\$ 94 billion; Hungary was the second with a stock of US\$ 62 billion, and The Czech Republic the third, with US\$ 60 billion.

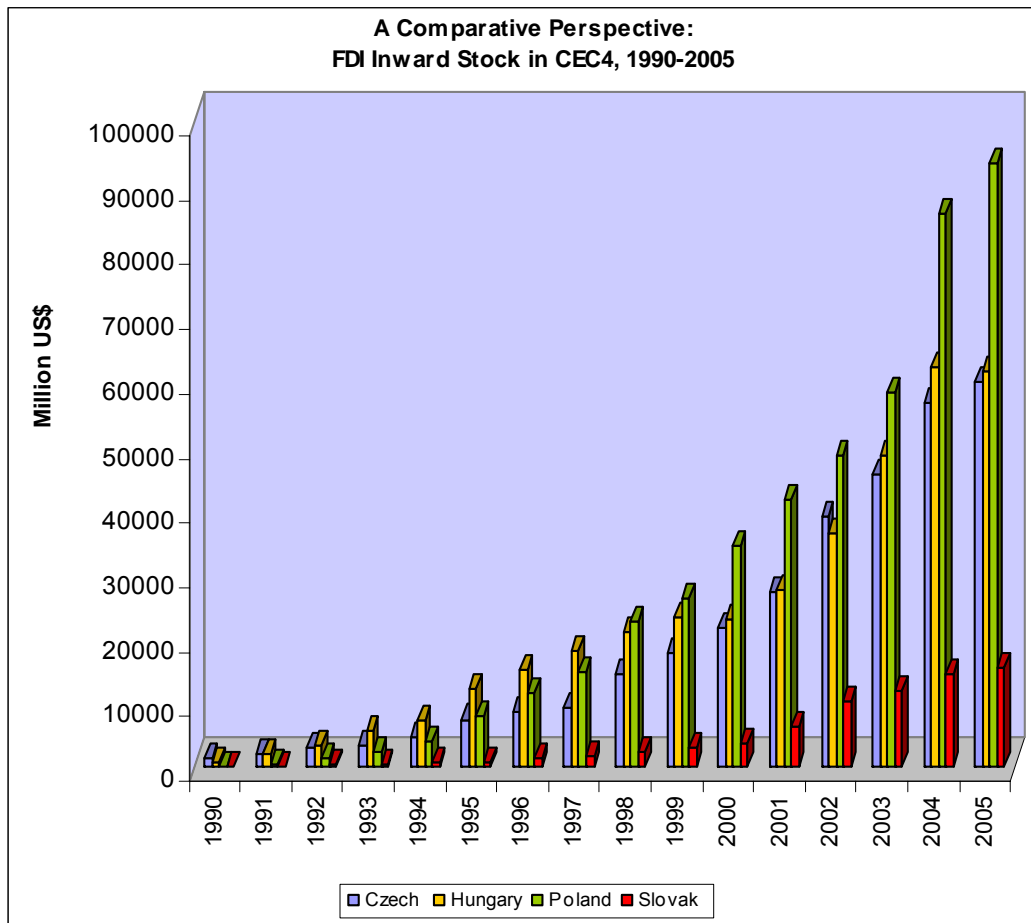
Table 2-6: FDI Inward Stock in CEC4, 1989-2005

FDI Inward Stock, 1989- 2005 (Million US\$)																	
Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech	1291	1363	1886	2889	3423	4547	7350	8572	9234	14375	17552	21644	27092	38669	45287	56415	59459
Hungary	258	569	2107	3424	5585	7095	11919	14961	17968	20733	23260	22870	27407	36224	48340	61727	61221
Poland	...	109	425	1370	2307	3789	7843	11463	14587	22479	26075	34227	41247	48320	57877	85605	93329
Slovak	..	81	168	268	400	592	810	1 379	1 539	2 267	2 868	3 733	6 213	10 225	11864	14501	15324
CEC4	1549	2122	4586	7951	11715	16023	27922	36375	43328	59854	69755	82474	101959	133438	163368	218248	229333
CEEC	2171	2841	6636	11421	17730	24080	40187	53750	71629	93076	108582	129169	155734	187868	263270	263270	56562
CEC4/ CEEC (%)	71.35	74.69	69.11	69.62	66.07	66.54	69.48	67.67	60.49	64.31	64.24	63.85	65.47	71.03	62.05	82.90	405.45
World	1692711	1954152	2120852	2167608	2338719	2623846	2789585	3233228	3436651	4088068	5196046	6146812	6606855	7122506	8245074	8895279	10129739
CEC4/ World (%)	0.09	0.11	0.22	0.37	0.50	0.61	1.00	1.13	1.26	1.46	1.34	1.34	1.54	1.87	1.98	2.45	2.26

Sources: 1) IMF, *International Financial Statistics Yearbooks*, 1999 - 2006.(line 79 lbd - International Investment Position-Direct Investment in Reporting Economy). 2) UNCTAD, FDI/TNC database.

N.B: Data for CEEC in 2005 present South-East Europe (Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Macedonia, Serbia & Montenegro)

Figure 2-17: FDI Inward Stock, 1990-2005



2.4.2 FDI Inward Stock/GDP

Table 2-7 describes FDI inward stock as a share of GDP over the period 1990-2005. The GDP statistic generally used in these ratios is calculated at current prices and exchange rates (nominal GDP). Between 1990 and 2005, there have been significant changes in the share of FDI stock to GDP in the analysed countries. This share is low in 1990 in all the countries; however, big individual projects elevated the share to relatively higher levels in the Czech Republic and Hungary. In 2005 Hungary had the highest level of FDI stock/GDP accounting about 56 percent of GDP. In the Czech Republic it accounted about 48 percent of GDP, in the Slovak Republic 33 percent and in Poland 31 percent.

Table 2-7: FDI Inward Stock/GDP (%), 1990-2005

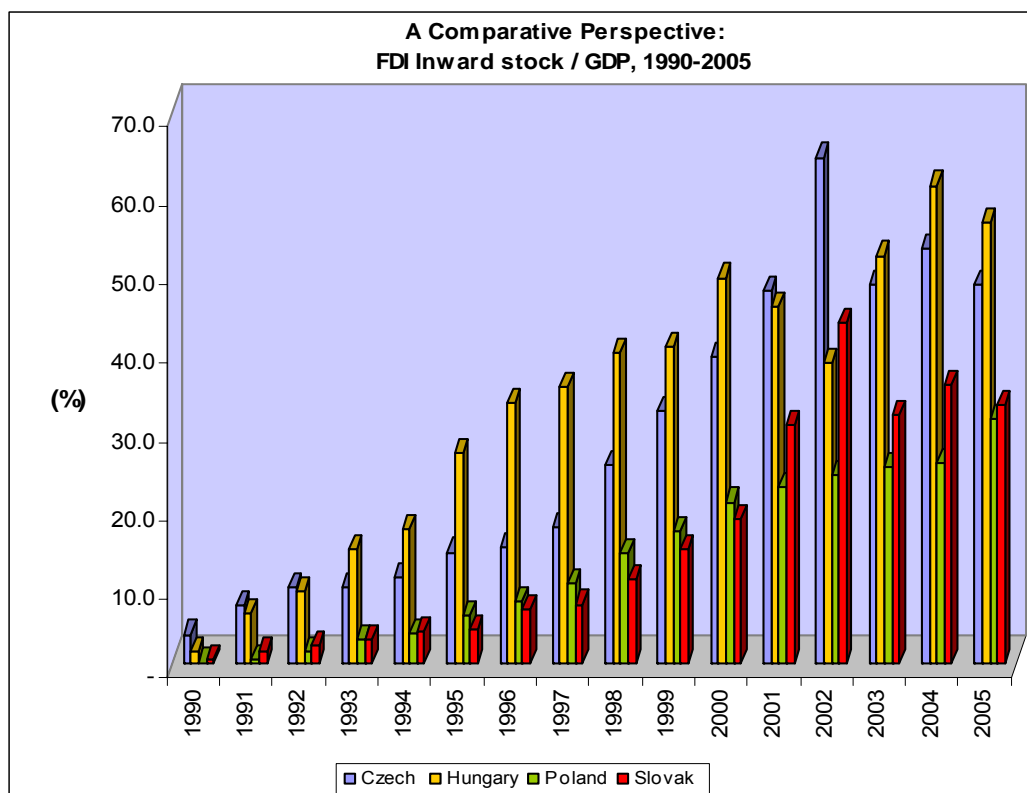
FDI Inward Stock/GDP (%), 1990 - 2005

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech	3.7	7.4	9.7	9.8	11.1	14.1	14.9	17.4	25.3	32.1	38.9	47.4	64.3	48	52.7	48.10
Hungary	1.6	6.3	9.2	14.4	17.1	26.7	33.1	35.2	39.4	40.2	49.0	45.4	38.2	51.8	60.7	55.90
Poland	0.2	0.6	1.6	3.0	3.8	6.2	8.0	10.1	14.1	16.8	20.5	22.4	24.0	24.9	25.4	31.10
Slovak	0.5	1.5	2.3	3.2	4.1	4.4	7.0	7.5	10.6	14.6	18.4	30.4	43.2	31.5	35.3	32.80
CEEC	1.3	0.9	1.6	2.6	3.6	5.3	6.2	8.1	12.1	16.8	18.1	19.1	20.9	24.8	35.3	26.70
World	8.5	9.4	8.6	9.5	10.0	10.3	11.2	12.2	14.7	16.9	18.3	21.2	22.3	22.9	21.7	22.70

Source: UNCTAD FDI/TNC database and WIR 1999 - 2006.

N.B: Data for CEEC in 2005 Presents South-East Europe.

Figure 2-18: FDI Inward Stock/GDP (%), 1990-2005



2.4.3 FDI Stock per Capita

A variant of FDI measures replaces GDP with country population, yielding stock per capita. Population can be established accurately over time, which facilitates cross-country comparisons (problems not entirely solved by GDP PPP), and it eliminates the problem of economic downturns. However, since per capita incomes vary considerably between countries, population figures are not likely to provide an accurate measure of economic size. Table 2-8 presents data concerning FDI stock per capita for the CEC4 over the period 1990-2005.

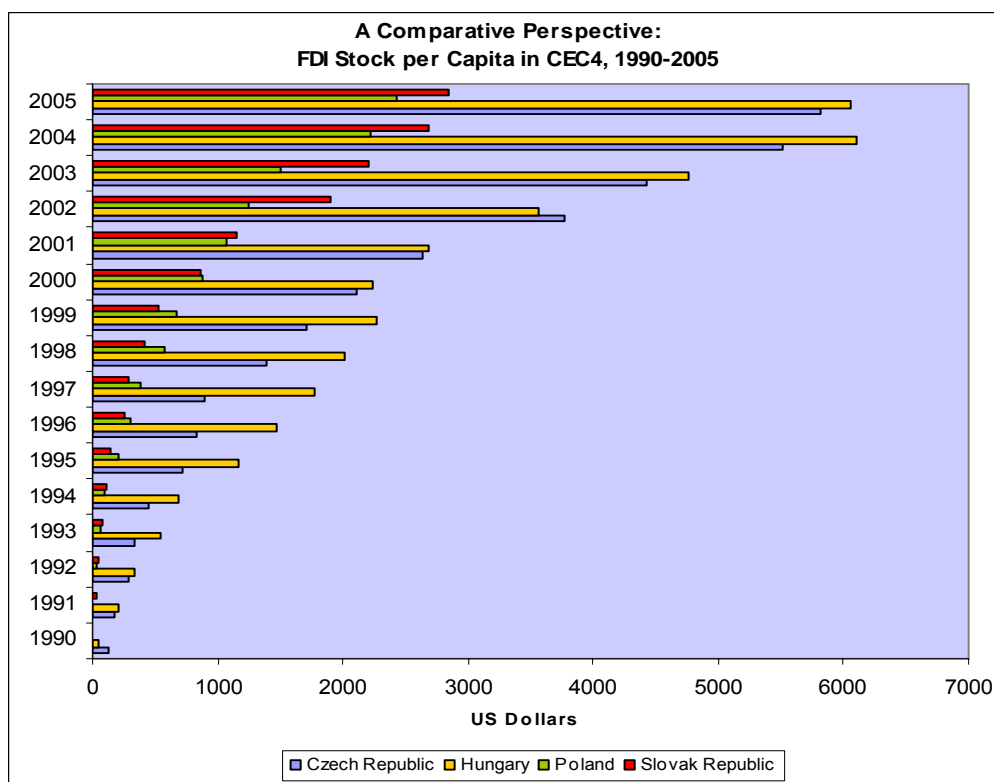
Table 2-8: FDI Inward Stock per capita, 1990-2005

FDI Inward Stock per capita in CEC4, 1990-2005 (US\$)

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic																
FDI Stock	1363	1886	2889	3423	4547	7350	8572	9234	14375	17552	21644	27092	38669	45287	56415	59459
Population	10.36	10.31	10.32	10.33	10.34	10.33	10.32	10.30	10.29	10.28	10.27	10.26	10.25	10.24	10.23	10.22
FDI stock p.c.	132	183	280	331	440	712	831	897	1397	1707	2107	2641	3773	4423	5515	5818
Hungary																
FDI Stock	569	2107	3424	5585	7095	11919	14961	17968	20733	23260	22870	27407	36224	48340	61727	61221
Population	10.36	10.35	10.32	10.29	10.26	10.23	10.19	10.15	10.27	10.25	10.23	10.20	10.18	10.15	10.12	10.10
FDI stock p.c.	55	204	332	543	692	1165	1468	1770	2019	2269	2236	2687	3558	4763	6100	6061
Poland																
FDI Stock	109	425	1370	2307	3789	7843	11463	14587	22479	26075	34227	41247	48320	57877	85605	93329
Population	38.12	38.24	38.37	38.46	38.54	38.59	38.62	38.65	38.67	38.65	38.61	38.65	38.62	38.59	38.56	38.53
FDI stock p.c.	3	11	36	60	98	203	297	377	581	675	886	1067	1251	1500	2220	2422
Slovak Republic																
FDI Stock	81	168	268	400	592	810	1379	1539	2267	2868	4634	6 213	10 225	11864	14501	15324
Population	5.28	5.28	5.31	5.32	5.35	5.36	5.37	5.38	5.39	5.40	5.39	5.38	5.38	5.39	5.39	5.4
FDI stock p.c.	15	32	50	75	111	151	257	286	421	531	860	1155	1901	2201	2690	2838

Sources: 1) UNCTAD FDI database, 2) IMF, IFS line 99z (population in million)

Figure 2-19: FDI Stock per capita, 1990-2005



The FDI stock per capita shows an uneven distribution of FDI in the four countries. Inward FDI stock per capita was in the range of US\$ 3 (Poland), to US\$ 132 (Czech Republic) in 1990. This ratio, which is an important indicator of FDI penetration, has witnessed a dramatic increase during the 1990s. This ratio increased sharply during the transition of CEC4 to a market economy. According to data provided by the UNCTAD and the IMF, FDI stock per capita in the Czech Republic has increased from US\$132 in 1990 to US\$ 5818 in 2005; in Hungary the ratio has increased from US\$55 in 1990 to US\$ 6100. In Poland, it has increased from US\$ 3 in 1990 to US\$ 2422, and in the Slovak Republic, it has risen from US\$ 15 in 1990 to US\$ 2838. Therefore, on the basis of FDI stock per capita, by the end of 2005, the highest per capita FDI stock is a characteristic of Hungary (US\$ 6100). The Czech Republic has the second (US\$ 5818), The Slovak Republic the third (US\$ 2838), and Poland the fourth (US\$ 2422).

To compare the ratio of FDI stock per capita of CEC4 with respect to the CEEC region, the study faces the problem of population measurement of CEEC. This study uses UNCTAD data for FDI inward stock. According to UNCTAD WIR, data on FDI inward stock of CEEC region includes countries such as the Belarus, Republic of Moldova, Russian Federation, and Ukraine.⁶ In order to calculate FDI inward stock per capita of CEEC, population measurement should include all the countries which are considered by UNCTAD as CEEC countries. Such a comparison would be improper. In other words, comparing FDI inward stock per capita of CEC4 with respect to CEEC region having into consideration countries such as the Russian Federation and Ukraine might not be a correct comparison.

2.4.4 FDI Inflows/Gross Fixed Capital Formation

The FDI/domestic investment ratio is often analysed assuming (at least implicitly) that FDI contributes to local gross fixed capital formation. This can be justified if FDI inflows represent capital goods in kind or if FDI cash flows are used to purchase capital equipment as is typically the case with Greenfield or follow-up investment in existing facilities (in both cases FDI increases the capital stock and productive capacity). The ratio loses this interpretation when FDI takes the form of M&A, which represent change in ownership (rather than fixed investment). Also the inter-company loan component of FDI may be used for transactions other than the finance of capital goods (e.g. financial speculation).

Table 2-9 describes FDI inflows in CEC4 as a share of gross fixed capital formation during the period 1990-2005. The ratios fluctuate significantly both in the analysed years and the analysed countries, and there are significant differences among the analysed countries as well. The fluctuations can be explained on the basis of the changes in the two elements of the index: the actual changes in the inflow of FDI and of fixed capital formation. The index can be higher in a given year because of the

⁶ According to UNCTAD World Investment Report, data on Central and Eastern Europe include the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Republic of Moldova, Romania, Russian Federation, Serbia and Montenegro, Slovakia, Slovenia, TFYR Macedonia, and Ukraine.

relatively high inflow of FDI or because of the relatively low level of fixed capital formation. In 1995, for example, the index was particularly high in Hungary (59.7%), because both the FDI inflow was exceptionally high because of big privatisation deal and because the overall investment activity was poor. In 2005, according to the same ratio, FDI inflow is most significant in The Czech Republic (34 %).

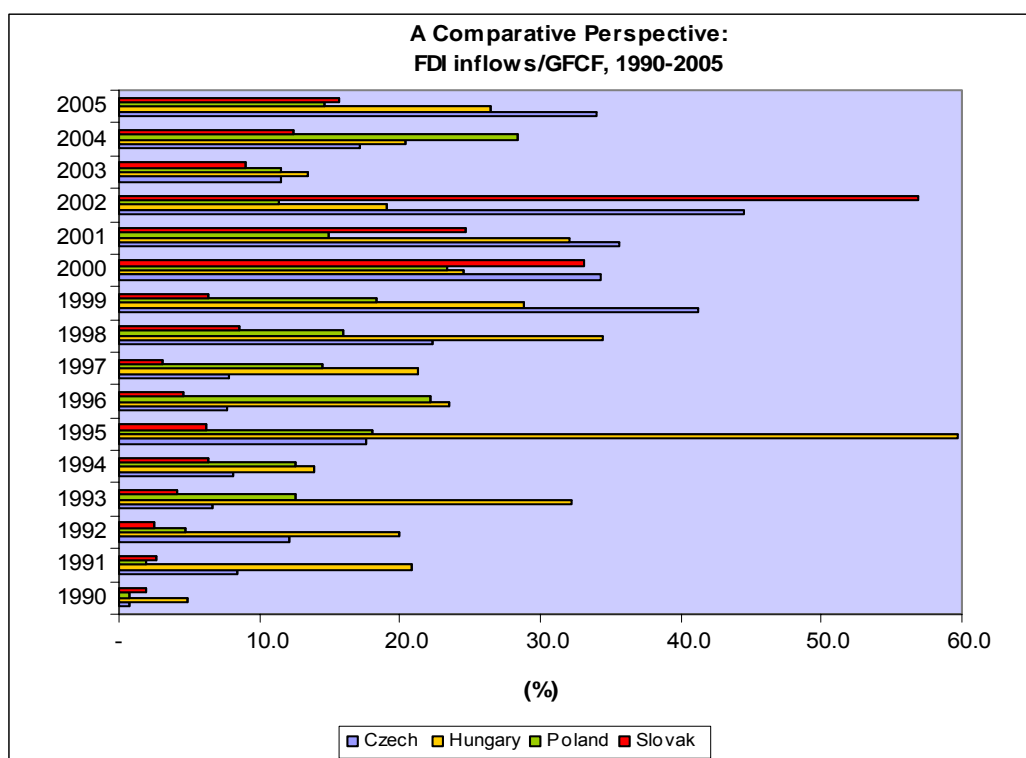
Table 2-9: FDI Inflows/GFCF (%), 1990-2005

FDI Inflows / GFCF (%), 1990-2005																
Country / Region	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech	0.8	8.5	12.1	6.6	8.1	17.6	7.7	7.9	22.3	41.3	34.3	35.6	44.5	11.6	17.2	34.00
Hungary	4.9	20.9	20.0	32.2	13.9	59.7	23.5	21.3	34.4	28.8	24.5	32.1	19.1	13.5	20.4	26.50
Poland	0.7	2.0	4.8	12.6	12.5	18.1	22.2	14.5	15.9	18.4	23.4	14.9	11.4	11.6	28.4	14.60
Slovak	1.9	2.6	2.6	4.1	6.3	6.2	4.5	3.0	8.6	6.4	33.1	24.7	56.9	9	12.4	15.70
CEEC	1.3	6.4	2.5	4.8	5	9.3	7	10.7	15.2	19.3	18.3	15.4	16.8	9.5	27.6	25.40
World	4.5	3.2	3.0	4.2	4.6	5.4	6.0	7.5	10.9	16.5	20.8	12.8	10.6	8.3	7.7	9.40

Source: UNCTAD, FDI/TNC database & *World Investment Reports*, 1997 - 2006.

N.B: Figures for CEEC for 2005 present South-East Europe.

Figure 2-20: FDI Inflows/GFCF (%), 1990-2005



On the basis of the analysed relative indices of FDI penetration, inward FDI amounted to significant levels in the four Central European countries – The Czech and Slovak Republics, Hungary and Poland. All in all, between 1990 and 2005, the CEC4 have attracted impressive amounts of FDI. Compared to their CEEC region, they attracted the bulk of FDI in the region. On a global scale, their share remains weak.

2.5 Origins of FDI in CEC4

It is also possible to estimate the level of FDI penetration in CEC4 using disaggregated “source” country data on the investments made by foreign investors. Tables 2-10 to 2-17 and charts 2-5 to 2-8 describe the countries of origin of FDI activity (inflows and inward stock) in each CEC4 country during the period under study. Data are from the OECD *International Direct Investment Statistics Yearbook*. They are broken down by geographical allocation of inward FDI activity (inflows and inward positions) from OECD area, and describe bilateral FDI inward activity from individual OECD countries. Data available suggest that inward FDI in CEC4 originates mainly from the OECD area. The statistical tables and charts suggest that inward FDI into CEC4 come largely from the EU, with Germany, the Netherlands, Austria, the United Kingdom, and France being the main investors (charts 2-5 to 2-8). In fact, a considerable proportion of direct investment has come from neighbouring countries. The underlying bilateral pattern of investment appears to reflect geography. Geographical proximity to major West European markets and production centres is a major advantage for the four countries, which share borders with the EU. Central Europe’s proximity to Western markets and the availability of a relatively high skill, but low cost, labour force has led to inward investment by many smaller and medium-sized companies. Proximity to the European Union has surely stimulated “market-seeking” investment of EU-based multinationals. For example, the size of the Polish economy, with a population of 38 million, has contributed to its leading position as a domicile for FDI. Historical and cultural ties and existing business linkages may help, also, to account for the primary sources of FDI flows to these countries. However large strategic investments have also been made in CEC4 by major multinational firms from more distant economies such as the U.S., and Korea, reflecting both the once-off

opportunities offered by privatisation as well as the desire to fill gaps in global production and marketing arrangements.

2.5.1 The Czech Republic

Tables 2-10 and 2-11 describe the annual total FDI inflows and inward stock, the percentage share of OECD area in total annual inflows and stock, as well as the bilateral inflows and inward position from 13 OECD countries into the The Czech Republic during the period 1993-2003. Data clearly demonstrate that the OECD area accounts between 80 to 100 percent of total inflows and inward stock.

Table 2-10: Czech Republic: FDI Inflows by Country of Origin, 1993-2004

Czech Republic: FDI Inflows by Country of Origin (13 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total FDI Inflows	983	654	878	2568	1435	1286	3700	6313	4987	5641	9323	2514	4454
FDI Inflows from OECD Area	...	548	770	2451	1381	1188	3430	6298	4785	5489	8213	2013	...
% of OECD Area /Total	...	0.84	0.88	0.95	0.96	0.92	0.93	1.00	0.96	0.97	0.88	0.80	...
Source Country													
Austria	...	55	80	87	208	95	415	833	738	264	762	484	448
Belgium-Luxembourg	...	32	33	25	57	56	47	1378	53	161	437	-253	37
Canada	...	20	0	0	0	0	-5	11	155	73	-112	131	36
Denmark	...	2	5	12	11	3	25	43	103	157	94	-13	11
France	...	34	77	168	20	102	142	232	232	1539	142	680	172
Germany	...	82	418	567	249	391	958	1300	1322	1313	4652	163	869
Italy	...	12	12	1	90	-36	27	47	36	-2	127	73	87
Japan	...	0	5	0	39	11	23	5	46	29	116	328	263
Netherlands	...	30	6	736	259	134	838	1131	1036	948	1229	-1056	1055
Sweden	...	12	19	22	56	89	-70	127	148	21	109	-49	151
Switzerland	...	14	39	679	55	47	112	354	228	175	271	136	143
United Kingdom	...	0	38	53	84	196	347	104	158	434	-220	636	107
United States	...	255	39	101	253	99	535	581	303	245	189	154	282

Sources: (1) OECD, International Direct Investment Statistics Yearbook, 2004.

(2) Czech National Bank, Foreign Direct Investment.

Original values are in Czech Koruna. They are converted into US\$ using yearly average exchange rates of Annex III, OECD yearbook.

The sign (...) refers to data not available or applicable or data not provided for confidentiality purposes.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

Table 2-11: Czech Republic: FDI Inward Position by Country of Origin, 1997-2003

Czech Republic: FDI Inward Position by Country of Origin (22 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Inward Stock	2889	3423	4547	7350	8572	9700	14375	17800	21644	27092	38669	45287
Inward Stock from OECD Area	9684	12581	17831	20617	25225	34685	...
% of OECD Area / Total						1.00	0.88	1.00	0.95	0.93	0.90	
Source Country												
Australia	(-)	15	0	5	-1	-5	1
Austria	959	1650	1778	2409	2708	4409	5351
Belgium-Luxembourg	201	211	987	1159	1511	2621	2558
Canada	22	45	37	83	146	78	285
Denmark	34	131	172	269	132	199	347
Finland	3	8	9	132	128	37	67
France	610	677	774	926	1787	2312	3588
Germany	3132	4252	4667	5522	6545	8557	9314
Greece	(-)	1	1	4	4	0	3
Ireland	10	15	4	8	57	26	94
Italy	180	131	180	172	165	296	486
Japan	54	77	61	109	206	432	805
Korea	(-)	0	0	7	7	9	17
Netherlands	2807	3898	5387	6508	7914	13192	14001
Norway	53	105	108	106	91	76	159
Portugal	0	0	1	2	2	6	9
Spain	1	31	35	37	61	119	236
Sweden	296	208	258	294	227	483	538
Switzerland	162	260	388	872	1062	1355	1262
Turkey	(-)	2	1	0	0	0	3
U.K.	505	679	888	750	1663	1043	1923
U.S.	651	1179	1180	1401	1735	1885	2335

Sources: OECD, International Direct Investment Statistics Yearbook, 2004.

Original values are in Czech Koruna. They are converted into US\$ using yearly average exchange rates of Annex III, OECD yearbook.

The sign (...) refers to data not available or applicable or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

2.5.2 Hungary

Tables 2-12 and 2-13 provide data about the origins of FDI in Hungary. They suggest that most FDI originates from the OECD area. Concerning inward FDI position Germany seems to be the largest investor in Hungary. By the end of 2003, Germany's FDI stock accounts for 37 percent of total FDI stock in Hungary. Netherlands is the second, showing a share of 24 percent of total FDI stock. The remaining major investors are from Austria, the U.S., and France (Chart 2-6).

Table 2-12: Hungary: FDI Inflows by Country of Origin, 1999-2003

Hungary: FDI Inflows by Country of Origin (22 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI Inflows	1480	2350	1144	4519	2274	4155	3343	3308	2770	3944	2863	2580
FDI Inflows from OECD area	1878	1647	3494	2549	2524
% of OECD Area /Total								0.57	0.59	0.89	0.89	0.98
Source Country												
Australia	-5	0	1	1	1
Austria	62	79	397	572	882
Belgium-Luxembourg	68	214	172	508	270
Canada	26	8	49	28	19
Czech Rep.	0	1	2	4	10
Denmark	3	25	31	38	-9
Finland	14	117	115	87	128
France	62	60	57	-186	224
Germany	541	89	2111	384	698
Greece	1	5	1	2	0
Ireland	-37	66	4	90	-6
Italy	53	-3	56	26	19
Japan	20	10	255	90	66
Korea	-2	19	39	40	23
Netherlands	607	340	-263	259	348
Norway	1	1	15	68	37
Spain	7	1	4	18	473
Sweden	6	63	87	-39	94
Switzerland	15	150	42	-31	-552
Turkey	37	1	8	0	1
United Kingdom	31	220	38	107	-518
United States	367	188	272	483	271

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

Original values are in Hungarian Forints. They are converted into US\$ using yearly average exchange rates of Annex III, OECD yearbook.

The sign (...) refers to data not available or applicable or data not provided for confidentiality purposes.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

Table 2-13: Hungary: FDI Inward Position by Country of Origin, 1992-2004

Hungary: FDI Inward Position By Country of Origin (22 Countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total Inward Stock	4500	6800	7500	11919	14961	16086	18517	19299	19804	23562	24416	48340
Inward Stock from OECD AREA	4437	6734	7478	9839	9552	10489	10471	10528	9851	19411	23959	...
% of OECD Area / Total	0.99	0.99	1.00	0.83	0.64	0.65	0.57	0.55	0.50	0.82	0.98	...
Source Country												
Australia	88	93	13	3	11	2	1	1	1	0	2	4
Austria	1191	1109	1559	1653	1468	1198	1337	1338	1270	2368	2960	4355
Belgium-Luxembourg	144	301	304	434	379	474	415	471	556	758	1009	2481
Canada	30	42	68	61	39	119	26	29	22	106	121	158
Denmark	15	18	45	64	110	52	42	40	51	87	120	178
Finland	13	13	16	33	21	48	62	59	167	317	411	694
France	239	332	407	844	791	633	662	689	678	1196	1437	1686
Germany	878	1992	1747	2559	2413	2713	3022	3017	2685	7374	8854	11333
Greece	4	11	7	10	6	10	5	4	2	3	4	5
Ireland	10	11	25	35	24	87	35	44	71	8	75	6
Italy	154	271	366	391	386	367	333	299	284	492	556	718
Japan	122	179	147	136	166	168	203	217	215	367	475	665
Korea	49	27	31	51	85	85	(...)	71	79	115	147	226
Netherlands	421	395	872	1092	967	1594	1752	2485	2342	3291	4035	7583
Norway	0	0	0	14	26	22	32	36	28	47	272	696
Portugal	(...)	(...)	(...)	4	1	3	4	5	12	14	21	22
Spain	2	6	11	16	13	13	13	40	40	28	61	838
Sweden	51	49	87	69	64	94	81	77	90	271	442	587
Switzerland	206	137	301	302	228	290	341	273	223	325	346	447
Turkey	2	1	2	4	3	3	3	48	38	45	2	59
U.K.	230	275	351	395	592	837	706	210	110	241	299	335
U.S.	587	1472	1118	1660	1739	1669	1328	974	854	1955	2263	2022

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

Original values are in Hungarian Forints. They are converted into US\$ using yearly average exchange rates of Annex III, OECD yearbook.

The sign (...) refers to data not available or not applicable or data not provided for confidentiality purposes.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

2.5.3 Poland

Tables 2-14 and 2-15 describe the bilateral FDI inflows and inward position in Poland from 24 OECD countries. They demonstrate that most FDI in Poland originates from the OECD area accounting for about 100 percent of total inward position.

Table 2-14: Poland: FDI Inflows by Country of Origin, 1993-2003

Poland: FDI Inflows by Country of Origin (24 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI Inflows	678	1715	1875	3659	4498	4908	6365	7270	9342	5714	4131	4225
FDI Inflows from OECD area	...	1085	1042	3536	4332	4701	6177	7261	9323	5687	4099	4181
% of OECD Area / Total	...	0.63	0.56	0.97	0.96	0.96	0.97	1.00	1.00	1.00	0.99	0.99
Source Country												
Australia	...	(-)	1	134	24	8	1	1	-1	-9	-4	5
Austria	...	33	20	110	110	151	161	274	272	223	266	347
Belgium-Luxemburg	...	35	14	88	105	69	255	67	291	401	566	449
Canada	...	9	6	13	21	-5	13	18	9	15	-2	...
Czech Rep.	...	(-)	(-)	5	16	16	8	2	-2	-9	-14	-15
Denmark	...	7	16	73	221	189	132	145	126	308	125	178
Finland	...	9	7	16	24	32	45	39	104	28	31	62
France	...	15	53	429	370	406	467	1604	3533	1829	-11	612
Germany	...	223	282	766	1093	1016	1366	1227	940	1051	509	264
Greece	...	(-)	(-)	3	-9	(...)	(-)	-1	-4	-1	16	1
Hungary	...	(...)	4	1	(-)	1	10	-2	-2	7	60	16
Ireland	...	2	1	43	99	76	71	109	41	49	218	168
Italy	...	324	49	73	125	33	28	1134	365	135	101	148
Japan	...	2	3	9	8	7	99	-3	39	32	-173	130
Korea	...	(-)	6	34	202	89	165	152	-216	-79	-158	271
Netherlands	...	92	165	651	1138	1485	2040	1206	1968	1104	1836	376
Norway	...	20	10	38	-10	44	25	16	4	11	13	4
Portugal	...	(-)	(...)	5	2	1	4	68	69	166	34	1
Spain	...	25	1	2	4	-14	-4	234	357	-96	47	149
Sweden	...	9	41	93	96	86	256	207	595	25	-34	-37
Switzerland	...	19	57	182	96	89	56	130	323	-127	92	172
Turkey	...	1	(-)	3	9	28	25	1	16	-6	-15	-8
United Kingdom	...	94	44	144	132	197	207	208	170	46	184	339
United States	...	166	262	621	457	698	748	427	325	586	403	549

Source: OECD, *International Direct Investment Statistics* Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

Table 2-15: Poland: FDI Inward Position by Country of Origin, 1994-2003

Poland: FDI Inward Position by Country of Origin (22 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI Inward Stock	1370	2307	3789	7843	11463	14587	22479	26075	34227	41247	47900	52700
FDI Stock From OECD Area	2698	7593	10791	13967	21654	25326	32178	39160	45455	52770
% of OECD Area / Total	0.71	0.97	0.94	0.96	0.96	0.97	0.94	0.95	0.95	1.00
Country												
Australia	25	189	140	24	11	12	14	7	1	4
Austria	124	384	461	553	693	834	1100	1372	1745	2221
Belgium-Luxembourg	61	198	280	263	592	575	862	1333	2074	2631
Canada	25	39	51	40	51	63	71	89	91	97
Denmark	54	150	342	470	602	687	867	1213	1386	1693
Finland	22	41	69	85	124	147	219	263	349	435
France	105	432	1027	1332	1798	3096	4172	6348	6675	8000
Germany	632	1518	2459	3151	4815	5391	6482	7767	8681	9532
Greece	14	22	8	6	5	3	(-)	21	23	22
Ireland	1	43	99	154	234	294	398	422	646	986
Italy	166	263	706	600	605	1094	1478	1710	1989	2156
Japan	8	15	20	23	119	102	140	176	56	197
Korea	6	42	227	263	640	681	458	154	-245	15
Netherlands	371	1338	2162	3659	6422	6670	8432	10001	11892	12899
Norway	28	71	62	92	119	126	144	169	222	249
Portugal	(-)	5	7	6	10	92	165	287	225	248
Spain	16	28	30	19	22	262	655	533	602	787
Sweden	76	218	271	268	542	657	1182	1235	1715	2109
Switzerland	154	378	444	410	459	545	848	711	806	1047
Turkey	1	4	12	36	57	60	60	49	36	28
United Kingdom	148	321	332	550	811	943	1131	1287	1526	2020
United States	653	1883	1555	1938	2867	2948	3240	3934	4820	5232

Source: OECD, International Direct Investment Statistics Yearbooks, issues 2002 - 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

2.5.4 The Slovak Republic

Tables 2-16 and 2-17 describe the annual total FDI inflows and inward stock in the Slovak Republic. They provide information about the share of FDI from the OECD area, as well as the bilateral inflows and inward stock from each of 22 OECD countries. The data clearly suggest that the OECD area is the source of about 100 percent of FDI in the Slovak Republic.

Table 2-16: Slovak Republic: FDI Inflows by Country of Origin, 2000-2003

Slovak Republic: FDI Inflows by Country of Origin (22 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI Inflows	100	166	255	300	301	220	684	390	2200	1579	4094	770
FDI Inflows from OECD Area	2000	1465	3694	770
% of OECD Area /Total	0.91	0.93	0.90	1.00
Source Country												
Australia	(-)	0	...	3
Austria	188	350	162	49
Belgium-Luxembourg	41	14	6	63
Canada	92	4	2	0
Czech Republic	46	0	74	218
Denmark	15	8	-6	28
Finland	1	1	2	-3
France	33	44	1488	-2
Germany	870	172	1653	40
Greece	(-)	...	0	0
Ireland	0	1	-1	16
Italy	-2	462	109	4
Japan	0	-2	0	14
Korea	0	...	-1	(-)
Netherlands	620	168	-29	43
Norway	1	13	1	1
Portugal	(-)	4	...	0
Spain	0	-2	-2	-1
Sweden	15	-1	0	3
Switzerland	3	9	7	-25
U.K.	-6	157	146	51
U.S.	0	42	89	7

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

Table 2-17: Slovak Republic: FDI Inward Position by Country of Origin, 2000-2002

Slovak Republic: FDI Inward Position by Country of Origin (22 countries)
(Million US\$)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total FDI Inflows	268	400	592	810	1379	1539	2267	2868	4634	6213	10225	11864
Stock from OECD Area	4533	5685	7381	...
% of OECD Area / Total									0.98	0.92	0.72	
Source Country												
Australia	9	10	11	...
Austria	720	1062	705	...
Belgium-Luxembourg	83	160	177	...
Canada	395	1	...	...
Denmark	23	37	52	...
Finland	8	8	12	...
France	137	153	595	...
Germany	1061	1287	2380	...
Greece	(-)	...	0	...
Ireland	1	4	3	...
Italy	60	529	617	...
Japan	13	14	14	...
Korea	13	13	2	...
Netherlands	1016	912	964	...
Norway	51	66	70	...
Portugal	(-)	...	(-)	...
Spain	8	6	5	...
Sweden	35	36	20	...
Switzerland	39	61	74	...
Turkey	(-)	...	1	...
U.K.	263	394	508	...
U.S.	0	357	461	...

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The zeros (0) in the tables present amounts less than half a million US \$. They are positive or negative.

The charts below (Charts 2-5 to 2-8) present the share of OECD countries having the major FDI inward position in CEC4 by the end of 2003.

Chart 2-5: Czech Republic: FDI Inward Position by Country of Origin, end of 2003

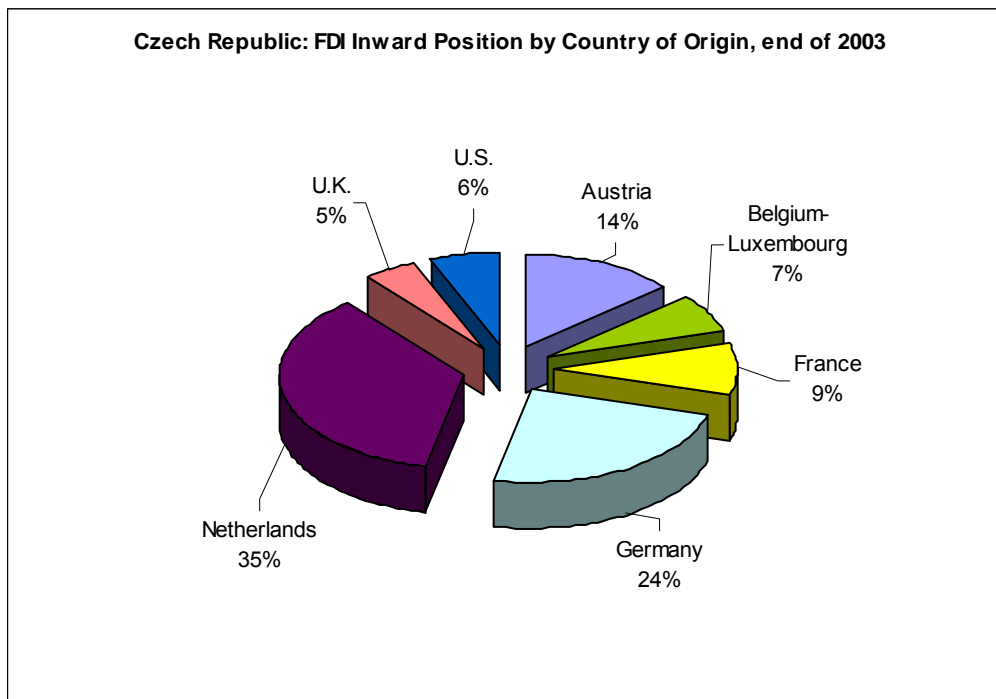


Chart 2-6: Hungary: FDI Inward Position by Country of Origin, end of 2003

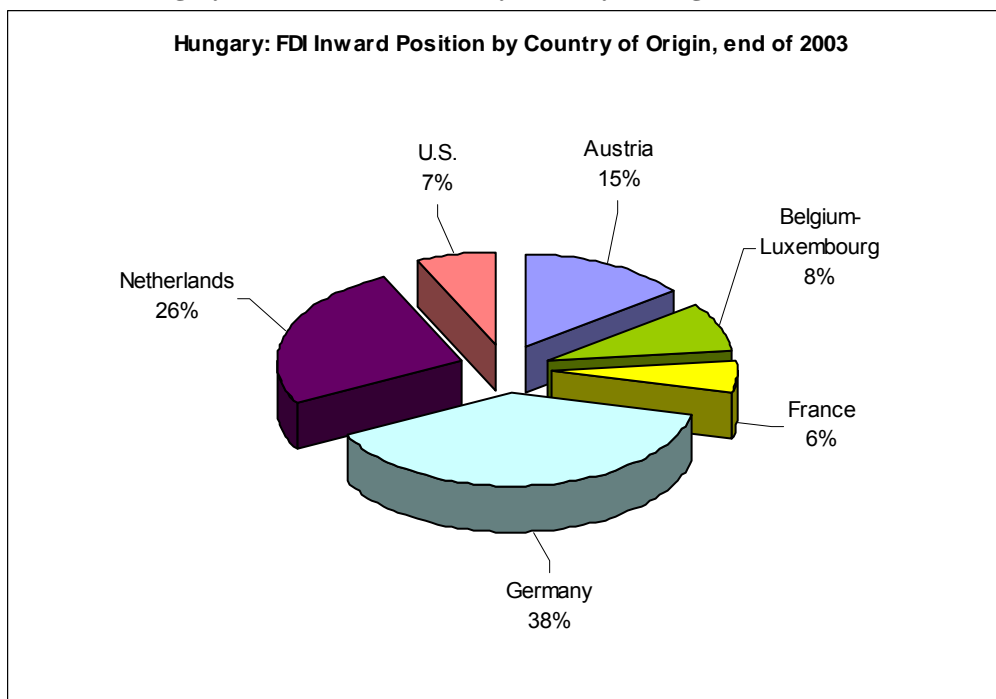


Chart 2-7: Poland: FDI Inward Position by Country of Origin, end of 2003

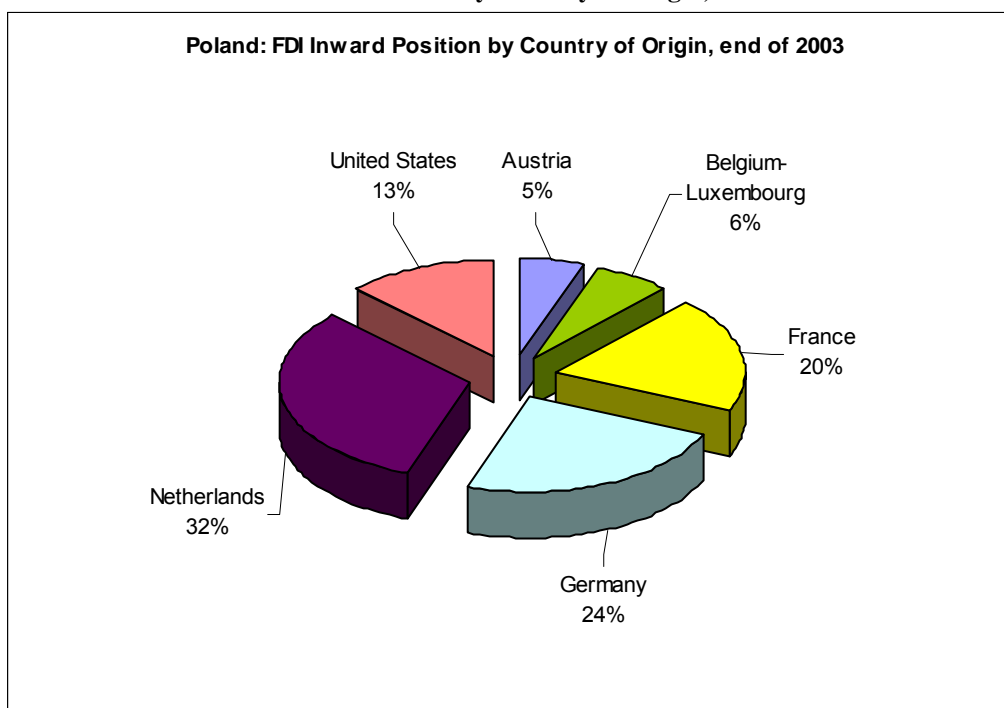
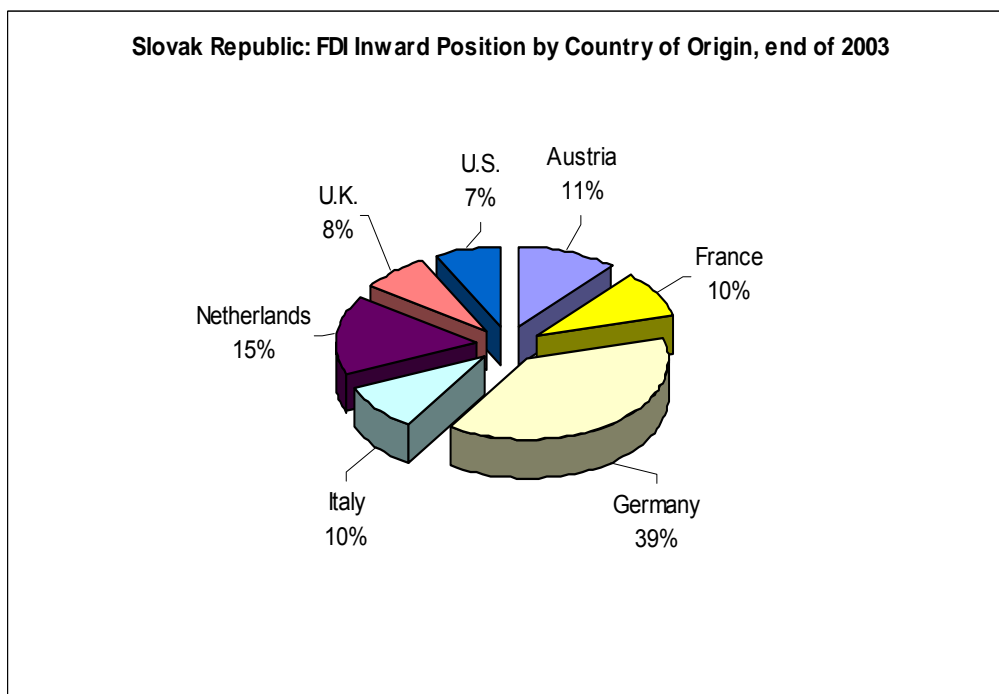


Chart 2-8: Slovak Republic: FDI Inward Position by Country of Origin, end of 2002



2.6 Outward FDI from CEC4

This section of the study looks at the levels of outward FDI from CEC4 to the 22 OECD countries included in the study. The purpose is to investigate whether or not BIT ratification has stimulated outward FDI from CEC4 to the 22 OECD countries. Since BITs are agreements between two countries for the reciprocal encouragement, promotion, and protection of investments in each others' territories by companies based in either country, the researcher expects that BIT ratification should increase also outward FDI from CEC4 to the 22 OECD partner countries in the near future, or in the long run.

Tables are provided below to describe outward FDI from CEC4 to the 22 OECD countries included in the study. Data available suggest that outward FDI from CEC4 are either not available or are not provided for a considerable period of time. For example, data for The Czech and Slovak Republics, and Hungary start from 1997. Data concerning Poland are available since 1993. Even when data are available, they suggest that outward FDI from CEC4 to the 22 OECD countries are nil or negligible. All in all, available data suggest that there are some outward FDI from the CEC4 but it is very weak.

In connection to outward FDI from CEC4, Andreff and Andreff (2006) have studied the CEEC competition with EU15 for both inward and outward FDI. According to the authors, CEEC competition facing former EU15 members to attract inward FDI has become harsher from 1993 to 2003. Outward FDI from CEEC does not exhibit yet a similar competitive threat to the EU. Furthermore, the authors argue that outward FDI from CEEC exists before transition to a market economy. Some so called 'red multinationals' have spread abroad during the communist system. However, it dampened with the economic crisis that accompanied the early years of transition. Most 'red multinationals' were no longer able to finance their investment abroad, some of them went bankrupt, others were dismantled, restructured or partly privatized. However, since the mid 1990s, there is a recovery of outward FDI from CEEC. Consequently, new EU members are competing with incumbent members as

regards to outward FDI as well. The authors discuss outward FDI from EU25 from 1993 to 2003, by using Dunning's *investment development path* (IDP) model. Their empirical result reveals that outward FDI is determined by the level of economic and technological development in the home countries. Concerning the CEECs economic catch up process with the EU, helps their outward FDI, in accordance with the IDP model. A lower technological level at the moment is a handicap for their TNCs' expansion. A harsh competition from CEECs as home countries for outward FDI is not foreseen in the near future. The authors conclude that the CEECs competitive strength on the European market for outward FDI remains weak so far whereas new EU members compete much more significantly regarding their attractiveness to inward FDI (Andreff and Andreff, 2006).

Tables are provided below to describe outward FDI – outflows and stock - from the four Central European countries. Data are from the OECD *International Direct Investment Statistics*. Table 2-18 describes outward FDI from the Czech Republic. Table 2-19 describes that from Hungary. Table 2-20 provides information related to Poland and Table 2-21 to the Slovak Republic.

2.6.1 The Czech Republic

Table 2-18: Czech Republic: Outward FDI (Outflows and Position), 1992-2003

Czech Republic: <i>FDI Outflow</i> by Country (22 countries) Million Czech Koruna												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	1721	876	2370	5567	6435
Australia	(-)	47	5
Austria	-9	118	42	...	...
Belgium-Luxembol	38	(-)	8	...	...
Canada	198	-177	-82	29	-24
Denmark	2	2	2	...	...
Finland	28	...	...
France	-1	-27	...	...	...
Germany	52	-147	-21	...	...
Greece	1	...	...
Ireland	-4	...	...
Italy	(-)	-8	274	...	...
Japan	(-)	(-)	(-)	(-)	(-)
Korea	(-)	(-)	(-)
Netherlands	120	-674	187	...	...
Norway	-36	-101	-98
Portugal	(-)
Spain	18	...	...
Sweden	-2	-42	-30	...	...
Switzerland	98	-41	60	38	90
Turkey	(-)	(-)	(-)
United Kingdom	337	-61	4	...	...
United States	137	296	220	257	391

Czech Republic: <i>FDI Outward Position</i> by Country (22 countries) Million Czech Koruna												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	6870	7787	18100	17355	18724	24576	...
Australia	30	30	43	-15	-15	-15	...
Austria	439	505	544	655	163	...	...
Belgium-Luxembol	-67	727	-70	78	540	...	...
Canada	283	226	327	75	8	-33	...
Denmark	(-)	...	3	6	4	...	...
Finland	128	121	80	64	86	...	...
France	90	208	142	155	41	...	...
Germany	2287	2240	2016	1393	1109	...	...
Greece	32	22	(-)	(-)	1	...	...
Ireland	56	284	434	486	155	...	...
Italy	18	42	694	687	418	...	...
Japan	(-)	(-)	(-)	(-)	(-)	(-)	...
Korea	(-)	(-)	(-)	(-)	(-)	(-)	...
Netherlands	731	757	863	7	1359	...	...
Norway	-133	-34	-9	-84	-113	-223	...
Portugal	(-)	2	3	2	2	...	...
Spain	63	57	151	35	45	...	...
Sweden	92	57	63	47	9	...	...
Switzerland	453	688	743	600	132	1080	...
Turkey	(-)	(-)	(-)	(-)	(-)	(-)	...
United Kingdom	1034	345	607	941	613	...	...
United States	277	284	292	557	364	562	...

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

2.6.2 Hungary

Table 2-19: Hungary: Outward FDI (Outflows and Position), 1992-2003

HUNGARY: FDI Outflows by Country (22 countries) Forint Million												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	43216	67843	5612	58010	102797
Australia	1	11	17	91	115
Austria	4943	11035	-3040	1915	-1966
Belgium-Luxer	827	248	11413	1218	576
Canada	6	95	-10	124	46
Denmark	(-)	35670	1032	1905	950
Finland	-2	-74	-1	13	(-)
France	161	662	473	159	282
Germany	1904	13543	158	5567	1037
Greece	(-)	4	-21	9	(-)
Ireland	1003	20	-7	220	-46
Italy	177	80	-138	246	105
Japan	2	97	9	347	(-)
Korea	2922	-3022	-1	3204	1077
Netherlands	10823	-3233	-18466	4162	3716
Norway	(-)	6	-1	16	1
Portugal	(-)	(-)	-49	(-)	7
Spain	157	426	492	479	293
Sweden	12	50	17	714	43
Switzerland	285	-1397	-323	1950	914
Turkey	(-)	(-)	-30	141	7701
United Kingdoi	5776	1406	292	423	1308
United States	10661	-1205	-4709	3336	-937

Hungary: FDI Outward Position by Country (22 countries) Forint Million												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	256271	268767	...
Australia	(-)	(-)	...
Austria	14267	1685	...
Belgium-Luxer	11057	10993	...
Canada	21	(-)	...
Denmark	35260	35588	...
Finland	(-)	(-)	...
France	672	162	...
Germany	2409	9331	...
Greece	39	40	...
Ireland	430	330	...
Italy	142	193	...
Japan	92	87	...
Korea	(-)	3448	...
Netherlands	94727	88252	...
Norway	(-)	(-)	...
Portugal	7	(-)	...
Spain	139	169	...
Sweden	(-)	(-)	...
Switzerland	1463	765	...
Turkey	40	142	...
United Kingdoi	2985	2864	...
United States	15470	15813	...

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

2.6.3 Poland

Table 2-20: Poland: Outward FDI (Outflows and Position), 1992-2003

Poland: <i>FDI Outflows by Country (22 countries) US\$ million</i>												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	...	7	9	15	13	39	278	30	-6	196	187	175
Australia	(-)	(-)	(-)	(-)	(-)	(-)
Austria	...	(-)	(-)	(-)	3	...	16	(-)	8	26	...	...
Belgium-Luxemb.	...	2	2	(-)	1	2	167	-12	-38	64	-16	10
Canada	...	(-)	(-)	(-)	(-)	(-)	(-)	(-)	-1	1	(-)	(-)
Denmark	...	(-)	(-)	(-)	(-)	(-)	(-)	(-)	-1	...	3	-1
Finland	...	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)	(-)
France	(-)	1	...	-5	-6	-9	(-)	2	105	3
Germany	...	4	1	3	3	33	-2	-9	-3	26	-14	131
Greece	(-)	(-)	(-)	(-)
Ireland	1	...	...	...	1	65
Italy	1	...	...	...	...	...	...	-1	1
Japan	(-)	(-)	(-)	(-)	(-)
Korea	(-)	(-)	(-)
Netherlands	13	-11	6	-15	148	-3
Norway	-1
Portugal	(-)	(-)	(-)
Spain	1	...	...	3	(-)	-6	1
Sweden	-1	-1	1	1	(-)
Switzerland	...	(-)	(-)	(-)	1	...	...	64	...	-18	...	3
Turkey	37	8	4	32	1	...
United Kingdom	...	1	5	3	1	6	47	9	5	81	-10	-6
United States	...	(-)	(-)	3	2	5	5	-12	3	-3	-20	-18

Poland: <i>FDI Outward Position by Country (22 countries) US\$ million</i>												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	86	137	348	298	720	665	655	644	926	1198
Australia	(-)	-1	...	-1	-1	-1	...	...	(-)	(-)
Austria	4	5	15	12	29	26	39	11	15	19
Belgium-Luxemb.	4	6	40	37	217	172	134	103	90	63
Canada	(-)	(-)	2	2	1	2	1	...	(-)	(-)
Denmark	1	1	1	1	1	1	(-)	(-)	3	3
Finland	(-)	(-)	(-)
France	7	6	60	46	45	30	27	24	145	177
Germany	23	32	93	76	100	82	72	37	29	188
Greece	(-)
Ireland	(-)	1	1	...	...	...	68
Italy	2	36	2	2	2	2	2	1	...	2
Japan	1	1	1	1	...	...	(-)	(-)	(-)	(-)
Korea	(-)	(-)	(-)	(-)
Netherlands	2	1	...	1	14	3	7	101	273	307
Norway	(-)	(-)	(-)	(-)	-1
Portugal	(-)	(-)
Spain	3	6	12	7	8
Sweden	(-)	1	2	1	2	1	...	(-)	1	1
Switzerland	3	4	4	4	7	66	62	82	100	111
Turkey	(-)	(-)	-2	2	54	55	57	100	101	101
United Kingdom	28	36	76	76	127	132	118	36	41	37
United States	11	16	50	50	103	86	95	101	79	62

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

2.6.4 The Slovak Republic

Table 2-21: Slovak Republic: Outward FDI (Outflows and Position), 1992-2003

Slovak Republic: <i>FDI Outflows</i> by Country (22 countries) SKK million												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	856	1379	170	618
Australia	6	...	...	(-)
Austria	175	57	321	193
Belgium-Luxembo	-207	...	...	-423
Canada	-2	...	...	(-)
Denmark	(-)	(-)
Finland	(-)	(-)
France	-2	1	-3	(-)
Germany	-19	104	11	20
Greece	(-)	(-)
Ireland	(-)	(-)
Italy	11	7	...	(-)
Japan	(-)	(-)
Korea	(-)	(-)
Netherlands	45	338	-35	22
Norway	(-)	(-)
Portugal	(-)	(-)
Spain	(-)	(-)
Sweden	(-)	-11
Switzerland	(-)	1	3	51
Turkey	(-)	(-)
United Kingdom	-2	255	...	82
United States	(-)	99	-42	39

Slovak Republic: <i>FDI Outward Position</i> by Country (22 countries) SKK million												
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
OECD AREA	4064	10926	13031	13849	19928	18626	...
Australia	(-)	6	5	5	...
Austria	284	169	141	363	389	704	...
Belgium-Luxembo	3	108	224	97	1573	1197	...
Canada	(-)	4	...	1	...
Denmark	(-)	(-)	...	11	...
Finland	(-)	(-)	...	(-)	...
France	15	19	9	16	8	19	...
Germany	2643	259	235	264	74	133	...
Greece	1	2	3	...	2	...
Ireland	(-)	(-)	...	1328	...
Italy	23	1	3	15	14	15	...
Japan	19	19	17	15	...
Korea	(-)	(-)	...	(-)	...
Netherlands	8	5	7	48	77	42	...
Norway	(-)	(-)	1455	(-)	...
Portugal	284	...	(-)	(-)	...	(-)	...
Spain	8	8	(-)	1	...	2	...
Sweden	(-)	(-)	...	11	...
Switzerland	57	65	222	232	233	235	...
Turkey	1686	(-)	...	(-)	...
United Kingdom	14	1785	2517	2846	3135	2606	...
United States	101	222	28	(-)	199	209	...

Source: OECD, International Direct Investment Statistics Yearbook, 2004.

The sign (...) refers to data not available or data not provided for confidentiality purposes.

The sign (-) refers to Nil or negligible.

2.7 Conclusion

Since the late 1980s, the CEC4 have attracted impressive amounts of capital inflows. This chapter provided facts regarding the structure, size, and trends of capital inflows into each CEC4 country during the period 1989-2005. First, it looked at the three most important types of capital inflows – FDI inflows, Portfolio investments, and “Other” investments. It compared the size of each type relative to the total. Comparing the size among the three types revealed that FDI constituted an important component of the capital structure.

Given the importance and size of FDI relative to the other types of capital inflows, the remaining part of the chapter concentrated on FDI in CEC4. It provided detailed tables and figures describing the evolution, size and pattern of FDI into each CEC4 over the period 1989-2005. Then it compared the evolution and size of FDI among the four countries. The levels of FDI inflows are different among the four countries during the period under study. This reflects the fact that governments adopted different economic policies to attract foreign investment. The chapter also compared total FDI inflows in CEC4 to that of the CEEC region, and global FDI inflows during the period 1989-2005. The figures suggested that the four countries (CEC4) attracted the bulk of FDI in the CEEC region. Next, it presented and described the various indicators of FDI penetration. Finally, comparative tables and figures complemented the information for individual countries by the geographical breakdown for inward and outward FDI flows and stock to and from the OECD area. Tables describing the countries of origin of FDI in individual CEC4 suggest that foreign investments originate mainly from the OECD area. Another set of tables describing outward FDI from CEC4 to the OECD countries, revealed that outward FDI from CEC4 is still weak.

3 International Investment Agreements

“With the ascendancy of FDI as one of the main factors driving international economic relations in the era of globalization, international investment rule making has come to the forefront of economic diplomacy. It may well be that, as the second half of the 20th century was characterized by the establishment of an international trade law system, the first half of the 21st century may be characterized by the establishment of an international investment law system.”

(Karl P. Sauvant, in UNCTAD 2004b, p. xxiii)

3.1 Introduction

The growth of FDI in quantitative as well as qualitative terms is at the core of the continuing process of global integration, usually referred to as “globalization”. The total volume of FDI has kept increasing: in 2005, the global inflows of FDI reached to US\$ 916 billion, while FDI stock exceeded US\$ 10 trillion in book value. Inward FDI grew in all the main sub-regions, in some to unprecedented levels, and in 126 out of the 200 economies covered by UNCTAD. Global FDI outflows amounted to US\$ 779 billion. Developed countries remain the leading sources of such outflows. Cross-border M&As, especially those involving companies in developed countries, have spurred the recent increase in FDI (UNCTAD, WIR 2006). In terms of operational forms, the relatively isolated operators of the past have been replaced by increasingly integrated Transnational corporations (TNCs), which most of them privately owned, undertake FDI. A new international actor has thus come to the fore, whose activities have been a

major factor in the unprecedented degree of integration of the world economy. In fact, not only FDI but also a good part of trade, technology transfer and finance are now conducted under the common governance of TNCs.

In this transformation, legal and policy change, at the national and international levels, has been both cause and effect. The lowering of national barriers to trade and other forms of economic intercourse, throughout the half century since the end of the Second World War and at an increasing pace in the 1990s, has made possible close interactions across borders and has thereby facilitated the internationalization of production. This process has put continuing pressure on national policy makers at all levels to help increase a legal framework to match the needs and capabilities of the world economy, while ensuring that particular national economies share in world growth and development. A major consequence has been that the legal regulation of FDI is now increasingly accepted as a matter of international concern. Only a few decades ago, FDI was still perceived as being governed mainly by national legal rules and principles. International law was deemed to be relevant chiefly with respect to the initial allocation of national jurisdiction and in exceptional circumstances, especially in cases of government action causing major disruptions to foreign investment operations. Today, the accepted role international law rules and processes – customary, conventional or other – in investment matters has considerably expanded and is under constant pressure to expand further.

While there is no single legal instrument covering all aspects of FDI, a broad international legal framework is taking shape, consisting of a wide variety of principles and rules, of diverse origins and forms, differing in their strength and specificity and operating at several levels with gaps in their coverage of issues and countries. This framework includes rules of customary international law, bilateral, regional and multilateral agreements, acts of international institutions, and authoritative texts without formal binding force, such as declarations adopted by States or resolutions of international organization organs, all in interplay with and against the background of national legal rules and procedures.

This chapter seeks to present a broad overview of this international legal framework, focusing on international agreements that directly concern and affect FDI. It presents key concepts and issues in international investment agreements (IIAs). The chapter starts by presenting the “sources” of international FDI law and policy, and summary of historical overview with an emphasis on the recent decades. It then considers the general approaches and the types of legal instruments in use over the years. The core of the chapter is the section which examines the key issues of law and policy concerning FDI. Next, it presents characteristics of IIAs at different levels. The chapter concludes by presenting a list of BITs concluded by CEC4 as of June 2006. A necessary caveat should be made at the very start: law, national and international, has played a prominent role in the radical transformation of the world economy in the past 50 years.

3.2 The International Legal Framework for FDI

3.2.1 Sources and Principles

This part discusses the sources and principles of international law that affect FDI.

3.2.1.1 Sources of International Investment Law

Investment treaties, both bilateral and regional, have increased in number, and have become the basic “source” of international investment law. In the past, foreign investment was largely regulated domestically. In general, the only international rules that applied to some aspects of foreign investment were rules of customary international law, and their application was purely exceptional. With the adoption of bilateral investment treaties (BITs) beginning in the 1980s, an international legal framework started to emerge. Both developed and developing countries were eager to negotiate investment rules in order to further cross-border investment.

3.2.1.2 Reasons Countries Sign IIAs

Countries conclude IIAs – at the bilateral, regional and multilateral levels - for various reasons. For most host countries, it is mainly to help attract FDI. For most home countries, it is mainly to make the regulatory framework for FDI in host countries more transparent, stable, predictable, secure, and to reduce obstacles to future FDI flows. In other words, they allow the economic determinants to assert themselves. When IIAs reduce obstacles to FDI and the economic determinants are right, they can lead to more FDI.

3.2.1.3 Nature and Content of International Investment Law

Because domestic laws and policies can be changed unilaterally, while bilateral, regional, and multilateral rights and obligations cannot, industrialized countries have preferred to rely on treaties as a more stable basis for their companies wishing to invest abroad. Within this framework, the four Central European countries (CEC4), in the early stages of their transition in the late 1980s, needed foreign capital and foreign investment, especially FDI, to help them grow and develop. For that purpose they opted to signing investment treaties extensively with the developed countries of OECD, since most FDI in the world originates from the OECD area. They believed that the existence of an investment treaty will influence foreign investors' choice for their country. From a foreign investor's point of view, the purpose of an investment treaty is to provide international legal protection and hedge against political risk.

3.2.1.4 Impact of International Law on International Investment

Whether investment treaties actually attract foreign investment to potential host countries is debatable. This study wishes to verify this issue. To achieve that purpose, the researcher seeks to empirically examine to what extent international investment rules actually influence the flow of international investments. Foreign investors have many other considerations for deciding whether or not to invest in a country. They are concerned with the “economic conditions” of a host country, such as, market size, growth prospects, macroeconomic stability (inflation, exchange rate levels and

volatility), financial system's level of development and efficiency, country creditworthiness, quality of institutions, the existence of a dynamic private sector, labour costs, availability of skilled labour, infrastructure, trade policy, etc.

3.2.2 Historical Overview

To understand current legal approaches to FDI, it is useful to present a brief look at the historical evolution of national and international law and policy on the matter.

3.2.2.1 The Legal Situation up to the Second World War

The rules of classical international law, i.e. public international law as crystallized by the end of the nineteenth century, were mainly concerned with the allocation of jurisdiction among States. Since FDI issues involve primarily relations between foreign investors and host States, they were treated in the main as matters of national law. International law dealt with related problems only in exceptional cases, in terms of the treatment of the property of aliens (foreigners) by the host State, the rules concerning the international responsibility of States for acts in violation of international law, and the exercise of diplomatic protection by the State of the alien's nationality (UNCTAD, 2004b).

3.2.2.2 Developments since 1945: The Early Years

In the context of the creation of a broad organizational framework for the post-war economy, an attempt was made to formulate international principles concerning FDI in the Havana Charter of 1948. The Charter was intended to establish an International Trade Organization and dealt mainly with international trade (the original General Agreement on Tariffs and Trade (GATT) was based on its trade provisions). It also included, however, important provisions that addressed, directly or indirectly, other issues, such as investment and competition (Hoekman and Kostecki, 2001). The initial United States proposals for the provisions on foreign investment were intended to provide protection to investors, but, during the last phase of the negotiations, important

qualifications were introduced through the efforts of developing, particularly Latin American countries. The end product met with strong opposition by investor interests in developed countries, and this was in fact partly responsible for the Charter's failure to enter into force. The first post-war years were marked by large-scale nationalizations of key industries, affecting foreign as well as domestic firms, not only in the countries that became part of the socialist bloc, but also in Western Europe (e.g. France and the United Kingdom). As colonial territories began to acquire their independence, moreover, takings of foreign-owned property multiplied. The number of cases of nationalization or expropriation of foreign property (chiefly in natural resources) kept increasing worldwide reaching its peak in the early 1970s (UNCTAD, 2004b).

Several early proposals by private investor associations for the conclusion of a comprehensive international agreement were aimed primarily at the protection of foreign investments against expropriation rather than at the liberalization of the admission of investments. These proposals did not find wide support (UNCTAD, 2004b). When developed country Governments took over the task, they had no greater success. In the Organization for Economic Co-operation and Development (OECD), a draft Convention on the Protection of Foreign Property was prepared and in 1967 was approved by the Organization's Council, but was never opened for signature. The one successful effort on a world wide basis was directed at a specific aspect of FDI protection. This was the World Bank-sponsored Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), signed in 1965, initially with rather limited participation, although the number of States party to it eventually expanded considerably, especially in the 1980s and 1990s, to reach 156 by December 2006 (see www.worldbank.org/icsid/).

Around the same time, i.e. in the early 1960s, developed countries embarked upon a process of gradual investment liberalization. The two OECD Codes of Liberalization, of Capital Movements and of Current Invisible Operations, established binding rules for continuing liberalization and provided effective machinery for gradual implementation and expansion (OECD 1995). The creation and growth of the

European Economic Community (as it was then called), established in 1957, initiated a movement towards regional economic integration, broadly followed later by other groups of countries, developed and developing, which has affected considerably the situation of FDI.

The early 1960s also saw the beginning of the process of negotiating bilateral investment promotion and protection agreements (BITs) (UNCTAD, 1998b). The conclusion of such agreements was recommended early on, in the Havana Charter, while unsuccessful efforts were made to include investment in broader traditional international treaties (treaties “of establishment” or “of Friendship, Commerce and Navigation”). Specialized bilateral treaties, however, dealing solely with investment protection (and to a lesser extent with its promotion), proved more successful, although it was only later, in the late 1980s and 1990s, that they proliferated (Table 3-2 and Figure 3-1). Through such agreements, an increasing number of developing countries subscribed to basic standards for investment protection and treatment, while rejecting them on the multilateral level (UNCTAD, 2004b).

3.2.2.3 The Decade of the 1970s

In the early 1970s, the energy crisis had a profound impact on the international environment for development and for FDI. The atmosphere in international forums became for a time more favorable to the views of the developing countries, and they were able to set the agenda – although not to determine the eventual outcome - in international economic organizations. Developed countries were apprehensive over the control of energy resources by what appeared to be at the time a rather solid coalition of developing countries. Before this short period was over, the developing countries sought to assert the legitimacy of their interests and perceptions on FDI issues, among others. A direct result of the energy crisis was the Conference on International Economic Cooperation, which met in Paris from 1975 to 1977. Within its framework representatives from 27 developed and developing (including oil-exporting) countries conducted negotiations concerning energy, trade and financing, including FDI. While there was agreement on a significant, and wide-ranging, agenda of issues, no common ground was reached on several critical points (UNCTAD, 2004b).

At the same time, the efforts to establish standards for the conduct of TNCs led to negotiations for the adoption in legally non-binding forms of “international codes of conduct” for TNC activities (UNCTAD, WIR 2003). The lead was taken by the OECD. In 1976, the Organization’s Council adopted a Declaration on International Investment and Multinational Enterprises that included a set of voluntary Guidelines for Multinational Enterprises. They consist of recommendations addressed to enterprises, not to Governments, which, while requiring respect of host country laws and policies, also establish international standards of proper conduct. They cover both general issues and specific topics, such as employment and industrial relations and the disclosure of information.

Parallel efforts were undertaken within the framework of the United Nations system. The most comprehensive instrument of this kind was the United Nations draft Code of Conduct on Transnational Corporations. After lengthy negotiations, from the late-1970s to the mid-1980s, and despite agreement over the contents of many of its provisions, a number of important points were left open (especially as regards host country obligations), and the instrument was never adopted, even in non-binding form. Although the United Nations draft Code of Conduct and the OECD Guidelines resembled one another in significant respects, the former’s scope was considerably broader.

Other codes of conduct, dealing with specific issues, were also negotiated, with varying results: the International Labour Organization’s (ILO) Governing Body adopted in 1977 a Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy. The United Nations General Assembly adopted in 1980 a Set of Multilaterally Agreed Equitable Rules and Principles for the Control of Restrictive Business Practices, negotiated under the auspices of UNCTAD. The negotiations over international codes of conduct, whether ultimately successful or not, were instrumental in defining the areas of common understanding over the proper conduct of TNCs and in clarifying the standards for their treatment. While the proposed or adopted texts were largely concerned with reaffirming the competence of host States to determine and enforce national policies, they also sought to formulate

international rules that went beyond merely requiring compliance with local laws and policies and themselves specified the appropriate kinds of conduct.

3.2.2.4 The Decades of the 1980s and 1990s

The general climate surrounding FDI started to change in the 1980s. A series of national and international developments has led to a radical reversal of the policy trends prevailing. To begin with, the international economy has changed. The industries in which TNCs are active are not the same as those of 20 years ago, and related attitudes have changed accordingly (UNCTAD, 2004b). In the first decades after the Second World War, most discussions on FDI dealt, expressly or by implication, with the exploitation of petroleum and other natural resources. In recent years, while investment in natural resources has remained important, concern has shifted to investment in manufacturing, services and high technology. The very perception of the investment process has changed, reflecting current realities of the world economy. As the Uruguay Round negotiations have made evident, the *problématique* of FDI and technology transfer has become more closely linked to that of international trade, in the sense that they are both increasingly perceived as intertwined modalities of operation in the international production process.

The international, political environment has also changed radically. The bargaining position of developing countries is now weaker, and their ability to determine the agenda of international economic relations decreased considerably. By the end of the 1970s, the developed countries had fully recovered from the “oil shock” and had regained their self-assurance and their willingness to pursue their perceptions and interests. On the other hand, the onset of the debt crisis in the developing countries, including in several of the oil-producing ones, helped to make these countries less assertive. The debt crisis brought about a relative scarcity of indirect investment and made FDI more desirable: not only was it relatively more easily available but it also did not burden the country as much with debt, and brought additional contributions to the host economy, in terms of know-how, technology, skills, and access to markets. Host countries thus became more interested in attracting foreign investors. Besides, in most developing countries, the process of gaining control over natural resources had

considerably advanced since the immediate post-war period and was no longer a matter of first priority; interest shifted to the need for investment in other sectors and to the competition for it. Finally, the emphasis on the need to control FDI was further affected by a spreading perception that, despite marked successes in a few cases, the foreign investment control policies of host countries had often been ineffective.

Other important developments played a role. On an international political level, the relative cohesion of the third world decreased considerably, while the gradual collapse of the socialist bloc and the end of the cold war helped to strengthen market-oriented attitudes and forces and deprived developing countries of a bargaining tool. The international economic environment was drastically altered by the growth of TNCs and increasing global integration. In the national policies of many developed countries, where the need for direct government intervention in the economy was for long widely accepted, market-oriented approaches gained political momentum. The hegemony of these views soon spread in many developing countries as well, directly affecting their national economic policies.

All these developments had a significant impact on national laws and policies regarding inward FDI. The decades of the 1980s and 1990s have been a time of investment liberalization, promotion and protection: of the 1,885 national policy changes identified for the period 1991-2003, 94 per cent went in the direction of creating a more favourable climate for FDI (Table 3-1). The screening requirements and other entry regulations imposed earlier have been considerably softened or eliminated. Restrictions on the operations of foreign affiliates have weakened considerably; investors are increasingly allowed freely to transfer their profits and capital out of the host country. The incidence of property takings has greatly decreased, and acceptance of international arbitration for resolving conflicts between investors and host governments is expanding. Host countries now seek to attract foreign investment, by offering strict guarantees, both national and international, against measures seriously damaging the investors' interests.

Table 3-1: National Regulatory Changes in Investment Regimes, 1991-2003**National Regulatory Changes, 1991- 2003**

Item	1991	1995	1998	1999	2000	2001	2002	2003
Number of countries that introduced changes in their investment regimes	35	64	60	63	69	71	70	82
Number of regulatory changes of which:	82	112	145	140	150	208	248	244
More favourable to FDI	80	106	136	131	147	194	236	220
Less favourable to FDI	2	6	9	9	3	14	12	24

Source: UNCTAD WIR 2004, p. 8.

Recent policy changes at the national level, however, have not yet been extensively reflected in general multilateral instruments. The 1985 World Bank-sponsored Convention Establishing the Multilateral Investment Guarantee Agency (MIGA) heralded a period of increased interest in FDI. Yet, the most important multilateral instruments expressing the new trends are those of the 1994 Uruguay Round agreements, which address only in part topics directly or indirectly related to investment, especially the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the Agreement on Trade-Related Investment Measures (TRIMs). Such trends have also found some expression in non-binding texts. The 1992 Guidelines on the Treatment of Foreign Direct Investment prepared within the framework of the World Bank are of a particular relevance (UNCTAD, 2004b).

To understand fully the effects of current trends, one has to look at instruments at other levels, primarily regional and interregional, as well as bilateral. At the regional level, liberalization trends are particularly apparent in instruments reflecting the numerous efforts at economic integration. Relevant are the provisions of the association agreements concluded after 1989 by the European Community with countries of Central and Eastern Europe. Developments at the OECD have been particularly interesting also. The scope of the Liberalization Codes was gradually expanded. Thus, in 1984, inward direct investment was redefined to cover the rights of establishment, while over the years most member countries lifted the reservations and exceptions on which they had initially insisted. The fate of the negotiations on a

multilateral agreement on investment (MAI) is characteristic both of the current hegemonic position of investment liberalization and protection policies and of the remaining uncertainties, ambiguities and ambivalence. The negotiations, aimed at a text that would promote both the liberalization of investment regulations and the protection of foreign investors proceeded at first at a fast pace, but then, just when they appeared to be nearing their conclusion, unexpected resistance emerged and the effort was discontinued (UNCTAD, 2004b). BITs have continued to be negotiated in increasing numbers, so that by the end of 2005 more than 2,495 such treaties had been concluded, about 85 per cent of them after 1990 (Table 3-2 and Figure 3-1) (UNCTAD, 2006b).

3.3 Instruments in Use: IIAs

As the preceding historical overview indicated, the international legal framework for FDI consists of a wide variety of national and international rules and principles, differing in form, strength and coverage. The present section attempts to look at the methods and instruments used, bilateral, regional, and multilateral agreements. Modern international economic law is largely based on international agreements, bilateral, regional, plurilateral and multilateral. They are the most effective means for developing and applying international norms, with respect to FDI as in other areas. On the one hand, their contents reflect the common, agreed positions of more than one State; on the other, they are legally binding, and States are under a duty to conform to their provisions.

With respect to FDI, no comprehensive global international convention dealing with FDI exists, and various efforts in this direction, in the past as well as more recently, have met with no success (Nunnenkamp and Pant, 2003, UNCTAD, 2003, and 2004b). However, several multilateral instruments of less comprehensive scope are directly relevant. In addition, regional agreements have increasingly dealt with FDI, sometimes pioneering in expressing international trends in the field. Moreover, the expanding BIT network has developed principles directly concerned with the treatment and protection of FDI.

3.3.1 Bilateral Investment Treaties (BITs)

As noted, the most important effort to create international rules for investment in the early years after World War II was multilateral – in the framework of the Havana Charter. It failed. The bilateral level proved to be most productive in terms of producing investment rules. It focused first on protection and then on liberalization. The first instruments of choice were treaties for the protection and promotion of foreign investment – bilateral investment treaties (BITs).

3.3.1.1 What are BITs?

Bilateral investment treaties (BITs) are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each others' territories by companies based in either country (UNCTAD, 1998b). They constitute to date the most important instrument for the international protection of foreign investment by providing higher legal protection, guarantees, and security. They cover a span of 10 to 15 years with a rollover option. BITs are spinoffs from general treaties dealing with economic relations between countries (such as Friendship, Commerce and Navigation treaties).

BITs are a principal element of the current framework for FDI (UNCTAD, 1998b, Banga, 2003, Hallward-Driemeier, 2003). Their principal focus has been from the very start on investment protection, in the wider context of policies that favour and promote FDI: the protection of investments against nationalization or expropriation and assurances on the free transfer of funds and provision for dispute-settlement mechanisms between investors and host States. BITs also cover a number of other areas in particular, non-discrimination in the treatment (national treatment, and most-favoured nation treatment), and in some cases, the entry, of foreign-controlled enterprises, subrogation in the case of insurance payment by the capital-exporting country's investment guarantee agency, and other topics. An important characteristic of the new generation of BITs is a considerable uniformity in the broad principles

underlying the agreements, coupled with numerous variations in the specific formulations employed (UNCTAD, 1998b, and 2000b).

As elements of the international legal framework for FDI, BITs have been useful because they have developed a large number of variations on the main provisions of IIAs, especially those related to the protection of investments, of course, but also those referring to the ways in which national investment procedures may be taken into account. Although the treaties remain quite standardized, they are able to reflect in their provisions the differing positions and approaches of the many countries which have concluded such agreements. The corpus of BITs may thus be perceived as a valuable pool of possible provisions for IIAs (UNCTAD, 2004b).

BITs were initially addressed exclusively to relations between home and host, developed and developing, countries. Yet, they have shown over the years a remarkable capability for diversification in participation, moving to other patterns, such as agreements between developing countries, or with countries with economies in transition or even with the few remaining socialist countries. Thus, while lacking the institutional structures and emphasis on review and development of multilateral and regional instruments, BITs appear capable of adapting to special circumstances. They have been successfully utilized, for instance, in the 1990s through the process of transition of Central and Eastern European countries towards a market-type economy. The recent increase in the number of BITs between developing countries suggests that they may also be useful in dealing with some of the problems in such relationships. Their most significant function appears to be that of providing signals of an attitude favouring FDI. Their very proliferation has made them standard features of the investment climate for any country interested in attracting FDI.

3.3.1.2 Trends in BITs

Since the adoption of the first BIT between Germany and Pakistan in 1959, the number of such treaties has grown steadily. The most dramatic increase took place during the 1990s. The number of treaties rose from 385 by the end of 1989 to 2,495 by the end of 2005 (Table 3-2 and Figure 3-1). The number of countries involved in BITs now encompasses 176 countries (Table 3-3 and Figure 3-2) (UNCTAD, 2006b).

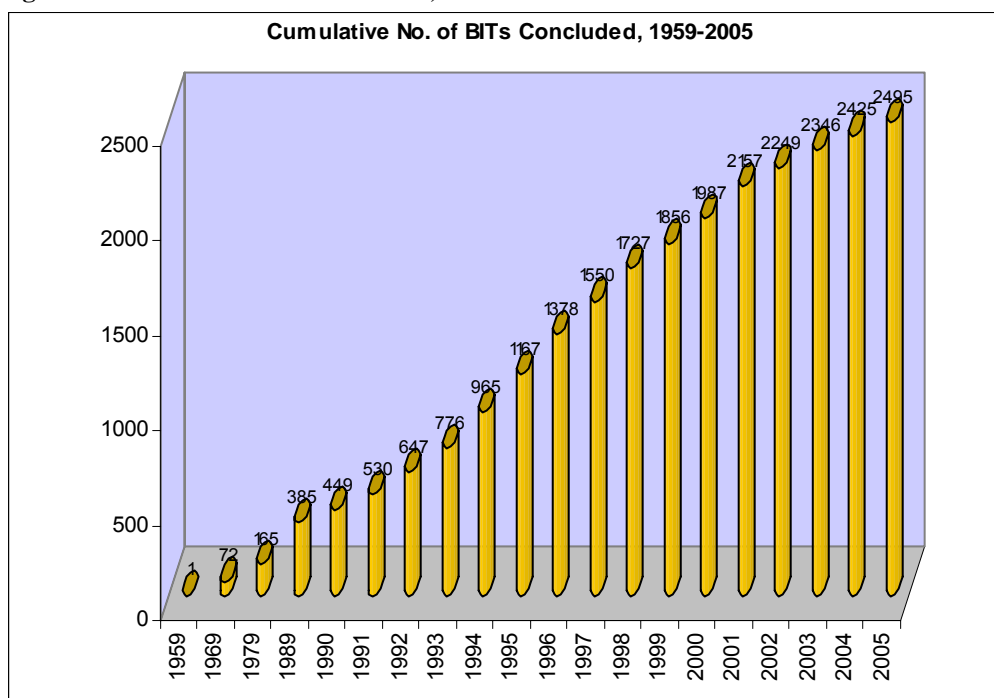
Table 3-2: Growth of the Number of BITs, 1959-2005

Number of BITs concluded, year-by-year and cumulative, 1959 - 2005

Years / Decade	Total per year	Cumulative total
1959	1	1
1969	71	72
1979	93	165
1989	220	385
1990	64	449
1991	81	530
1992	117	647
1993	129	776
1994	189	965
1995	202	1167
1996	211	1378
1997	172	1550
1998	177	1727
1999	129	1856
2000	131	1987
2001	170	2157
2002	92	2249
2003	97	2346
2004	79	2425
2005	70	2495

Source: UNCTAD database on IIAs (www.unctad.org/iiia).

Figure 3-1: Growth of the No. of BITs, 1959-2005



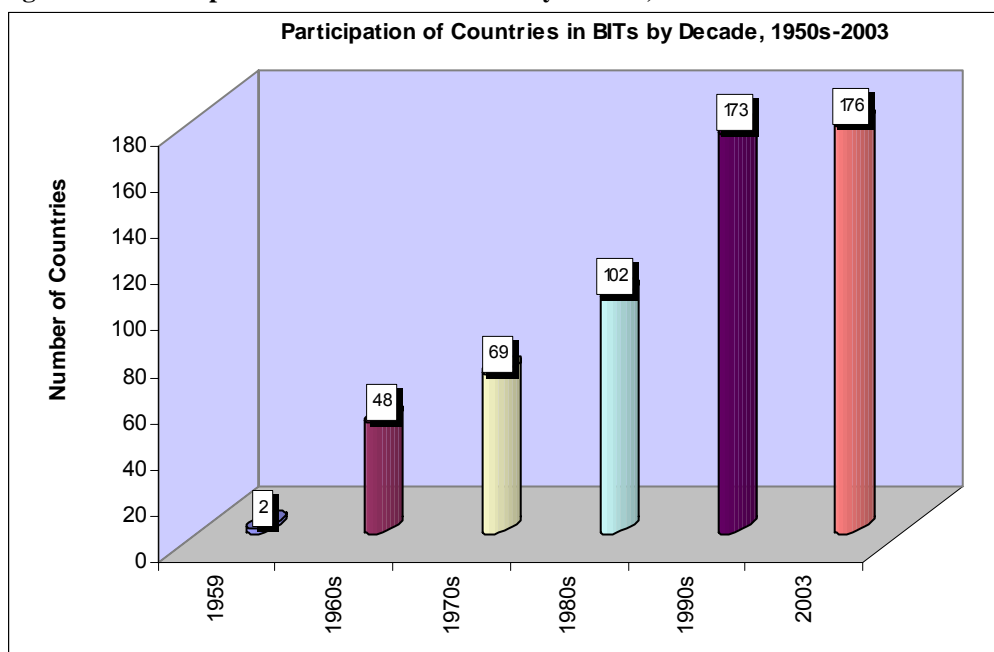
Initially, BITs were concluded between a developed and a developing country, usually at the initiative of the developed country. The developed country – typically a capital exporting country - entered into a BIT with a developing country – typically a capital importing country – in order to secure higher standards of legal protection and guarantees for the investments of its firms than those offered under national laws. The developing country, on the other hand, would sign a BIT as one of the elements of a favourable climate to attract foreign investors (UNCTAD, 2000b). This pattern has changed since the late 1980s and especially in the 1990s, as developing countries and economies in transition began to sign BITs between themselves in great numbers (UNCTAD, 2000b). As a result, the dividing line for BIT partners between capital exporting and capital importing countries no longer holds true and, in many instances, countries approach BITs with the dual purpose of protecting their outward investments to, while attracting inward investment from, the other BIT partner. Of course, the degree of emphasis that countries place on each of these objectives varies considerably from BIT to BIT (UNCTAD, 2000b). BITs have rarely been concluded between developed countries as their legal systems reflect investor protection standards evolved over many years of experience with such issues (UNCTAD, 2000b).

It is not only the number of BITs that has been growing, but also the number of countries involved, from 2 at the end of 1959 to 48 at the end of 1960s, 69 at the end of 1970s, 102 at the end of the 1980s, and a total of 176 at the end of 2003, including countries from all regions (Table 3-3 and Figure 3-2). All of this suggests that BITs are playing an increasingly important role in international investment relations worldwide, thus influencing the flow of international private capital flows, and shaping the new international financial architecture.

Table 3-3: Participation of Countries in BITs by Decade, 1950s-2003

Participation of Countries in BITs by Decade, 1950s - 2003	
Decade	Number of countries involved in BITs
1959	2
1960s	48
1970s	69
1980s	102
1990s	173
2003	176

Source: UNCTAD database on IIAs (www.unctad.org/iiia).

Figure 3-2: Participation of Countries in BITs by Decade, 1950s -2003

As far as geographical coverage is concerned, the participation of developed and developing countries in the network of BITs continued to increase, as they were involved in 45 and 60 new agreements respectively during 2005. By the end of 2005, the cumulative number of BITs concluded by developed and developing countries amounted to 1511 and 1878 respectively (Table 3-4).

Table 3-4: IIAs Concluded by Region, end of 2005

International Investment Agreements concluded by regions in 2005, and cumulative

Region	BITs		Other IIAs	
	Year 2005	Cumulative	Year 2005	Cumulative
Asia and Oceania	31	1003	12	89
Latin America	13	464	5	62
Africa	21	660	2	34
SEE&CIS	15	671	0	34
Memorandum				
Developed countries	45	1511	7	127
Developing countries	60	1878	14	185
South-South	20	644	7	86
Least developed countries	16	399	2	35

Source: Extracted from UNCTAD, *Developments in International Investment Agreements in 2005*, IIA Monitor No. 2 (2006), p. 4.

Note: The above figures reflect multiple counting (e.g. BITs concluded between countries from Asia and Africa are included in the list of both regions). The net total of each category of IIAs is therefore lower than the sum of the above figures.

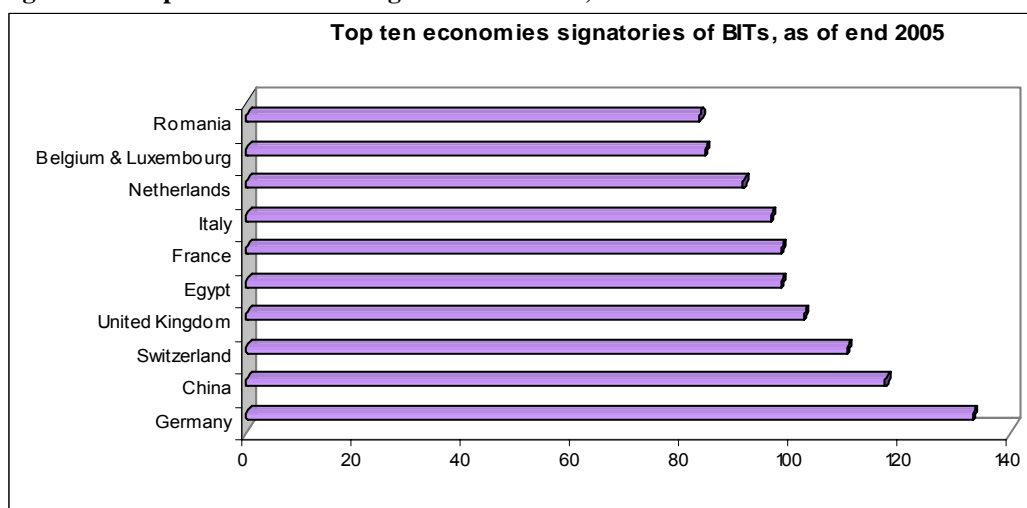
Table 3-5: Top Ten Economies Signatories of BITs, as of end 2005

Top 10 Economies Signatories of BITs, Concluded as of end 2005

Rank	Economy	No. of BITs
1	Germany	133
2	China	117
3	Switzerland	110
4	United Kingdom	102
5	Egypt	98
6	France	98
7	Italy	96
8	Netherlands	91
9	Belgium & Luxembourg	84
10	Romania	83

Source: Extracted from UNCTAD, WIR 2006, p. 279

Figure 3-3: Top Ten Economies Signatories of BITs, as of end 2005



The strong involvement of the developed countries, Germany, Switzerland, the United Kingdom, France, Italy, Netherlands, Belgium and Luxembourg, confirms their position among the “top ten” BIT signatories, as of end of 2005. It is noteworthy also China’s strong involvement in BIT network, confirmed by its position as having the second rank among the “top ten” (Table 3-5 and Figure 3-3).

3.3.1.3 The Entry into Force of BITs

Without entering into force, BITs cannot fulfil their intended role as legally binding instruments for the promotion and protection of foreign investment. An agreement enters into force when the terms for entry into force as specified in the treaty are met. BITs usually enter into force when both parties agree to be bound as of

a certain date. The vast majority of BITs condition the entry into force of the agreement to the completion of the domestic requirements for such entry into force (which often means ratification by the national parliaments). In most cases, the treaty becomes effective after the contracting parties have notified each other that these requirements have been met.⁷ Some BITs, however, provide that the agreement already enters into force upon signature (UNCTAD, 2006c).

The first ever BIT was concluded on 25 November 1959 between Germany and Pakistan and entered into force on 28 April 1962, i.e. 2 years and 5 months after the signing of the treaty. The vast majority of BITs followed this precedent. The time lag between signature and entering into force of a BIT is a reflection of the more or less complicated process of national ratification that is required to enact an international agreement. This process varies considerably from country to country. Furthermore, whether a BIT enters into force depends on its ratification by the *two* contracting parties (i.e. the time requirement of the slower is decisive).

Table 3-6: BITs Signed and Entered into Force, 1990-2005

BITs signed and entered into force, 1990-2005, annual and cumulative

	Number of BITs	1990	1992	1994	1996	1998	2000	2001	2002	2003	2004	2005
<i>Annual</i>	Signed	64	117	189	211	177	131	183	127	97	79	70
	In force	60	111	171	192	129	77	102	74	49	26	6
	Per cent	93.7	94.8	90.5	90.9	72.8	58.7	55.7	58.3	50.5	32.9	8.6
<i>Cumulative</i>	Signed	385	582	898	1308	1662	1939	2122	2249	2346	2425	2495
	In force	355	543	832	1193	1470	1633	1736	1810	1859	1885	1891
	Per cent	92.2	93.3	92.6	91.2	88.4	84.2	81.8	80.5	79.2	77.7	75.8

Source: Extracted from UNCTAD, *The Entry into Force of BITs*, IIA Monitor No. 3 (2006), p.3.

⁷ Notification usually takes place through diplomatic channels. Sometimes, there may be uncertainties on what date the two parties have notified each other, in particular, on what day such notification was received by the other contracting party.

The above table (Table 3-6), extracted from UNCTAD, illustrates that the large majority of BITs concluded between 1959 and 2005 (75.8%) has in the meantime entered into force, thereby providing foreign investors with enforceable rights in their host countries. This shows that contracting parties are serious about their commitments when concluding a BIT. The time required for the domestic ratification process may vary from a few months to several years, depending on the countries involved and the concrete issues at stake.

The economic implications of BITs entry into force on FDI

The distinction between the conclusion of an agreement and its entry into force is important. This is most obvious with regard to the legal rights and obligations deriving from it. They usually do not become effective before the treaty has entered into force. The time lag between the conclusion of a BIT and its entry into force may therefore have important implications, both for foreign investors and their respective host countries.

- Foreign investors may not be able to claim protection under the BIT if a dispute arises with the host country in the period between conclusion and entry into force of the agreement. Although the conclusion of the BIT already entails some legal consequences for the host country under international law⁸, they do not go so far as to establish legally binding obligations of the latter vis-à-vis the foreign investors.
- For host countries, the length of time lag between conclusion and entry into force of a BIT can become an issue, as it may undermine the positive signaling effect of signing the BIT in the first place (UNCTAD, 2006c). The longer foreign investors have to wait until an agreement becomes effective, the more they may lose interest in investing in that particular country, and look for alternative destinations.

⁸ Before a treaty enters into force, contracting parties have a general obligation to refrain from acts that would defeat the object and purpose of the agreement. See Article 18 of the Vienna Convention on the Law of Treaties.

3.3.2 Regional Agreements

Regional and/or plurilateral international agreements are agreements in which limited number of countries participate and are often not open to the participation of all countries⁹. They are of course binding on the participating countries alone and applicable only to them. Such instruments are increasingly important in FDI matters. *Regional economic integration agreements* are a significant subcategory. They often involve a higher than usual degree of unity and cooperation among their members, sometimes marked by the presence of “supranational” institutions, and it is therefore difficult to draw general conclusions from their provisions. The case of the European Community, now the European Union, is probably the most telling; the extensive liberalization of capital movements, the effective elimination of discriminatory measures and the adoption of common rules among its members has had far reaching effects on FDI among member countries and an important impact on investment in and from third countries. In this respect, it is noteworthy to mention that investment in Central European countries, particularly the CEC4 has been affected by the successive agreements concluded between the European Union/European Community and the Czech and Slovak Republics, Hungary, and Poland. The “Europe Agreement” was concluded in 1991 and entered into force in 1994 (Table 3-7).

Other regional integration arrangements involve “shallower” integration, but still affect in important ways FDI regulation. NAFTA is a significant illustration of a regional agreement which is not limited to developed countries only and may indeed be extended to other countries. It is pertinent to note that, although NAFTA is formally only a “free trade zone” – and not a common market or an economic union like the European Community/European Union – the agreement covers FDI. The ASEAN Investment Area, on the other hand, is focused on FDI alone. It seeks to promote investment in the area through the cooperation of the countries in the region in the

⁹ The relevant international law terminology is not very clear or fully consistent. In United Nations language, in particular, the term “regional” does not necessarily have a geographical connotation; it covers essentially multilateral arrangements which are not, in fact or in prospect, worldwide. The recent introduction of the terms “plurilateral” and “interregional” has further complicated the terminology. On the other hand, the geographical connotation is preserved in the case of “regional integration agreements”.

liberalization of investment regulations, the provision of national treatment to all investors from the countries involved, increased transparency and an interstate dispute-settlement system. Particularly important, on the broadly regional level, are a number of other agreements, such as the two OECD Liberalization Codes, covering Capital Movements and Current Invisible Operations (1961), respectively. Their coverage extends to most facets of inward FDI. OECD members are committed to provide non-discriminatory treatment to inward direct investment and related financial flows by virtue of the legally binding OECD Code.

OECD's *Code of Liberalisation of Capital Movements*, 2003 ed., pp. 11, states: “

Part I

Undertakings With Regard to Capital Movements

Article 1

General Undertakings

- a. *Members shall progressively abolish between one another, in accordance with the provisions of Article 2, restrictions on movements of capital to the extent necessary for effective economic co-operation. Measures designed to eliminate such restrictions are hereinafter called “measures of liberalisation”.*

- b. *Members shall, in particular, endeavour:*
 - (i) *To treat all non-resident-owned assets in the same way irrespective of the date of their formation, and*

 - (ii) *To permit the liquidation of all non-resident-owned assets and the transfer of such assets or of their liquidation proceeds.*

- c. Members should use their best offices to ensure that the measures of liberalisation are applied within their overseas territories.*
- d. Members shall endeavour to extend the measures of liberalisation to all members of the International Monetary Fund.*
- e. Members shall endeavour to avoid introducing any new exchange restrictions on the movements of capital or the use of non-resident-owned funds and shall endeavour to avoid making existing regulations more restrictive.*

Article 2

Measures of Liberalisation

- a. Subject to the provisions of paragraph (b)(iv), Members shall grant any authorisation required for the conclusion or execution of transactions and for transfers specified in an item set out in List A or B of Annex A to this Code.*
- b. A Member may lodge reservations relating to the obligations resulting from paragraph (a) when:*
 - (i) at item is added to List A of Annex A to this Code;*
 - (ii) obligations relating to an item in that List are extended;*
 - (iii) obligations relating to any such item begin to apply to that Member; or*
 - (iv) at any time, in respect of an item in List B.*

Reservations shall be set out in Annex B to this Code.

- c. Whenever the liquidation proceeds of non-resident-owned assets may be transferred, the right of transfer shall include any appreciation of the original assets.*

d. Whenever existing regulations or international agreements permit loans between residents of different Members otherwise than by issuing marketable domestic securities or by using, in the country in which the borrower resides, funds the transfer of which is restricted, the repayment obligation may be expressed or guaranteed in the currency of either of the two Members concerned.

Article 4

Obligations in Existing Multilateral International Agreements

Nothing in this Code shall be regarded as altering the obligations undertaken by a Member as a Signatory of the Articles of Agreement of the International Monetary Fund or other existing multilateral international agreements. ”

In connection to the *Articles of Agreement of the IMF, Article VIII*, states: “

General Obligations of Members

Section 1. Introduction: In addition to the obligations assumed under other articles of this Agreement, each member undertakes the obligations set out in this Article

Section 2. Avoidance of restrictions on current payments

Section 3. Avoidance of discriminatory currency practices

Section 4. Convertibility of foreign-held balances

Section 5. Furnishing of information

Section 6. Consultation between members regarding existing international agreements

Section 7. Obligation to collaborate regarding policies on reserve assets”

In this respect, the CEC4 introduced current account convertibility by the mid 1990s, consistent with their undertakings as OECD members, and signatory of an international monetary agreement, *IMF Article VIII*, with their objective to obtain membership in the European Union.

3.3.3 Multilateral Investment Agreements

As already noted, an effort to create a comprehensive instrument, although on a non-binding basis, was undertaken in the 1970s and early 1980s. The instrument in question, the United Nations draft Code of Conduct on TNCs, would have addressed many of the concerns of home and host countries, while reflecting, of course, the policies and positions of the period. Several declaratory texts of that period reflected similar concerns (UNCTAD, WIR 2003, and 2004b).

Of the relevant multilateral agreements in existence, some deal with broader issues that are important for FDI, as in the case of the Articles of Agreement of the IMF, the GATT, or even the international conventions concerning intellectual property, within the framework of the World Intellectual Property Organization (WIPO) or the World Trade Organization (WTO). The pertinent international organizations constitute in fact the sole existing institutional structure at the worldwide level that is directly or indirectly relevant to FDI. Other multilateral agreements, although not dealing with the FDI process in its entirety, address important aspects of it. Thus, the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention, 1965), concluded under the auspices of the World Bank and administered by it, provides a comprehensive framework for the settlement of disputes. It is complemented by other agencies dealing in particular with international commercial arbitration. The agreement creating the MIGA (1986), also under World Bank auspices, serves to enhance legal security for FDI and supplements existing national and regional investment guarantee operations.

Some of the WTO agreements concluded within the framework of the Uruguay Round are closely related to FDI. This being said, the current investment architecture of the WTO can be conceptualised as a continuum across which one finds agreements and provisions with different levels of relevance to foreign investment and foreign investors (OECD, 2003b). The WTO initiatives that impact on foreign investment are largely contained in four agreements: Trade Related Investment Measures (TRIMs),

General Agreement on Trade in Services (GATS), Trade Related Intellectual Properties (TRIPS), and Dispute Settlement Undertaking (DSU). While TRIPS and DSU provide minimal standards of protection for investment, the main provisions affecting investment are contained in TRIMS and GATS (Hoekman and Kostecki 2001).

The WTO Agreement on TRIMs – adopted as part of the Uruguay Round - prohibits certain trade-related investment measures (UNCTAD, WIR 2003). The TRIMs measures ban the imposition of performance requirements on foreign investors. This is not normally a part of BITs, with the exception of those BITs involving the United States (Vandevelde, 1998). In addition, TRIMS includes “standstill” and “rollback” provisions. Countries are required to notify all nonconforming measures to the Council for Trade in Goods, and there is a commitment to roll back these measures in five years for developing countries and seven years for least developed countries. Article III of the agreement imposes national treatment on signatories, while article XI forbids quantitative restrictions on exports and imports. It has been argued that TRIMS offers a natural base for consideration of a multilateral agreement on investment (Hoekman and Kostecki, 2001). However, the principal problem with TRIMS is that it is restricted to trade in goods and does not cover services. Moreover, TRIMS rules have remained highly contentious and various WTO members appear to have violated them (Nunnenkamp and Pant, 2003).

Important measures for investor protection under the WTO are contained in GATS. Of all WTO agreements, GATS, concluded as part of the Uruguay Round, offers a comprehensive set of rules covering all types of international services delivery, including “commercial presence”, akin to FDI. The GATS covers several investment situations; perhaps more important, it provides an important model for the regulation of FDI matters. The GATS leaves member countries considerable flexibility on the scope and speed of liberalizing services activities. It is the only agreement that provides a fairly unambiguous definition of foreign investment. It does so through Mode 3, defined as “the supply of a service by a service supplier of one Member, through commercial presence in the territory of any other Member” (Article I.2c).

Mode 4 may also be regarded as investment-related because it deals, *inter alia*, with the temporary entry of managerial and other key personnel. Such provisions have a direct bearing on investment. Nunnenkamp and Pant (2003) argue that GATS contains “provisions relating both to matters of investment liberalisation and investment protection, albeit with different degrees of comprehensiveness.” While Article II (1) imposes MFN treatment (a measure of liberalization), transparency (indicating investment protection) across all sectors is required by Article III. In accordance with the MFN obligation, parties to the GATS are committed to treating services and service providers from one Member in a no less favourable way than like services and service providers from any other as concerns measures affecting trade in services. This is regarded as an “immediate” and “unconditional” obligation. Member specific exemptions from this obligation, permitted at the entry into force of the Agreement, cannot, in principle, last more than ten years. However, GATS Article II (v) allows for exceptions to MFN. These exceptions relate mainly to regional trade arrangements (RTAs), bilateral tax treaties, and reasons of public health or morality. This is in conformity with most BITs.

Likewise, national treatment (NT) is subject to limitations in GATS (Nunnenkamp and Pant, 2003). National treatment is guaranteed only in service sectors listed in a member country’s schedule (Article XVII (1)). National treatment applies only to scheduled sectors when parties agree to provide national treatment in the context of specific “market access” commitments, formulated according to a “hybrid” approach involving both “bottom up” and “top down” elements.

In another clause, Article III (3) imposes “transparency” on members, who are required to publish and notify the Council for Trade in Services of all laws, regulations and administrative measures relevant to the agreement in the case of committed service sectors (UNCTAD, 2004b). According to Article XXIII, all disputes relating to GATS are to be governed by the Dispute Settlement Undertaking (DSU). The DSU contains the usual provisions for negotiations, consultations, arbitration, and compensation. However, unlike NAFTA, agreement, there is no provision for investor-state dispute settlement.

Even though TRIMS and GATS offer a number of provisions relating to investment, the main lacunae are in the context of expropriation, compensation, and subrogation. In addition, provisions for investor-state dispute settlement are missing.

In addition to the GATS, several other agreements also deal quite directly with foreign investment issues. The Understanding on Commitments in Financial Services (UCFS) contains three provisions that relate to foreign investment. Like the GATS, the Plurilateral Agreement on Government Procurement also specifies disciplines that protect foreign investors and their investments. The Agreement requires not only that there be no discrimination against foreign products, but also no discrimination against foreign suppliers and, in particular, no discrimination against locally established suppliers on the basis of their degree of foreign affiliation or ownership (OECD, 2003b). As previously noted, the TRIPs also cover several FDI-related issues, in parallel with existing conventions on intellectual property matters.

3.4 Key Issues in IIAs

BITs exhibit a certain pattern of uniformity in their structure and content. Elements common to virtually all BITs are the use of a broad definition of the term “investment”, protection of property rights, enforcement of contracts, the inclusion of certain standards of treatment of foreign investment, such as NT, MFN, fair and equitable treatment, constant protection and security, and more specific standards of protection regarding expropriation and compensation, and transfer of funds. Many BITs provide for the ability of States as well as foreign investors to resort to international arbitration (UNCTAD, WIR 2003, and 2004b).

The key issues covered by BITs are the following:

1. Scope and Definition
2. Admission and Establishment
3. National Treatment (NT)
4. Most-Favoured-Nation Treatment (MFN)

5. Fair and Equitable Treatment
6. Expropriation and Nationalization
7. Compensation for Losses
8. Transfer of Funds
9. Dispute Settlement: State-State and Investor-State
10. Transparency

3.4.1 Scope and Definition of Foreign Investment

The financial crises of the 1990s strengthened the case for adopting definitions with great care. The definition of investment is fundamental to international investment agreements, since it describes precisely which assets or investment flows are covered by the operational provisions of those laws and IIAs (UNCTAD, WIR 2003). The main question is not whether FDI should be defined as investment – it is. The question is what other investment should be granted the same status: portfolio investment (both equity and debt components), other capital flows (bank loans, non-bank loans and other flows) and various investment assets both tangible and intangible, including intellectual property rights, copyright, commercial trade marks, patents, industrial designs, etc. Concerning the scope of definitions, a number of developed countries do not have specific legislation or policies on FDI and so do not need to define it. Developing countries, concerned about the effects of volatile capital flows, have narrow definitions (UNCTAD, WIR 2003).

3.4.2 Admission and Establishment

Customary international law imposes no obligations upon host countries to permit the entry of aliens, including foreign investors. Accordingly, rights of natural and legal persons of one State to enter and conduct business in the territory of another State principally derive from international treaties (UNCTAD, 1999b, and 2004c).

1. Distinction between “admission” and “establishment”

“Admission” refers to the right of entry or presence *per se*, whereas “establishment” refers to a particular type of presence. While a right of admission can be temporary or permanent in nature, a right of establishment involves the setting up of a permanent business presence in a host country (UNCTAD, 1999b).

2. National regulations on admission and establishment of foreign investment

The main forms of regulation that have traditionally been employed by host countries with respect to the admission and establishment of foreign investment in their territories consist of (a) measures to control the presence of foreign investment in specific industries or activities; (b) measures to influence the level of foreign ownership or control in specific industries or activities; and (c) measures that permit foreign investment subject to certain conditions. Recent decades have witnessed a widespread trend towards the unilateral liberalization of laws and regulations affecting the admission and establishment of foreign investment. This has been accompanied by an increase in the number of investment agreements that limit the ability of host country governments to adopt measures that restrict the admission and establishment of foreign investment (UNCTAD, 1999b).

3. Provisions in IIAs on the treatment of investors with regard to the admission and establishment of investment

a. Agreements that subject the admission and establishment of foreign investment to domestic law

IIAs vary considerably as to the treatment of investors with regard to the admission and establishment of foreign investment. Most BITs preserve a large measure of discretion of host countries regarding the admission and establishment of foreign investment. A standard clause in such treaties requires each party to encourage and create favourable conditions for investors of the other party to make investments in its territory and to admit such investments, subject to its domestic laws and regulations, and, in some cases policies. Thus, for example, Article 2 (1) of the model BIT of Austria provides that:

“[e]ach Contracting Party shall, according to its laws and regulations, promote and admit investments by investors of the other Contracting Party”.

Similarly, the model BIT of the United Kingdom provides in its Article 2 (1):

“Each Contracting Party shall encourage and create favourable conditions for nationals or companies of the other Contracting Party to invest capital in its territory, and, subject to its right to exercise powers conferred by its laws, shall admit such capital.”

b. Application of national and most-favoured-nation treatment

In contrast, recent BITs of Canada and the United States adopt a “combined national treatment and most-favoured-nation treatment model” with regard to the admission and establishment of foreign investment. This means that under such treaties each party is required to accord investors of the other party the better of most-favoured-nation (MFN) treatment and national treatment in respect of both the establishment of investment and the treatment of investment in the post establishment phase, subject to the ability of the parties to make or maintain exceptions in sectors or matters specified in an annex to the treaty.

c. Right of establishment

The most far-reaching approach to the admission and establishment of foreign investment consists in the granting of a right of establishment.

d. Admission of investment as an aspect of the liberalization of capital movements

The OECD Code of Liberalization of Capital Movements, which was originally adopted in 1961 and has since been regularly updated by OECD Council decisions, obligates OECD member countries to liberalize progressively between one another restrictions on movements of capital, including direct investment. The Code allows for country-specific reservations and contains temporary derogations, including in the event of adverse balance-of-payments developments, and exceptions for measures taken on grounds of public order and security, measures taken pursuant to obligations

under existing multilateral agreements and measures applied by members forming part of special customs or monetary systems (OECD, 2003a).

e. Admission and establishment of investment in the context of provisions of the GATS on commercial presence

The GATS covers FDI by including into the definition of “trade in services” the supply of a service “by a service supplier of one Member, through commercial presence in the territory of any other Member”.¹⁰ The GATS adopts to a large extent a “selective liberalization model” regarding the admission and establishment of foreign investment. Whether a WTO member is obligated to permit the establishment of a commercial presence in a sector by a foreign service supplier depends upon whether that member has made specific commitments to accord market access and national treatment in the sector in question and upon whether any such commitments are subject to limitations or conditions. “Market access” in this context means that, in a sector in which market access commitments are undertaken, a member shall not apply certain restrictions enumerated in Article XVI of the GATS, unless otherwise specified in its Schedule of Specific Commitments.¹¹ These restrictions include certain measures that relate specifically to FDI.¹² “National treatment” means that, in a sector inscribed in its Schedule, and subject to any conditions and limitations set out therein, a member “shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers”.¹³ It should be noted that in virtue of Article II of the GATS a member is required to accord MFN treatment with respect to any measure affecting trade in services, which includes measures affecting the establishment of a commercial presence by service suppliers of other WTO members. This obligation is of general application and does not depend upon whether a member has made a specific commitment in a sector, but members have

¹⁰ Article I (2) (c) .

¹¹ See Article XX of the GATS.

¹² Article XVI (2) includes “(e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and (f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment”.

¹³ Article XVII (1).

been allowed to exempt from this obligation measures that are listed in an annex on Article II Exemptions (UNCTAD, 2004b, and c).

3.4.3 National Treatment

A national treatment rule in an IIA typically requires that host countries accord to foreign investors and their investments treatment that is no less favourable than the treatment accorded to domestic investors and investments.¹⁴

1. Scope of application

In most BITs, and a significant number of regional investment agreements, the scope of application of the national treatment rule is limited to the treatment of foreign investment after its admission in the territory of the host country. Accordingly, national treatment is not required in respect of the admission and establishment of foreign investment. An example of a national treatment clause limited to the post-entry phase is Article 3 (3) of Austria's model BIT:

“Each Contracting party shall accord to investors of the other Contracting party and to their investments treatment no less favourable than that it accords to its own investors and their investments or to investors of any third country and their investments with respect to the management, operation, maintenance, use, enjoyment, sale and liquidation of an investment, whichever is more favourable to the investor.”

This “post-entry national treatment” model has been adopted in most BITs concluded by European countries and in many BITs concluded between developing countries. It also features in instruments such as the (legally non-binding) OECD National Treatment Instrument¹⁵ and the Energy Charter.

¹⁴ While some agreements apply national treatment to “investments”, the more recent agreements generally provide for national treatment in respect of both “investments and investors”.

¹⁵ Contained in the OECD Declaration on International Investment and Multinational Enterprises.

By contrast, recent BITs of Canada and the United States and a number of recent regional investment arrangements also require that national treatment be accorded in respect of the admission and establishment of foreign investment. In virtually all these agreements, however, the application of national treatment to the entry of foreign investment is subject to the ability of parties to make exceptions in relation to particular sectors or policies.

The approach whereby the national treatment rule applies as a general obligation, unless otherwise specifically provided in country-specific exceptions, is generally known as a “negative list” approach. This contrasts with a “positive list” approach whereby an obligation applies in a particular sector only if a State has specifically included that sector in a list of commitments. The GATS combines a “positive list” approach to the scheduling of sectors with a “negative list” approach to the scheduling of limitation and qualifications of national treatment in the sectors inscribed in a member’s schedule of specific commitment:

“In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.”¹⁶

2. Substantive content of the standard

IAs in some cases explicitly provide that the national treatment rule involves a comparison between foreign investors/investments and domestic investors/investments that are in “like” or “similar” situations or circumstances. Examples are the BITs of Canada and the United States, the OECD National Treatment Instrument, the NAFTA. However, as evidenced by *inter alia* the BITs of France, Germany, Switzerland, and in many investment agreements the national treatment rule is not qualified by a “likeness” criterion.

¹⁶ See Article XVII (1) of the GATS.

The national treatment rule sometimes expressed as a requirement to accord foreign investors and investment the “same” or “as favourable treatment as” that accorded to domestic investors and investments. The most commonly used formulation of the national treatment rule, however, contemplates treatment of foreign investors and investments that is “no less favourable” than that accorded to domestic investors and investments of a host country.

The rationale for distinguishing between *de jure* and *de facto* national treatment is that a measure may entail less favourable treatment of foreign investors even where it provides for formally identical treatment of foreign and domestic investors. Articles XVII (2) and (3) of the GATS address this as follows:

“2. A Member may meet the requirement of paragraph 1 [national treatment] by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the member compared to like services or service suppliers of any other Member.”

3. Exceptions

Exceptions to NT rules in IIAs can be classified in the three main categories:

- A number of agreements include general exception clauses that permit the parties to adopt measures necessary for the protection of public health, public order and morals, and national security.
- Investment agreements sometimes contain more specific exceptions to national treatment and most-favoured-nation treatment rules with respect to matters such taxation; intellectual property rights; prudential measures in financial services; incentives; government procurement; and cultural industries.

- Especially where an investment agreement applies the national treatment rule to the entry of foreign investment, it normally provides for the right of each party to make country-specific exceptions to the national treatment rule with regard to particular sectors and policies that the party has listed in an annex to the agreement

3.4.4 Most-Favoured-Nation Treatment

The MFN treatment rule is one of several general requirements regarding the treatment of foreign investment normally included in IIAs. The rule requires host countries to accord to foreign investors and investments of foreign investors treatment that is no less favourable than the treatment accorded to investors of any third State and their investment (UNCTAD, 1999d).¹⁷

A basic distinction exists between investment agreements in which the MFN standard is limited to the treatment of investors and investments after the admission of an investment in the territory of a host country and agreements in which the MFN standard also extends to the admission and establishment of foreign investment. The former approach is characteristic of many BITs, especially those concluded by European countries. Thus, for example, Article 3 (3) of Austria's model BIT provides:

“Each Contracting Party shall accord to investors of the other Contracting party and to their investments treatment no less favourable than that it accords [...] to investors of any third country and their investments with respect to the management, operation, maintenance, use, enjoyment, sale and liquidation of an investment, whichever is more favourable to the investor.”

Recent BITs concluded by the United States and Canada apply the MFN rule to both the establishment and the subsequent treatment of foreign investors and investment, subject to the ability of the parties to the treaties to make country-specific exceptions regarding specific sectors and measures.

¹⁷ While some agreements apply the MFN rule to “investments”, more recent agreements apply the rule to both “investments” and “investors”.

MFN rules in IIAs are sometimes subject to country-specific exceptions in respect of particular measures or policies. In most cases, these country-specific exceptions are recorded through a “negative list” approach whereby the MFN rule applies except to the extent that a country has explicitly exempted a sector or policy from the rule. This also applies to the MFN rule in the GATS, which, unlike GATS provisions on market access and national treatment, is a rule that in principle applies as a general obligation (UNCTAD, 2004c).

In some agreements, the application of the MFN rule is further subject to the exceptions of a general nature, for example with respect to measures necessary to protect national security interests or public order, prudential measures in the financial services sector, and more specific exceptions. In the latter regard, most investment agreements explicitly provide that the MFN rule does not apply to treatment accorded to investors by virtue of bilateral agreements on the avoidance of double taxation and to measures applied pursuant to regional economic integration arrangements. Some agreements allow for specific exceptions to MFN treatment with respect to matters such as government procurement, subsidies and intellectual property (UNCTAD, 1999d).

3.4.5 Fair and Equitable Treatment

“Fair and equitable” treatment is one of several general standards of treatment that appears in most BITs and other international agreements on the promotion and protection of foreign investment. The formulations used in different instruments have varied somewhat with some instruments referring to “equitable” treatment or “just and equitable” treatment instead of “fair and equitable” treatment (UNCTAD, 1999c).

The reference to fair and equitable treatment in an IIA usually appears in a provision that also requires the parties to accord full or constant protection and security to foreign investments and not to impair the management, maintenance, use, enjoyment or disposal of foreign investments by unreasonable or discriminatory measures. For example, Article 3 (1)-(2) of the model BIT of Austria states:

“(1) Each Contracting party shall accord to investments by investors of the other Contracting party fair and equitable treatment and full and constant protection and security.

(2) A Contracting Party shall not impair by unreasonable or discriminatory measures the management, operation, maintenance, use, enjoyment, sale and liquidation of an investment by investors of the other Contracting Party.”

The application of the fair and equitable treatment standard to the facts of a given case involves a significant measure of subjective judgement as this standard is less amenable to a technical specification than rules requiring national treatment and MFN treatment of foreign investors (UNCTAD, 2004b).

3.4.6 Expropriation and Nationalization

BITs and other international instruments for the protection of foreign investment virtually always contain provisions prohibiting the taking of foreign investors’ assets by public authorities, except if done for a public purpose, on a non-discriminatory basis, against payment of compensation, and, in many cases, with due process of law (UNCTAD, 2000e, Hallward-Driemeier, 2003).

1. “Expropriation” versus “nationalization”

It has sometimes been suggested that the term “expropriation” refers to the taking of property of an individual firm whereas “nationalization” denotes the taking of property in a context of industry- or economy-wide measures of social and economic reform (UNCTAD, 2000e).

2. *Indirect expropriation / nationalization*

It is generally accepted that the concept of expropriation is not limited to instances in which there is a formal transfer of title to property but can also cover certain forms of interference by a State with property rights. IIAs reflect this notion that expropriation and nationalization can occur in various forms. They typically include references to “indirect” expropriation/nationalization and/or to measures that are “tantamount” to expropriation and nationalization. For example:

“Neither party shall expropriate or nationalize a covered investment either directly or indirectly through measures tantamount to expropriation or nationalization (‘expropriation’) except...”¹⁸

“Investments of nationals or companies of either Contracting Party shall not be nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation (hereinafter referred to as ‘expropriation’) in the territory of the other Contracting Party except...”¹⁹

It has been suggested that a “direct” expropriation / nationalization is characterized by acts that transfer title and physical possession, whereas “indirect” expropriation / nationalization involves acts that effectuate the loss of management, use or control, or a significant depreciation in the value, of assets.

3. *Standard of compensation*

A core element of provisions on expropriation / nationalization in IIAs, are rules on the amount and timing of the payment of compensation, the currency in which compensation must be paid and the rights to transfer any payment of compensation. Recent agreements display a trend towards an increasing use of a standard of “prompt, adequate and effective” compensation. References to “prompt, adequate and effective” compensation can be found in many BITs (UNCTAD, 2004b).

¹⁸ See Article III (1) of BIT model of the United States

¹⁹ See Article 5 (1) of BIT model of the United Kingdom.

3.4.7 Compensation for Losses

Aside from compensation for expropriation or nationalization of foreign investment, IIAs often contain requirements with respect to the payment of compensation in the case of losses suffered by foreign investors as a result of war, armed conflict, a state of national emergency, revolution and other disturbances (UNCTAD, 1998b). First, the parties to such agreements are typically required to accord non-discrimination (national and MFN) treatment to foreign investors in respect of any compensation paid for such losses. Second, many agreements also require the parties to compensate foreign investors, regardless of the treatment of domestic investors, if losses suffered by foreign investors in such situations are caused by the requisitioning or destruction of their property by a party's forces or authorities (UNCTAD, 2004b, and c).

3.4.8 Transfer of Funds

A variety of international instruments contain obligations regarding the transfer of funds related to foreign investment. The precise scope of such obligations depends upon the coverage and the objectives of the instrument in question. Thus for example, the scope of transfer of funds provisions in the context of investment protection rules differs from the scope of transfer of funds provisions in instruments aimed at the liberalization of capital movements (UNCTAD, 2000d).

1. Transfer of funds and investment protection

BITs and regional agreements that are modeled after such treaties always require that host countries guarantee the free transfer of payments related to investments as an important aspect of investment protection (UNCTAD, 2000d). This requirement only applies to transfers related to inward investment made by investors of one party in the territory of another party: transfers related to outward investment by domestic investors of the parties are not covered by such a requirement. The main categories of payments in respect of which this right of free transfer applies are:

- Outward transfers of amounts derived from or associated with protected investments. This category typically includes returns on investment (profits dividends, interest, capital gains, royalty payments, management, technical assistance or other fees and returns in kind); proceeds of the total or partial liquidation of investments; repayment of loans; and earnings and other remuneration of personnel engaged from abroad in connection with an investment.
- Outward transfers of payments made by a host country as compensation for an expropriation of investment or for losses suffered by foreign investors as a result of an armed conflict or civil disturbance and of payments that arise from dispute settlement proceedings.
- Inward transfers of amounts to be invested by a foreign investor, including inward transfers to develop or maintain an existing investment and, in the case of investment agreements that contain obligations to admit foreign investment, inward transfers for the purposes of making an investment.

For example, Article 5 of the model BIT of Germany provides:

“Each Contracting Party shall guarantee to nationals or companies of the other Contracting Party the free transfer of payments in connection with an investment, in particular

- (a) of the principal and additional amounts to maintain or increase the investment,
- (b) of the returns,
- (c) in repayment of loans,
- (d) of the proceeds from the liquidation or the sale of the whole or any part of the investment.
- (e) of the compensation provided for in Article 4

Provisions on transfer of funds often require host countries to ensure that transfers can be made without delay, in freely usable or freely convertible currencies, at the normal exchange rate applicable at the time of transfer (UNCTAD, 2000d).

For example, Article 6 of the model BIT of the United Kingdom provides:

“Each Contracting Party shall in respect of investments guarantee to nationals or companies of the other Contracting party the unrestricted transfer of their investments and returns. Transfers shall be affected without delay in the convertible currency in which the capital was originally invested or in any other convertible currency agreed by the investor and the Contracting Party concerned. Unless otherwise agreed by the investor transfers shall be made at the rate of exchange applicable on the date of transfer pursuant to the exchange regulations in force.”

2. Transfer of funds and the OECD Liberalization Codes

In the context of the OECD, rules relevant to the transfer of funds related to foreign investment are contained in the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations. In addition to covering outward transfers of all proceeds of inward investment, the Codes also apply to inward transfers related to the making of investment by non-residents and to transfers related to the making of outward investment by residents.

The obligation to permit a transfer under the OECD Codes includes the obligation not to limit the availability of foreign exchange for the purpose of making the transfer. The Codes cover both transfers and underlying transactions but differentiate between transfers and underlying transactions in terms of the nature of the applicable obligation. Whereas underlying transactions are subject to an obligation of non-discrimination, whereby transactions between residents may not be treated more favourably than transactions between residents and non-residents, the obligation not to restrict transfers is of an absolute nature and applies also to measures that are non-discriminatory.

The OECD Code enables OECD members to make reservations in respect of restrictions in force at the time a country becomes a member of the OECD. In principle, new restrictions may not be introduced except on a temporary and non-discriminatory basis in case of balance-of-payments difficulties and in case of “serious economic and financial disturbance”.²⁰ In addition, a member may lodge reservations when a new item is added to the Codes covered by the Code and when the obligation relating to an item is extended or begins to apply to a member. Furthermore, members may at any time lodge new reservations in order to impose restrictions on certain short-term financial transactions.²¹

3. Transfer of funds and the IMF Articles of Agreement

Article VIII (2) (a) of the articles of Agreement of the IMF provide that IMF members may not “impose restrictions on the making of payments and transfers for current international transactions” except where such restrictions are approved by the IMF. This provision protects the ability of an investor to repatriate income arising from investment but does not cover payments and transfers arising from the liquidation of investment and from the making of a new investment (UNCTAD, 2000d).

- “Current” transactions. Payments that arise from “current” transactions include, in addition to payments relating to trade and services, certain payments related to investments: income arising from investment, including interest on loans and other debt instruments, net of any income tax that may be levied by the country from which the payment is to be made. Not covered are other investment-related payments, such as payments arising from the liquidation of the original capital or any capital appreciation. Article VI of the IMF Articles of Agreement specifically preserves the right of IMF members to impose restrictions on capital transactions.

²⁰ See OECD Code of Liberalization of Capital Movements, Article 7 (b).

²¹ See OECD Code of Liberalization of Capital Movements, Article 2 (b).

- “International” transactions. “International” transactions are transactions between residents and non-residents. Thus transactions between a foreign affiliate and other companies in a host country are not considered international in this sense.
- “The making of payments and transfers”. The obligation in Article VIII (2) (a) comprises the right of a resident to make a payment to a non-resident and the right of a non-resident to transfer the proceeds of that payment from the country in question. It extends only to the making of outward payments and transfers and not to the receipt of inward payments and transfers. Thus in the case of investment-related payments and transfers, the provision protects the ability of a non-resident to transfer proceeds from an investment but does not apply to inward payments and transfers related to the making of an investment.
- “Restriction”. The concept of restriction comprises any governmental action whether of a formal or informal nature that impedes the making of current international payments and transfers, including limitations with respect to the purchase of foreign exchange for the purpose of making a payment or transfer. A restriction on an underlying current transaction is not considered to constitute a restriction on the making of payments and transfers for that transaction.

Closely related to the prohibition on restrictions on current payments and transfers is the prohibition in Article VIII (3) of the IMF Articles of Agreement of the use of multiple currency practices. The IMF may authorize a member to introduce temporary non-discriminatory restrictions on payments and transfers for current transactions in case of balance-of-payments difficulties.

4. Transfer of funds and the GATS

The GATS covers capital movements to the extent that such movements are related to specific commitments made by members with regard to market access (UNCTAD, 2000d). This is expressed in footnote 8 to Article XVI of the GATS:

“If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I [from the territory of one Member into the territory of any other Member] and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I [by a service supplier of one Member, through commercial presence in the territory of any other Member], it is thereby committed to allow related transfers of capital into its territory.”

In addition, Article XI of the GATS provides that:

“1. Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments.

2. Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund.”

Article XI of the GATS thus ensures that the imposition or maintenance by a member of restrictions on current payments or transfers relating to its specific commitments with the approval of the IMF will not be considered to give rise to a breach of the member’s obligations under the GATS. By permitting members to restrict capital

transactions at the request of the IMF it also accommodates the (limited) jurisdiction of the IMF regarding capital transactions.²²

Finally, as referred to in Article XI, restrictions on current payments and transfers and on capital transactions may be justified under a temporary derogation clause in Article XII (1) which can be invoked in the event of “serious balance-of-payments and external financial difficulties or threat thereof...”. Measures imposed under this provision must be non-discriminatory and consistent with the IMF Articles of Agreement; must avoid unnecessary damage to the commercial, economic and financial interest of any other; may not exceed those necessary to deal with the problems that justified the invocation of this provision; and must be temporary and be phased out progressively as the situation improves.²³ Procedural requirements attached to this provision include prompt notification of the WTO General Council and consultations in a Committee on Balance-of-Payments Restriction. In the latter regard, Article XII (5) (e) assigns an important role to the IMF by providing that:

“In such consultations, all findings of statistical and other facts presented by the International Monetary Fund relating to foreign exchange, monetary reserves and balance of payments shall be accepted and conclusions shall be based on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting Member.”

3.4.9 Dispute Settlement

Dispute settlement provisions in IIAs contain judicial mechanisms with which disputes arising between States (State –State) or between a foreign investor and a host State (investor-State) are dealt with (UNCTAD, WIR 2003).

²² Article VI (1) of the 1944 IMF Articles of Agreement provides that the IMF can request a member using IMF resources to restrict capital transactions in order to avoid the IMF’s general resources from being used to meet a large and sustained outflow of capital.

²³ Article XII (2).

1. Settlement of dispute between States

Most BITs provide that any dispute between States concerning the interpretation or application of the treaty which is not resolved through negotiations or consultations between the parties shall at the request of either party be submitted to an arbitral tribunal. The use of arbitration as a means of settlement of disputes between States distinguishes BITs from earlier Treaties of Friendship, Commerce and Navigation, which generally provided for the submission of inter-State disputes to the International Court of Justice (UNCTAD, 2004b).

Arbitration of inter-State disputes under modern BITs is of an *ad hoc* or non-institutional character. The arbitration tribunal is constituted in each individual case in accordance with the provisions of the treaty in question and applies procedural rules that are either specified in the treaty or which the tribunal establishes pursuant to an authorization contained in the treaty (UNCTAD, 2004b).

The constitution of arbitration tribunals for the settlement of inter-State disputes under BITs is governed by a standard clause providing that each party will appoint one member of the tribunal who will select a national of a third State to serve as the chairperson of the tribunal, a third member, subject to the approval by the two parties. In most cases, there is a specific time limit of two months for the appointment of the members by the parties and two or three months for the appointment of the chairperson of the tribunal. Where such appointments have not been made within the prescribed time limits, the possibility usually exists for either party to request a third person, typically the President of the International Court of Justice, to make the appointments (UNCTAD, 2004c).

Apart from stating that an arbitration tribunal shall decide by majority, most BITs do not contain or refer to specific rules governing the procedural aspects of State-State arbitration proceedings and provide instead that the tribunal shall determine its own procedures. BITs of the United States adopt a different approach in that they provide for the application of the UNCITRAL Arbitration Rules. Many BITs are silent on the question of the law to be applied by an arbitral tribunal in State-State disputes. To the

extent that the matter has been addressed, a variety of formulations have been used. Thus, tribunals have been directed to decide disputes “in accordance with this Agreement and the applicable rules and principles of international law”;²⁴ “on the basis of this Agreement and other relevant agreements between the two Contracting Parties, rules of international law and relevant rules of domestic law”²⁵; or “in accordance with the applicable rules of international law”.²⁶

In addition to arbitration mechanisms in IIAs, mention should be made of the WTO dispute settlement rules, which can be invoked in disputes that arise between States with regard to investment-related matters covered by the WTO agreements, notably the GATS, the TRIMs Agreement and the TRIPS Agreement (UNCTAD, 2004c).

2. Settlement of disputes between foreign investors and host countries

Virtually all modern BITs and investment protection rules contained in regional trade and economic agreements include a specific mechanism for the settlement of disputes between foreign investors and host countries, generally providing for the possibility to submit foreign investment disputes to international arbitration (UNCTAD, WIR 2003).

Prior recourse to consultations and negotiations is usually stipulated as a precondition for the invocation of international arbitration, by either the investor or the host country. A minimum period of time is often specified that must elapse before a dispute can be submitted to international arbitration. Usually this period is three or six months. Some IIAs also provide that a dispute can be submitted to arbitration only within a certain period of time (UNCTAD, 2004b).

As a rule, arbitration of investor-State disputes pursuant to IIAs is of an institutional nature in that the agreements provide that the arbitration shall take place

²⁴ See Article 21 (1) of the model BIT of Austria.

²⁵ See Article 12 (5) of the model BIT of the Netherlands.

²⁶ See Article X (1) of the model BIT of the United States.

under the rules of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID Convention)²⁷, which entered into force in October 1966.²⁸ Other forms of institutional arbitration that are sometimes mentioned in IIAs are the 1975 Rules of Arbitration of the ICC, administered by the International Court of Arbitration of the ICC, and the 1999 Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce (UNCTAD, 2004c). In some cases, *ad hoc* arbitration is provided for, often with reference to the Arbitration Rules of the UNCITRAL (UNCTAD, 1998a, b, 2003, 2004b, and c).²⁹

3.4.10 Transparency

A key aspect of the concept of “transparency” as commonly understood in connection with international economic agreements involves the publication of domestic laws, regulations and administrative practices that are relevant to the subject matter of the agreement in question. The prime example of a provision embodying such a publication requirement in the context of international trade agreements is Article X (1) of GATT 1944. Obligations of this nature are not typically contained in traditional BITs,³⁰ but can be found in some recently concluded BITs. As an example, the BITs recently concluded by Canada provide Articles on “Transparency”.

As compared with BITs, inclusion of provisions requiring the publication of domestic laws, regulations and practices is more prevalent in regional and multilateral investment agreements. A notable example is Article III of the GATS. The relevant provision reads:

²⁷ ICSID is an affiliate agency of the World Bank.

²⁸ Where one of the parties to an investment agreement is not a party to the ICSID Convention, the arbitration clause usually refers to arbitration under the ICSID additional Facility Rules, which were adopted in 1978 to provide for arbitration in investment disputes where either the host country or the home country is not a party to the 1966 ICSID Convention.

²⁹ The UNCITRAL Arbitration Rules were adopted on 15 December 1976 by the United Nations General Assembly Resolution 31/98.

³⁰ For example, BITs of the United Kingdom and Germany are silent on this issue.

“1. Each Member shall publish promptly and, except in emergency situations, at the latest by the time of their entry into force, all relevant measures of general application which pertain to or affect the operation of this Agreement. International agreements pertaining to or affecting trade in services to which a Member is a signatory shall also be published.

2. Where publication as referred to in paragraph 1 is not practicable, such information shall be made otherwise publicly available.”

The idea that transparency is to be ensured through the provision of adequate information on relevant domestic laws, regulations and administrative practices is also reflected in certain legally non-binding instruments, such as the World Bank Guidelines on the Treatment of Foreign Direct Investment.

3.5 Characteristics of IIAs at Different Levels

The advantages and disadvantages of bilateral, regional and multilateral approaches to negotiating international investment agreements (IIAs) can not be compared directly, since the three approaches serve different purposes.

1. The main objective of BITs is to provide investor protection at the international level.
2. Bilateral and regional approaches that combine investment and trade seek to reap the benefits of larger markets through trade liberalization accompanied by investment liberalization and sometimes protection.
3. A multilateral approach can aim at both protection and liberalization.

3.5.1 Advantages of BITs over other Investment Laws

BITs have the advantage of allowing countries the freedom of choosing the partners to enter into an agreement and tailor the agreement to their specific situations. They offer countries flexibility in designing their networks of IIAs, concluding them with countries that are key investors, avoiding countries that are less interesting or that may insist on unwanted provisions. Allowing each treaty to be negotiated separately gives countries more flexibility than under a multilateral approach. In addition, BITs can be negotiated quickly. Important is also that the overwhelming numbers of BITs cover only the post-establishment stage of investment, leaving admission and establishment – which have the greatest development implications – to be determined autonomously by host countries (UNCTAD, 2000b, and WIR 2003).

3.5.2 Advantages of Regional Agreements

Regional agreements typically deal with a range of issues, so there is more room for tradeoffs and bargaining. With the overall purpose of expanding the regional market, they often include the liberalization of foreign entry and establishment – and reduce operational restrictions. They offer – indeed require – more flexibility in how treaty provisions are applied to the different countries. Hence, the frequent use of exceptions, reservations, transition periods and the like, intended to ensure flexibility and cater to the needs and capacities of parties at different levels.

Regional and plurilateral instruments have some of the characteristics of multilateral ones: the agreement of many countries is needed for their negotiation and conclusion, they often have important institutional structures and they generally provide for their continuing growth and development. At the same time, the number of countries involved is smaller and they tend to be relatively homogeneous; the adoption of instruments that serve common interests in fairly specific fashion is more feasible. With respect to FDI, regional and plurilateral agreements have helped to change pre-existing structures of law and policy and to create important habits and patterns of expectations on a broader transnational level, even though not a universal one. As a

result in recent years, regional agreements have often been the harbingers of significant new trends in matters of investment law and regulation (UNCTAD, WIR 2003).

3.5.3 Advantages of Multilateral Approaches

The advantages and disadvantages of multilateral approaches are difficult to assess. The balance of advantages and disadvantages depends on the objectives, structure, content and implementation. One of the first arguments put forward in favour of a multilateral framework for investment was that it would facilitate further expansion of FDI. It was argued that legally binding multilateral discipline in investment would improve the enabling environment – by contributing to greater transparency, stability, predictability and security for investment in sectors not yet covered by multilateral rules. Some countries see multilateral disciplines as an important complement to the bilateral and regional IIAs, to create a common legal basis.³¹ Indeed, a multilateral agreement could create the “floor” of standards applicable to IIAs in general.

Multilateral agreements, especially those of worldwide scope, are the closest equivalent to “legislation” that exists in international law. They make possible the formulation and application of “universal” rules, agreed by and applicable to all States, or a large majority of them. Such agreements are often endowed with institutional machinery for their application and with provisions for their review and development. On the other hand, the necessity to find common ground among a large number of States often makes their provisions either very general or riddled with possible special cases. And the very difficulty of achieving agreement on topics such as FDI, where the approaches and policies of States differ, accounts for the lack of comprehensive instruments of this type.

³¹ One could also argue that multilateral negotiations may be more transparent (as compared to bilateral negotiations) in that they are more likely to receive scrutiny from the public, including civil society groups, given their higher profile.

The various approaches to international rule-making all have their merits and weaknesses, their benefits and costs. Whether it is desirable for a country to pursue one approach thus depends primarily on what it seeks from an agreement – investor protection, liberalization, broader international cooperation. Finally, the development orientation of any agreement depends on its objectives, structure, substantive provisions and implementation. All in all, the proliferation of IIAs at all levels means that international investment policies take place in a very different context from just 20 years ago.

3.6 BITs Concluded by CEC4

Since 1986, the year a BIT was concluded between Germany and Hungary the four Central European countries (CEC4) have signed 249 BITs, of which 93 were concluded with OECD countries (all signed in the early 1990s).

Below is a listing of BITs concluded by the CEC4 with the European Community, developed and developing countries, as of June 2006. One witnesses that these countries did not have BIT with any country before 1986. They started to conclude BITs extensively since the late 1980s. More importantly, the listing confirms that the early treaties were concluded with OECD countries, particularly with their European neighbours. These trends are the result of various factors, notably the move towards a free market economic system in Central Europe, and the emergence of new countries on the international economic scene.

Table 3-7: Number of BITs Concluded by CEC4, as of 1 June 2006

Number of BITs Concluded by CEC4, as of 1 June 2006

Country	BIT Signed		BIT Ratified	
	Overall	thereof with OECD	Overall	thereof with OECD
Czech Republic	81	25	75	25
Hungary	59	22	52	22
Poland	61	23	60	23
Slovak Republic	48	23	44	23
Total	249	93	231	93

Source: UNCTAD, IIAs online Database (www.unctad.org/iia).

Table 3-8: Bilateral Agreements Signed by the EU with the CEC4

Bilateral Agreements Signed by the European Community and its Member States with the CEC4

<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>
Hungary	16 December 1991	1 February 1994
Poland	16 December 1991	1 February 1994
Czechoslovakia	16 December 1991(*)	...
Czech Republic	4 October 1993	1 February 1993
Slovak Republic	4 October 1993	1 February 1993

Source: UNCTAD, *International Investment Agreements: Key Issues, Volume I*, p. 51. (2004)

(*) refers to no longer in force

Table 3-9: BITs Concluded by Chechoslovakia, 1 June 2006

BITs Concluded by Chechoslovakia (*), 1 June 2006

	<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>	<i>Partner's Membership</i>
1)	Belgium/Luxembourg	24 April 1989	13 February 1992	OECD
2)	United Kingdom	10 July 1990	26 October 1992	OECD
3)	Italy	01 August 1990	...	OECD
4)	France	13 September 1990	27 September 1991	OECD
5)	Germany	02 October 1990	02 August 1992	OECD
6)	Switzerland	05 October 1990	07 August 1991	OECD
7)	Austria	15 October 1990	01 October 1991	OECD
8)	Finland	06 November 1990	23 October 1991	OECD
9)	Sweden	13 November 1990	23 September 1991	OECD
10)	Canada	15 November 1990	09 March 1992	OECD
11)	Spain	12 December 1990	28 November 1991	OECD
12)	Denmark	06 March 1991	19 September 1992	OECD
13)	Netherlands	29 April 1991	01 October 1992	OECD
14)	Norway	21 May 1991	06 August 1992	OECD
15)	Greece	03 June 1991	31 December 1992	OECD
16)	Australia	29 July 1991	...	OECD
17)	Thailand	16 October 1991	...	
18)	United States	22 October 1991	19 December 1992	OECD
19)	China	04 December 1991	01 December 1992	
20)	Korea, Republic of	27 April 1992	16 March 1995	OECD
21)	Turkey	30 April 1992	01 August 1997	OECD

Source: UNCTAD, *International Investment Instruments online database*.

(*) Obligations from treaties concluded by Czechoslovakia have been assumed as from 1 January 1993 by both the Czech Republic and Slovakia

Table 3-10: BITs Concluded by The Czech Republic, 1 June 2006

BITs Concluded by the Czech Republic, 1 June 2006				
	<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>	<i>Partner's Membership</i>
1)	Slovakia	23 November 1992	01 January 1993	OECD
		26 March 2002	14 July 2003	
2)	Hungary	14 January 1993	25 May 1995	OECD
3)	Slovenia	04 May 1993	21 May 1994	
4)	Egypt	29 May 1993	04 June 1994	
5)	Poland	16 July 1993	29 June 1994	OECD
6)	Australia	30 September 1993	29 June 1994	OECD
7)	Romania	08 November 1993	28 July 1994	
8)	Portugal	12 November 1993	03 August 1994	OECD
9)	Tajikistan	11 February 1994	05 December 1995	
10)	Thailand	12 February 1994	04 May 1995	
11)	Peru	16 March 1994	06 March 1995	
12)	Ukraine	17 March 1994	02 November 1995	
13)	Russian Federation	05 April 1994	06 June 1996	
14)	Albania	27 June 1994	07 July 1995	
15)	Estonia	24 October 1994	18 July 1995	
16)	Latvia	25 October 1994	01 August 1995	
17)	Lithuania	27 October 1994	12 July 1995	
18)	United Arab Emirates	23 November 1994	25 December 1995	
19)	Phillipines	05 April 1995	04 April 1996	
20)	Singapore	08 April 1995	08 October 1995	
21)	Chile	24 April 1995	05 October 1996	
22)	Venezuela	27 April 1995	23 July 1996	
23)	Kuwait	08 January 1996	21 January 1997	
24)	Italy	22 January 1996	01 November 1997	OECD
25)	Croatia	05 March 1996	15 May 1997	
26)	Ireland	28 June 1996	01 August 1997	OECD
27)	Malaysia	09 September 1996	03 December 1998	
28)	Uruguay	26 September 1996	29 December 2000	
29)	Argentina	27 September 1996	23 July 1998	
30)	Kazakhstan	08 October 1996	02 April 1998	
31)	India	11 October 1996	06 February 1998	
32)	Belarus	14 October 1996	09 April 1998	
33)	Tunisia	06 January 1997	08 July 1998	
34)	Uzbekistan	15 January 1997	06 April 1998	
35)	Lebanon	19 September 1997	24 January 2000	
36)	Jordan	20 September 1997	25 September 2001	
37)	Israel	23 September 1997	16 March 1999	
38)	Serbia & Montenegro	13 October 1997	13 March 1998	
39)	Viet Nam	25 November 1997	09 July 1998	
40)	Mongolia	13 February 1998	5 July 1999	
41)	Korea, Democratic's People's	27 February 1998	10 October 1999	
42)	Indonesia	17 September 1998	...	
43)	Costa Rica	21 October 1998	5 March 2001	
44)	Paraguay	21 October 1998	24 March 2000	
45)	South Africa	14 December 1998	17 September 1999	
46)	Bulgaria	17 March 1999	30 September 2000	
47)	Mauritius	05 April 1999	27 April 2000	
48)	Pakistan	07 May 1999	...	
49)	Moldova, Republic of	12 May 1999	21 June 2000	
50)	Panama	27 August 1999	20 October 2000	
51)	Zimbabwe	13 September 1999	...	
52)	El Salvador	29 November 1999	28 March 2001	
53)	Algeria	22 September 2000	...	
54)	Nicaragua	2 April 2000	24 February 2004	
55)	Morocco	11 June 2001	30 January 2003	
56)	Cyprus	15 June 2001	25 September 2002	
57)	Macedonia, TFYR	21 June 2001	20 September 2002	
58)	Mexico	4 April 2002	13 March 2004	OECD
59)	Malta	9 April 2002	9 July 2003	
60)	Bosnia & Hzerzegovina	17 April 2002	30 May 2004	
61)	Guatemala	8 July 2003	29 April 2005	
62)	China	8 December 2005	...	

Source: UNCTAD, *International Investment Instruments online database* (www.unctad.org/ia)

Table 3-11: BITs Concluded by The Slovak Republic, 1 June 2006**BITs Concluded by the Slovak Republic, 1 June 2006**

	<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>	<i>Partner's Membership</i>
1)	Czech Republic	23 November 1992	01 January 1993	OECD
		26 March 2002	14 July 2003	
2)	Hungary	15 January 1993	19 July 1996	OECD
3)	Slovenia	28 July 1993	28 March 1996	
4)	Russian Federation	30 November 1993	02 August 1996	
5)	Tajikistan	14 February 1994	12 March 1996	
6)	Romania	03 March 1994	07 March 1996	
7)	Ukraine	22 June 1994	03 April 1996	
8)	Indonesia	12 July 1994	01 March 1995	
9)	Bulgaria	21 July 1994	09 March 1995	
10)	Poland	18 August 1994	14 March 1996	OECD
11)	Portugal	10 July 1995	15 May 1999	OECD
12)	Turkmenistan	17 November 1995	10 March 1999	
13)	Yugoslav, Federal Republic of	07 February 1996	16 July 1998	
14)	Croatia	12 February 1996	05 February 1997	
15)	Canada	3 February 1997	30 January 2001	
16)	Cuba	22 March 1997	05 December 1997	
17)	Egypt	30 April 1997	1 January 2000	
18)	Latvia	09 April 1998	30 October 1998	
19)	Italy	30 July 1998	22 November 2000	OECD
20)	Korea, Democratic People's Republic of	27 October 1998	17 April 1999	
21)	Malta	07 September 1999	29 May 2000	
22)	Israel	08 September 1999	24 June 2003	
23)	Turkey	09 October 2000	23 December 2003	OECD
24)	Iceland	5 April 2002	19 June 2003	
25)	Uzbekistan	06 March 2003	17 October 2003	
26)	Estonia	21 October 2003	...	
27)	Belarus	26 August 2005	...	
28)	Korea, Republic of	27 May 2005	7 February 2006	
29)	China	7 December 2005	...	

Source: UNCTAD, *International Investment Instruments online database* (www.unctad.org/ia)

(*) Obligations from treaties concluded by Czechoslovakia have been assumed as from 1 January 1993 by both the Czech Republic and Slovakia

Table 3-12: BITs Concluded by Hungary, 1 June 2006

BITs Concluded by Hungary, 1 June 2006				
	<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>	<i>Partner's Membership</i>
1)	Germany	30 April 1986	07 November 1987	OECD
2)	Belgium/Luxembourg	14 May 1986	23 September 1988	OECD
3)	France	06 November 1986	30 September 1987	OECD
4)	Italy	17 February 1987	23 February 1990	OECD
5)	United Kingdom	09 March 1987	28 August 1987	OECD
6)	Sweden	21 April 1987	21 April 1987	OECD
7)	Netherlands	02 September 1987	01 June 1988	OECD
8)	Denmark	02 May 1988	18 October 1988	OECD
9)	Austria	26 May 1988	01 September 1989	OECD
10)	Finland	06 June 1988	12 May 1989	OECD
11)	Switzerland	05 October 1988	16 May 1989	OECD
12)	Korea, Republic of	28 December 1988	01 February 1989	OECD
13)	Cyprus	24 May 1989	25 May 1990	
14)	Greece	26 May 1989	01 February 1992	OECD
15)	Uruguay	25 August 1989	01 July 1992	
16)	Kuwait	08 November 1989	01 March 1994	
17)	Spain	09 November 1989	01 August 1992	OECD
18)	Norway	08 April 1991	04 December 1992	OECD
19)	Israel	14 May 1991	14 September 1992	
20)	China	29 May 1991	01 April 1993	
21)	Australia	15 August 1991	10 May 1992	OECD
22)	Canada	03 October 1991	21 November 1993	OECD
23)	Thailand	18 October 1991	18 October 1991	
24)	Morocco	12 December 1991	3 February 2000	
25)	Turkey	14 January 1992	01 March 1995	OECD
26)	Portugal	28 February 1992	08 October 1997	OECD
27)	Indonesia	20 May 1992	13 February 1996	
28)	Poland	23 September 1992	16 June 1995	OECD
29)	Czech Republic	14 January 1993	25 May 1995	OECD
30)	Slovakia	15 January 1993	19 July 1996	OECD
31)	Argentina	05 February 1993	01 October 1997	
32)	Malaysia	19 February 1993	08 July 1995	
33)	Paraguay	11 August 1993	01 April 1995	
34)	Romania	16 September 1993	06 May 1996	
35)	Bulgaria	08 June 1994	07 September 1995	
36)	Viet Nam	26 August 1994	16 June 1995	
37)	Mongolia	13 September 1994	29 August 1995	
38)	Ukraine	11 October 1994	03 December 1996	
39)	Kazakhstan	07 December 1994	03 March 1996	
40)	Russian Federation	06 March 1995	29 May 1996	
41)	Moldova, Republic of	19 April 1995	19 August 1996	
42)	Egypt	23 May 1995	21 August 1997	
43)	Albania	24 January 1996	01 April 1998	
44)	Croatia	15 May 1996	1 March 2002	
45)	Slovenia	15 October 1996	9 June 2000	
46)	Chile	10 March 1997	...	
47)	Singapore	17 April 1997	01 January 1999	
48)	Lithuania	25 May 1999	20 May 2003	
49)	Latvia	10 June 1999	25 August 2000	
50)	Cuba	22 October 1999	...	
51)	Serbia & Montenegro	20 June 2001	14 May 2004	
52)	Macedonia, TFYR	20 June 2001	14 March 2002	
53)	Lebanon	22 June 2001	23 July 2002	
54)	Estonia	1 January 2002	...	
55)	Bosnia & Herzegovina	26 September 2002	22 December 2003	
56)	Uzbekistan	28 October 2002	...	
57)	Tunisia	13 May 2003	...	
58)	India	03 November 2003	...	
59)	Yemen	18 January 2004	...	

Source: UNCTAD, *International Investment Instruments online database* (www.unctad.org/iiia).

Table 3-13 : BITs Concluded by Poland, as of 1 June 2006

BITs Concluded by Poland, 1 June 2006				
	<i>Partner Country</i>	<i>Date of Signature</i>	<i>Date of entry into force</i>	<i>Partner's Membership</i>
1)	Belgium/Luxembourg	19 May 1987	02 August 1991	OECD
2)	United Kingdom	08 December 1987	14 April 1988	OECD
3)	China	07 June 1988	08 January 1989	
4)	Austria	24 November 1988	01 November 1989	OECD
5)	France	14 February 1989	10 February 1990	OECD
6)	Italy	10 May 1989	10 January 1993	OECD
7)	Sweden	13 October 1989	04 January 1990	OECD
8)	Korea, Republic of	01 November 1989	02 February 1990	OECD
9)	Switzerland	08 November 1989	18 April 1990	OECD
10)	Germany	10 November 1989	24 February 1991	OECD
11)	Kuwait	05 March 1990	18 December 1993	
12)	United States	21 March 1990	06 August 1994	OECD
14)	Denmark	01 May 1990	30 October 1990	OECD
15)	Norway	05 June 1990	24 October 1990	OECD
16)	Canada	26 October 1990	22 November 1990	OECD
17)	Australia	07 May 1991	27 March 1992	OECD
18)	Israel	22 May 1991	06 May 1992	
19)	Argentina	31 July 1991	01 September 1992	
20)	Uruguay	02 August 1991	21 October 1994	
21)	Turkey	11 August 1991	19 August 1994	OECD
22)	Belarus	24 April 1992	18 January 1993	
23)	Cyprus	04 June 1992	01 July 1993	
24)	Spain	30 July 1992	01 May 1993	OECD
25)	Netherlands	07 September 1992	01 February 1994	OECD
26)	Hungary	23 September 1992	16 June 1995	OECD
27)	Russian Federation	02 October 1992	...	
28)	Indonesia	06 October 1992	01 July 1993	
29)	Greece	14 October 1992	20 February 1995	OECD
30)	Thailand	18 December 1992	10 August 1993	
31)	Ukraine	12 January 1993	14 September 1993	
32)	United Arab Emirates	31 January 1993	09 April 1994	
33)	Albania	05 March 1993	09 August 1993	
34)	Portugal	11 March 1993	03 August 1994	OECD
35)	Tunisia	29 March 1993	22 September 1993	
36)	Malaysia	21 April 1993	23 March 1994	
37)	Latvia	26 April 1993	19 July 1993	
38)	Estonia	06 May 1993	06 August 1993	
39)	Singapore	03 June 1993	29 December 1993	
40)	Czech Republic	16 July 1993	29 June 1994	OECD
41)	Bulgaria	11 April 1994	09 March 1995	
42)	Romania	23 June 1994	30 December 1995	
43)	Slovakia	18 August 1994	14 March 1996	OECD
44)	Viet Nam	31 August 1994	24 November 1994	
45)	Kazakhstan	21 September 1994	25 May 1995	
46)	Morocco	24 October 1994	29 May 1995	
47)	Moldova, Republic of	16 November 1994	27 July 1995	
48)	Uzbekistan	11 January 1995	29 April 1995	
49)	Croatia	21 February 1995	04 October 1995	
50)	Egypt	01 July 1995	17 January 1998	
51)	Chile	05 July 1995	22 September 2000	
52)	Mongolia	08 November 1995	21 March 1996	
53)	Slovenia	28 June 1996	31 March 2000	
54)	Yugoslavia, Federal Republic of	03 September 1996	23 January 1997	
55)	India	07 October 1996	31 December 1997	
56)	Finland	25 November 1996	11 March 1998	OECD
57)	Macedonia, the former Yugoslav Republic of	28 November 1996	22 April 1997	
58)	Azerbaijan	26 August 1997	10 February 1999	
59)	Jordan	04 October 1997	14 January 1999	
60)	Bangladesh	08 July 1998	19 November 1999	
61)	Iran, Islamic Republic of	02 October 1998	26 October 2001	

Source: UNCTAD, *International Investment Instruments online database* (www.unctad.org/iiia).

3.7 Conclusion

This chapter elaborated the international legal framework for FDI. It presented the sources and principles of international investment law. IIAs constitute the international legal framework for international investment. It explained the reasons countries sign IIAs. The chapter proceeded by presenting a historical overview of the growth of IIAs. IIAs increased dramatically during the last decade of the 20th century, especially at the bilateral level. This increase in the number of BITs reflects the interest of countries in attracting and promoting FDI. BITs are agreements between two countries for the reciprocal encouragement, promotion and protection of investments in each others' territories by companies based in either country. They provide international legal protection to foreign investors. Next, it elaborated regional economic agreements and focused on the OECD Code of Liberalization of Capital Movements. While presenting multilateral investment agreements, attention was stressed on the WTO investment related provisions in the framework of multilateral investment agreements. The core of the chapter is the section that explicitly elaborated the key issues covered in BITs. The principal issues treated by BITs and other IIAs are the scope and definition of investment and investor; admission and establishment; standards of treatment by a host country towards foreign investors, national treatment (NT), most-favoured-nation treatment (MFN), and fair and equitable treatment; protection against war losses, nationalization and expropriation; compensation for losses; transfer of funds, repatriation of profits, income and dividends; dispute settlement mechanisms both State-State and Investor-State, and transparency. Finally, the chapter presented a list of BITs concluded by the four Central European countries as of June 2006.

4 Theories of Foreign Direct Investment

“There is not one but a number of competing theories with varying degrees of power to explain FDI.” (Jumana Agarwal, 1980, p. 740)

“No single theory of international trade can satisfactorily explain all forms of cross-border transactions in goods and services.”

(John Dunning, 2003, p. 29)

4.1 Introduction

The importance of and growing interest in the causes and consequences of FDI has led to the development of a number of theories that try to explain why foreign investors indulge in FDI, why they choose one country in preference to another to locate their foreign business activity, and why they choose a particular entry mode. These theories also try to explain why some countries are more successful than others in obtaining FDI. Thus, some of the theories try to explain outward FDI “push factors” (why foreign investors choose to invest abroad), whereas others try to explain inward FDI “pull-factors” (that is, a country’s propensity and ability to attract FDI). Though less theoretical, the “pull and push approach”, which tries to bring together the various investment considerations, has formed the basis for many empirical analyses (Calvo, Leiderman and Reinhart, 1993, Fernandez-Arias, 1996, Taylor and Sarno, 1997, Montiel and Reinhart, 1999a, b, Claessens, Oks, and Polastri, 1998). It distinguishes between two groups of explanatory variables: international or external factors “push-factors”; and domestic factors “pull-factors”. Push-factors are thought of conditions in

global capital markets that influence the supply of capital and are outside the control of a particular recipient country. Pull-factors are thought of as country-specific factors and conditions influencing the interest of foreigners investing in that particular country. Researchers using this approach identified broad categories of macroeconomic, institutional, and policy variables that influence the level of FDI flows.

Theories of FDI may be classified under the following headings:

1. Theories Assuming Perfect Markets³²
2. Theories Assuming Imperfect Markets
3. Other Theories
4. Theories Based on Other Factors

It must be stated at the outset that this classification, which is suggested by Lizondo (1991) following Agarwal (1980), may result in some overlap. It will be observed that some variables and factors that influence FDI may appear under more than one heading and be used by more than one theory. However, it is felt that this classification is useful for expository purposes. Also, theories of FDI can be classified according to other criteria. For example, they can be classified according to whether the factors determining FDI are macro factors, micro factors or strategic factors.³³ All these factors and others will be examined under the various theories or hypotheses that will be presented in this chapter. It has to be borne in mind that the common denominator in all the theories is that the most important reason for undertaking investment is profit-making, and FDI is no exception.

³² Market imperfections are departures from the assumption of perfect competition (that is, large numbers of buyers and sellers, homogeneous products, free access to information, and so on). Market imperfections also take the form of barriers to trade, transaction costs, transportation costs and taxes.

³³ The macro factors include such factors as the size of the host economy, interest rates, wages and profitability. The micro factors pertain to the characteristics of firms and industry that confer certain advantages on MNCs compared with other firms. These include product differentiation, technological and advertising effects, the product life cycle and the size of the firm. The strategic factors include various factors that indirectly affect the decision to invest abroad.

The theories of FDI, classified under the headings suggested above, will be discussed in turn. The study follows Agarwal (1980, p.740) by referring to these theories as hypotheses because “*there is not one but a number of competing theories with varying degrees of power to explain FDI*”.

4.2 Theories Assuming Perfect Markets

Three Models fall under this heading:

1. The Differential Rates of Return Theory
2. The Portfolio Diversification Theory
3. The Market Size Theory

4.2.1 The Differential Rates of Return Theory

The differential rate of return hypothesis represents one of the first attempts to explain FDI flows. This hypothesis postulates that capital flows from countries with low rates of return to countries with high rates of return move in a process that leads eventually to the equality of *ex ante* real rates of return. The rationale for this hypothesis is that firms considering FDI behave in such a way as to equate the marginal return on and the marginal cost of capital. The hypothesis obviously assumes risk neutrality, making the rate of return the only variable upon which the investment decision depends. Risk neutrality in this case implies that the investor considers domestic investment and FDI to be perfect substitutes, or in general that direct investment in any country, including the home country, is a perfect substitute for direct investment in any other country.³⁴

³⁴ Risk neutrality implies that investors do not require a risk premium to be persuaded to take on a foreign investment project. In other words, investors who are risk neutral are indifferent between domestic and foreign projects if they produce the same return. On the other hand, risk aversion implies that investors require a risk premium to choose a foreign project such that the rate of return on the foreign project is higher than the rate of return on the domestic project by an amount that is equal to the risk premium.

To test this hypothesis, therefore, one may examine the relationship between relative rates of return in a number of countries and the allocation of FDI among them. Most of the empirical studies aimed at testing this hypothesis failed to provide supporting evidence, as documented by Agarwal (1980). One problem with the differential rates of return hypothesis is that it is not consistent with the observation that countries experience inflows and outflows of FDI simultaneously. This is because a rate of return differential implies capital flows in one direction only, from the low-rate country to the high-rate country, and not vice versa.

The validity of the differential rates of return hypothesis can be questioned on the theoretical grounds. First, MNCs may indulge in FDI for reasons other than profit, particularly in the short run and medium run. For example, the objective may be to maximize sales revenue in accordance with market penetration objective. Or the objective may not be purely financial, but rather logistical and operational, such as the desire to circumvent trade barriers. In general, MNCs are faced with a multiplicity of objectives for their international operations, and these objectives are likely to change with the passage of time. More importantly, however, risk aversion implies that the FDI decision does not only depend on return, but also on risk. Instead of maximizing the rate of return *per se*, the objective could be to maximize the rate of return per unit of risk (or to minimize risk per unit of return). This loophole is plugged by the diversification hypothesis, which will be discussed next. Finally, the differential rate of return hypothesis does not explain why a firm indulges in FDI rather than portfolio investment.

4.2.2 The Portfolio Diversification Theory

When the assumption of risk neutrality is relaxed, risk becomes another variable upon which the FDI decision is made. If this proposition is accepted, then the differential rates of return hypothesis become inadequate, in which case we resort to the portfolio diversification hypothesis to explain FDI. The choice among various

projects is therefore guided not only by the expected rate of return but also by risk.³⁵ The idea of reducing risk via diversification that is relevant to portfolio investment is also used here. Because of risk aversion, a rate of return differential will not induce capital flows in one direction until the differential disappears via arbitrage. Rather, capital mobility will be constrained by the desire to minimize or reduce risk, which is achieved by diversification. The theoretical foundations of this hypothesis can be traced back to the theory of portfolio selection of Tobin (1958) and Markowitz (1959).

One way to test this hypothesis is to examine the relationship between the share of FDI going to a group of countries and the two decision variables: the rate of return, and risk as measured by the variance or the standard deviation of the rate of return. The results provided by studies involving empirical testing of this hypothesis offer only weak support, as documented by Agarwal (1980). However, it remains true that the diversification hypothesis, which takes risk into account, is superior to the differential rates of return hypothesis, for the following reasons. First, the diversification hypothesis offers the main advantage that it can be generalized. Second, it offers a plausible explanation for cross-investment between countries and industries (Agarwal, 1980). Third, it considers risk, which constitutes a very important element in FDI decisions.

Like the differential rates of return hypothesis, the portfolio diversification hypothesis does not explain why MNCs are the greatest contributors to FDI, and why they prefer FDI to portfolio investment. One explanation, perhaps, is financial market imperfections. In the case of developing countries, financial markets are not only imperfect but also rudimentary, making portfolio investment less attractive than FDI. Another factor, of course, pertains to the very character that distinguishes FDI from portfolio investment: the degree of control. MNCs prefer FDI over portfolio investment because FDI gives more control over foreign investment (Moosa, 2002, 2003).

³⁵ Risk in this context includes, *inter alia*, foreign exchange risk and country risk.

4.2.3 The Market Size Theory

According to the market size hypothesis, the volume of FDI in a host country depends on its market size, which is measured by the sales of a MNC in that country, or by the country's GDP (that is, the size of the economy).³⁶ The market size is a measure of market demand in the country. This is particularly so for the case of *import-substituting FDI*. As soon as the size of the market of a particular country has grown to a level warranting the exploitation of economies of scale, the country becomes a potential target for FDI inflow.

One way to test the market size hypothesis is to find out whether or not the share of FDI of a given country going to a group of host countries is correlated with the individual income level of the host country. The empirical studies using this testing methodology seem to support the hypothesis that higher levels of sales and the host country's income are related positively to FDI. A number of survey studies have also dealt with market size as a determinant of FDI. Most of the survey studies have produced results supporting the relationship between FDI on the one hand, and the sales of foreign subsidiaries and / or GDP on the other. However, there is no obvious foundation for using the country's GDP. The relevance of GDP as a measure of potential market size does not have much theoretical foundation, but it has been used in empirical studies on FDI. Agarwal (1980) warns of the hazards of interpreting the significance of this relationship, for the following reasons:

- (i) The relationship is based on the assumptions of the neoclassical theories of domestic investment that are invariably unrealistic.

³⁶ Agarwal (1980) distinguishes between the market size hypothesis and the output hypothesis, depending on whether the market size is measured by sales in the host country or by the country's GDP. He argues that the output hypothesis is applied to the micro level, postulating a positive relationship between the FDI of a firm in a particular host country and its output or sales in that country. The market size hypothesis, he argues, applies to the macro level. In this case FDI is related positively to market size proxied by GDP. It seems the only difference is that between the total market and the market for the investing firm's products (its market share).

- (ii) Market size is likely to influence the FDI undertaken to produce goods for consumption in the host country, and not the FDI aimed at exports. In practice, it is rather difficult to distinguish between various kinds of FDI, for statistical reasons.
- (iii) While GDP and FDI are highly correlated, this says nothing about the direction of causality.
- (iv) Since this hypothesis is based on neoclassical domestic investment theories, investment should be defined as including expenditure on plant and equipment only. But statistics on FDI do not distinguish between expenditure on plant and equipment and other forms of investment such as inventory and financial assets.
- (v) Statistics on output (GDP and related measures) typically are subject to significant measurement errors, particularly in developing countries.
- (vi) The decisions of a firm regarding initial FDI and expansionary FDI are likely to be guided by different considerations.

The majority of empirical studies of the determinants of FDI include some measures of market size in the host country, typically using real GDP as a proxy. Moore (1993), Bajo-Rubio and Sosvilla-Rivero (1994), and Wang and Swain (1995) all used real GDP in their empirical models and found it to be significant determinant of FDI. But in a study based on Australian data, Yang *et al.* (2000) failed to find a relationship between FDI flows and either contemporaneous or lagged change in GDP. Other proxies for market size have been used, such as the growth rate of real GDP (Wang and Swain, 1995). Real GDP per capita was used by Schneider and Frey (1985), and Campos and Kinoshita (2003). Lipsey (2000) used size and growth variables to explain FDI inflows, FDI outflows, and net FDI flows and stocks. The explanatory, size-related variables he uses are nominal GDP, growth in real GDP per capita, real GDP per capita, and gross fixed capital formation as a percentage of GDP.

Love and Lage-Hidalgo (2000) used GDP per capita as an explanatory variable (a proxy for domestic demand) in an equation designed to explain US FDI in Mexico. The variable turned out to be a significant determinant of FDI flows, a result that they took to imply support for the market size hypothesis.

Finally, size does matter, according to a survey by *A. T. Kearney*, the results of which were summarized in the *FDI Confidence Index 2003*. The top three countries favoured for investment turned to be the U.S.A., China, and Brazil. The ranking of countries from the top to the bottom of the list did not exactly match the ranking of countries in terms of size, because of the influence of the other determinants of FDI.

4.2.4 The Growth Prospects Theory

The rate of growth of a country's economy would seem to be important for attracting FDI, as a fast growing economy in the present would indicate future market potential. Wang and Swain (1995) have used the growth rate of real GDP to explain FDI in China and Hungary. Yang *et al.* (2000, pp.47-8) argue that the growth rate of GDP may be regarded as a measure of the future potential of the host country's domestic market, while per capita income may be used to represent the level of the host country's economic development. Lipsey (2000) uses, also, size and growth variables to explain FDI inflows and outflows, and net FDI flows and stocks. Schneider and Frey (1985), Gastanaga, Nugent and Pashamova (1998), Tobin and Rose-Ackerman (2005), and Neumayer and Spess (2005) have used also the growth rate of real GDP as a proxy for future market potential in their empirical analysis.

4.3 Theories Assuming Imperfect Markets

Hymer (1960) was the first economist to point out that the structure of the market and the specific characteristics of investing firms could explain FDI. The market imperfection hypothesis postulated that FDI is the direct result of an imperfect global market environment. Kindelberger (1969) refined and publicized Hymer's ideas.

Several models fall under this heading and these will be discussed in turn.

1. The Industrial Organization Theory
2. The Internalization Theory
3. The Location Theory
4. The Eclectic Theory
5. The Investment Development Path (IDP)
6. The Product Life-Cycle Theory
7. The Oligopolistic Reactions Theory / or Strategic Competition

4.3.1 The Industrial Organization Theory

Hymer (1960) developed the industrial organization hypothesis, which was extended by Kindelberger (1969), Caves (1971) and Dunning (1988a).³⁷ According to this hypothesis, when a firm establishes a subsidiary in another country it faces several disadvantages in competing with local firms. These disadvantages emanate from differences in language, culture, the legal system and other inter-country differences. For example, MNCs may have to pay higher wages in the host country than do local firms, because employment with them is regarded by local workers as being more risky. If, in spite of these disadvantages, MNCs are able to compete with local firms that have a much better knowledge of the local market and environment, it is because MNCs present some sort of compensatory advantage, such as:

- (i) imperfect competition, for example, as a result of a product differentiation;
- (ii) imperfect competition in the factor market, for example, access to patented or proprietary knowledge, discrimination regarding access to capital, or skill advantages;
- (iii) internal or external economies of scale, including those arising from vertical integration;
- (iv) government intervention, i.e., restriction on imports.

³⁷ Hymer's work first appeared in his Ph.D. dissertation in 1960. In 1976 the dissertation was published as a book.

With these advantages MNCs would prefer to supply the foreign market by way of direct investment instead of through (direct) exports. In an analogous manner, foreign firms would not be willing to license production to local firms if the local firms were uncertain about the value of the license or if the know-how transfer costs (property rights) were too high.

Kindelberger (1969) slightly modified Hymer's analysis. Instead of MNC behavior determining the market structure, it is the market structure – monopolistic competition – that will determine the conduct of the firm, by internalizing its production. According to Kindelberger, the comparative advantage has to be firm-specific, it must be transferable to foreign subsidiaries, and it should be large enough to overcome these disadvantages. Caves (1971) also developed a similar analysis, in which structure dictates conduct. FDI will be made basically in sectors that are dominated by oligopolies. If there is product differentiation, horizontal investments may take place, i.e., in the same sector. If there is no product differentiation, vertical investments will be made, in sectors that are behind in the productive chain of firms. The existence of FDI is further related to trade barriers, as a way of avoiding uncertainties in supplies, or as a way of imposing barriers to new firms on the external market.

Lall and Streeten (1977) argue that the matter is just not one of the preferences of the MNC, since many of the advantages or the intangible assets cannot be sold to other firms, either because they are inherent in the organization or because they are difficult or impossible to define, value and transfer. Intangible assets that cannot be sold, even though the MNC may want to do so, include the MNC's managerial and organizational capabilities, the experience and the spirit of its executives, its standing in financial markets, and its contacts with various officials and other firms (Lall and Streeten, 1977, p.36). It is these firm-specific advantages that explain why a firm can compete successfully in a foreign market. This approach has been used by Graham and Krugman (1991) to explain the growth of FDI in the USA.

Markusen (1984, 2002), Helpman (1984), Helpman and Krugman (1985), and Markusen and Venables (1998) developed a model along the same line, comparing the

importance of multinational firms activity to trade. The most critical issue about the relationship between FDI and trade is whether they are complements or substitutes. Whether FDI and trade are complements or substitutes depends on whether FDI is horizontal – as in Markusen (1984, 2002), or Vertical – as in Helpman (1984) and Helpman and Krugman (1985). Whether FDI is horizontal or vertical depends on various country characteristics. For example, if countries have significantly different factor endowments, then vertical FDI dominates. On the other hand, horizontal FDI dominates if countries are similar in size and relative endowments, and if trade costs are moderate to high.

In horizontal FDI, firms serve foreign markets by setting up plants there to provide identical goods (Markusen 1984). Hence, exports from the source country to the host country will decline, implying that they are substitutes. In vertical FDI, MNCs separate different production stages geographically across countries, to take advantage of lower factor prices (Helpman 1984). Specifically, the unskilled-labour intensive stages of production are located in a low-wage country. In this case, there will be an increase in the exports of final products from the host country (the cheap labour country), while there is also an increase in the exports of intermediate products by the MNC (from the source country) to the host country where the subsidiary is located. Hence, FDI and trade are complements in this case.

A parallel path of developing ever-more sophisticated models of MNC behavior was undertaken by James Markusen and co-authors in the 1990s. Building first off of Markusen (1984) to clarify the horizontal MNCs, a “*knowledge-capital model*” was developed in Markusen, Venables, Eby-Konan and Zhang (1996) and Markusen (1997, 2002) that unified horizontal and vertical motivations of MNCs. These Markusen models have typically been two-country, two-factor, and two-sector models. The imperfectly competitive sector is Cournot oligopolists and there is added complexity in assumptions of differing factor requirements for headquarter services of MNCs, production, and transportation of goods. An important result of these models is that factor endowments may matter significantly for FDI patterns, in addition to the

traditional gravity variables, such as trade and FDI frictions (that may be proxied by distance) and parent and host market sizes (proxied by GDP).

Car, Markusen and Maskus (2001) provided the first empirical examination of the “*knowledge-capital model*” hypotheses. From numerical simulations of the model they conjecture an empirical specification where affiliate sales in a host country is a function of GDP of the two countries, trade costs of the two countries, FDI costs, and differences in factor endowments between the parent and the host. The last term is labeled “skill differences” as the prediction comes from a two-factor model of skilled and unskilled labour. The complexity of the model gives rise to nonlinearities in the simulated results which the authors capture with a GDP sum and GDP difference term and interactions between the skill difference, the host country’s trade costs, and the GDP difference. In rough terms, the horizontal side of the model predicts a positive coefficient on GDP sum term, a negative coefficient on the GDP difference term, and a positive sign on the host trade cost variable. The identifying coefficient on the vertical side is on the skill difference variable which should be positive. The authors use a panel dataset of bilateral country-level US outbound and inbound affiliate sales from 1986-1994, and find empirical evidence for both the horizontal and vertical motivations for FDI, consistent with this unified “*knowledge-capital model*”.

Along the industrial organization line of thinking, for reasons endogenous to the firm, there are studies developed by Graham (1978, 1998, and 2000). According to these studies, the emergence of MNCs is a result of oligopolistic interaction as firms grow, as a risk reduction strategy. In his recent study, Graham, employs “*game theory*” in order to develop a simplified two-country, one sector model to analyze the entrance of a firm in a foreign country, and to study the reaction to the entrance of a firm from another country in the local market. The relevant point here is that the rivalry between firms is an important dimension which is not always considered in MNCs. One problem with this approach, however, is that it fails to explain why the firm does not utilize its advantages by producing in the home country and exporting abroad, which is an alternative to FDI.

According to Kindelberger, firms will be inclined to indulge in FDI in preference to exports if they operate with minimum costs at home, in which case additional production for exports would move them into a segment of rising costs. Moreover, lower production costs abroad may be achieved because of the procurement of cheap raw materials, an efficient transportation network, superior managerial skills, non-marketable technology, and substantial investment in R&D in the home country. While the industrial organization hypothesis explains why firms invest in foreign countries, it does not explain why firms choose to invest in country A rather than country B. The location hypothesis, which will be considered shortly, seeks to provide an answer to this question.

4.3.2 The Internalisation Theory

According to the internalisation hypothesis, FDI arises from efforts by firms to replace market transactions with internal transactions. This idea is an extension of the original argument put forward by Coase (1937) that certain marketing costs can be saved by forming a firm.³⁸ For example, if there are problems associated with buying oil products on the market, a firm may decide to buy a foreign refinery. These problems arise from imperfections and failure of markets for intermediate goods, including human capital, knowledge, marketing and management expertise. The advantages of internalisation are the avoidance of time lags, bargaining and buyer uncertainty. Indeed, the main motive for internalisation is the presence of externalities in the goods and factors markets.

Buckley and Casson (1976) suggest that if markets in intermediate products are imperfect, firms have an incentive to bypass them by creating internal markets, such that the activities linked by the markets are brought under common ownership and control. The internalisation of markets across national boundaries leads to FDI, and this process continues until the marginal benefits and marginal costs are equal.

³⁸ Coase considered four main types of cost (i) the cost of discovering the correct price; (ii) the cost of arranging the contractual obligations of the parties in an exchange transaction; (iii) the risk of scheduling of goods and inputs; and (iv) the taxes paid on exchange transactions.

The internalisation hypothesis explains why firms use FDI in preference to exporting and importing from foreign countries. It also explains why they may shy away from licensing. Because of the significant time lags and transaction costs associated with market purchases and sales, firms replace some of the market functions with internal processes; that is, with intra-firm transactions. Moreover, the internalisation process eliminates uncertainty. For example, a steel firm may face considerable supply uncertainties and transportation costs as it has to purchase iron ore in the open market, most probably from different parts of the world. However, when this firm acquires a foreign mining company, the internalisation of the market process, involving the purchase of iron ore and shipping, eliminates uncertainty.

It is sometimes claimed that the internalisation hypothesis represents a general theory of FDI, whereas other theories are subsets of the general theory of internalisation. Petrochilos (1989) argues that, while it is clear that MNCs do bypass the market for intermediate products through FDI, it is not certain that the motive for internalisation is the external market's inefficiency in terms of high transaction costs and longer time lags, or anything else. He further suggests that a stronger argument is the one put forward by Dunning (1977) that firms want to retain the exclusive right of using the innovations generated by their R&D efforts. Buckley and Casson (2000) present what they call a formal extension of the internalisation hypothesis by providing a model that attempts to explain variations in the entry mode.

Thus, the internalisation theory (Rugman, 1986) explained FDI in terms of a need to internalise transaction costs so as to improve profitability and explained the emergence of "efficiency-seeking" FDI. However, there are two problems with the internalisation hypothesis. First, Rugman (1986) argues that the hypothesis is so general that it has no empirical content. Second, Buckley (1988) argues that the hypothesis cannot be tested directly. The statistical tests are bound to be based on simplifying assumptions, and boil down to the conclusion that the process of internalisation is concentrated in industries with relatively high incidence of R&D expenditure (Buckley and Casson, 1976). However, the evidence shows that the pattern of FDI across countries is broadly consistent with this hypothesis.

4.3.3 The Location Theory

According to this hypothesis, FDI exists because of the international immobility of some factors of production, such as labour and natural resources. This immobility leads to location-related differences in the cost of factors of production. Investors choose a location of investment according to the expected profitability associated with each location. Profitability of investment is in turn affected by various country-specific factors and the type of investment motives (Dunning, 1993a). For example, *market-seeking* investors will be attracted to a country with a large and fast-growing local market. *Resource-seeking* investors will look for a country with abundant natural resources. *Efficiency-seeking* investors will weigh more heavily geographical proximity to the home country, to minimize transportation costs. Thus, the location of FDI is closely related to a country's *comparative advantage*, which in turn affects the expected profitability of investment.

(i) Labour Cost, Productivity, and Quality

One form of the location-related differences in the costs of factors of production is the locational advantage of low wages. Thus, the level of wages in the host country relative to wages in the home country is an important determinant of FDI. Availability of low-cost labour is a prime driver for export-oriented FDI. That is why countries such as India attract labour-intensive production (for example, footwear and textiles) from high-wage countries. It is also why MNCs wanting to establish production facilities in North America would choose Mexico in preference to Canada. Of course, high wages may be indicative of high quality of labour, in which case the relationship between low wages and FDI does not hold. For example, activities such as banking and finance, and R&D, are not relocated to countries where people working in these fields earn low wages. What matters in this case is the quality of labour (Wheeler and Mody, 1992). It is important to bear in mind that differences in cross-country labour productivity can be so significant that consideration of wage rates alone is not a reliable variable. Petrochilos (1989) points out that cross country differences in labour productivity can explain partially why the bulk of FDI goes to high-wage industrial countries.

Evidence on the hypothesis that cheap labour attracts FDI is mixed. For example, Schneider and Frey (1985), Moore (1993), Campos and Kinoshita (2003) found that lower cost sites attract FDI, as seen from the negative sign on labour cost. That is a rise in the host country's wages (given wage rates in the source country) would discourage FDI flows. On the other hand, other researchers found no significant effect or even the reverse effect. These researchers include Wheeler and Mody (1992), Yang et al. (2000), Bajo-Rubio and Sosvilla-Rivero (1994), Wang and Swain (1995), and Barrell and Pain (1996). Foreign investors are concerned not only with the cost of labour, but also with its "quality". A more educated labour force can learn and adopt new technology faster, and the cost of training local workers would be less for investing firms. Many empirical studies tested for the impact of labour quality, using the general secondary education enrolment rate (Campos and Kinoshita, 2003).

(ii) Labour Market Flexibility

Another factor that pertains to the labour market is labour disputes, which should have an adverse effect on FDI inflows. The adverse effect on FDI would depend on two characteristics of industrial disputes: incidence and severity. Moore (1993) and Tcha (1998) experimented with variables representing disputes and came up with contrasting results. A related factor would be the extent of unionisation in the host country. It is now conventional wisdom that MNCs prefer flexible non-unionised labour markets, and when unionisation is present, decentralized firm-level wage bargaining processes over centralized ones. The underlying idea is that unionisation leads to higher labour costs.

(iii) Natural Resource Availability

Locational advantages not only take the form of low wages; they are also applicable to other factors of production. For example, a firm may indulge in FDI by building a factory in a country where it is cheap to generate hydroelectric power. Similarly, a factory could be located near a copper mine in the host country if copper is an important input in the production process. This is a locational advantage because significant savings can be made on the cost of shipping copper from where it is produced to where it is used.

(iv) Cost of Capital

Capital may also be the underlying factor of production, particularly if capital markets are segmented. The idea here is that FDI will flow to countries where the cost of capital is low. For example, one of the explanatory variables used by Love and Lage-Hidalgo (2000) to explain FDI flows from the USA to Mexico is the difference between the US and Mexican costs of capital. A perverse result was obtained, showing that the effect of the differential cost of capital runs in the opposite direction from that predicted by theory.

4.3.4 The Eclectic Theory (OLI Paradigm)

The seeds of the eclectic theory of international economic involvement were first sown by John Dunning in 1976 in a presentation to a Nobel Symposium in Stockholm on The International Allocation of Economic Activity, the proceedings of which were published by Ohlin *et al.* (1977). The theory was an intellectual response to the growing role of international production and multinational corporation (MNC) in the world economy, and to developments within theory itself that led a scholar to refine the theoretical structures of economic analysis (Tolentino, 2003).

In explaining the growth and composition of international production and the MNC, the emergence of the eclectic theory in 1976 was a by-product in the evolution of at least six main branches of economic theory: the macroeconomic theories of trade, international capital movements and location, the mesoeconomic theories of industrial organisation and innovation, and the microeconomic theories of the firm (Dunning *et al.*, 1986). The synthesis of the *ownership*, *internalisation* and *location* factors in the eclectic theory drew on macroeconomic theories in the elaboration of the concept of location advantages, and on mesoeconomic and microeconomic theories in the development of the concepts of ownership and internalisation advantages. It is partly because it draws upon a variety of theoretical approaches in economics and partly because it explains a number of possible channels of international economic involvement, each of which is determined by a number of factors, that the theory (or

the paradigm as it came to be known since the mid-1980s) is known as *eclectic* (Dunning 1977, 1981a, 1988b).

The elaboration of the eclectic theory emerged from a required shift in the emphasis of neoclassical economic theory on location factors towards newer theories incorporating factors associated with the ownership and organisation of economic activity in an attempt to address the changing patterns of international economic transactions after the Second World War. The central thesis of the eclectic theory, or the eclectic paradigm since the mid-1980s, has always been that channels of international economic involvement or international economic transactions or the international competitiveness of a country's output of goods and services is determined by the possession of ownership-specific endowments of its enterprises, by the ability and desire of these enterprises to internalise these advantages or the markets to these advantages, and by comparative location endowments of home *vis-à-vis* foreign countries which are exogenous to firms (Dunning, 1977)

The key propositions of the eclectic paradigm

Dunning (1977, 1979, 1980, 1988a, 1993a, 1995, 2000a, and 2003) developed and stated the propositions of the eclectic paradigm by integrating the industrial organization hypothesis, the internalisation hypothesis, and the location hypothesis. The subject he explained is the extent and pattern of international production, i.e. production financed by FDI and undertaken by MNCs. The paradigm affirms that, at any given moment of time, this will be determined by the configuration of three sets of forces:

1. The (net) *competitive advantages* which firms of one nationality possess over those of another nationality in supplying any particular market or set of markets. These advantages may arise either from the firm's privileged ownership of or access to, a set of income-generating assets, or from their ability to coordinate these assets with other assets across national boundaries in a way that benefits them relative to their competitors, or potential competitors.

2. The extent to which firms perceive it to be in their best interests to *internalise* the markets for the generation and or the use of these assets, and by so doing add value to them.
3. The extent to which firms choose to *locate* these value-adding activities outside their national boundaries.

The eclectic paradigm further asserts that the significance of each of these advantages and configuration between them is likely to be context specific, and in particular, is likely to vary across industries (or types of value-added activities), regions or countries (the geographical dimension) and among firms. Thus there are likely to be country-specific differences in the ownership advantages of (say) Korean firms compared with (say) Canadian firms. The extent of market failure influencing whether or not the market for technology is internalised is likely to be different in (say) the wood and pulp industry than in (say) the semi-conductor industry; while the relationship to the comparative locational advantages of Thailand and Taiwan as a manufacturing base for motor vehicles may be differently regarded by (say) the Toyota than (say) the Honda Corporation (Dunning, 2000a).

Dunning (2003) argues that the eclectic paradigm is best regarded as a framework for analysing the determinants of international production rather than as a predictive theory of the MNC. He asserts that no single theory can be expected to satisfactorily encompass all kinds of foreign-owned value-added activity because the motivations for, and expectations from, such production vary a great deal. The variables necessary to explain import-substituting FDI are likely to be different from those that explain resource-oriented FDI; and both are likely to be different from those that explain rationalized or strategic asset-seeking investment. In formulating operational hypotheses about the relationship between individual OLI variables and the level and pattern of international production, it is important to specify the context in which this relationship is being examined. But, as Dunning has opined always that no single theory of international trade can satisfactorily explain all forms of cross-border transactions in goods and services.

Moreover, the eclectic theory aims at answering the following questions. First, if there is demand for a particular commodity in a particular country, why is it not met by a local firm producing in the same country, or by a foreign firm exporting from another country? Second, suppose that a firm wants to expand its scale of operations, why does not do so via other channels? These other channels include the following: (i) producing in the home country and exporting to the foreign country; (ii) expanding into a new line of business within the home country; (iii) indulging in portfolio investment in the foreign country; (iv) licensing technology to foreign firms that carry out production. It seems that the answer to these questions is that a foreign subsidiary can out-compete other potential suppliers in the foreign market, and that FDI is more profitable than other means of expansion. Another question arises: why is this case? The eclectic theory attempts to answer this question and the related questions. Therefore, according to the eclectic paradigm, three conditions must be satisfied if a firm is to engage in FDI:

1. First, it must have a *comparative advantage* over other firms arising from the ownership of some intangible assets. These are called *ownership advantages*, which include things like the right to a particular technology, monopoly power and size, access to raw materials, and access to cheap finance.
2. Second, it must be more beneficial for the firm to use these advantages rather than to sell or lease them. These are the *internalisation advantages* that refer to the choice between accomplishing expansion within the firm or selling the rights of the means of expansion to other firms.
3. Third, it must be more profitable to use these advantages in combination with at least some factor inputs located abroad. If this is not the case, then exports would do the job. These are the *locational advantages*, which pertain to the question of whether expansion is best accomplished at home or abroad.

How the eclectic theory explains FDI?

Suppose that there is demand for a particular product in which a particular domestic firm has an ownership advantage. What happens depends on the internalisation and locational advantages. So, there are the following possibilities:

1. If there are no internalisation gains, the firm will license its ownership advantage to another firm, particularly if locational factors favour expansion abroad.
2. If there are internalisation gains and if locational factors favour home expansion, the firm expands at home and exports.
3. If there are internalisation gains and if locational factors favour foreign expansion, FDI will take place and an MNC will emerge.

Casson (1990) seems to have been thinking along similar lines when he put forward his 'integrated theory of FDI', which is the result of integrating the theory of international capital markets, the theory of the firm, and the theory of trade. He argues that the integration of the theory of international capital markets with the theory of the firm is quite straightforward. He also argues that the integration of the theory of international capital markets with the theory of trade poses no major problems in principle. However, he argues that the integration of the theory of the firm with trade theory is more problematic. The integration of these theories, Casson argues, provides answers to a complex set of questions pertaining to FDI.

4.3.5 The Investment Development Path (IDP)

One of the first applications of the eclectic paradigm was to examine its relevance in explaining the changing international position of countries as they passed through different stages of development. The concept of the *investment development cycle* (or path) was first put forward in 1975 and has since gone through various iterations (e.g.

Dunning 1981b, 1988a, 1993a, 2003; Dunning and Narula 1996; Narula 1996; Dunning *et al.* 2001).

The basic hypothesis of the *investment development path* (IDP) is that as a country develops, the configuration of the OLI advantages facing foreign-owned firms that might invest in that country and of its own firms that might invest overseas, undergoes change, and that it is possible to identify both the conditions making for the change and their effect on the trajectory of the country's development. The concept also suggests the ways in which the interaction between foreign and domestic firms might itself influence the country's investment path; but only recently has this aspect been incorporated in the literature. The IDP identifies several stages of development a country might pass through. The first stage is one of pre-industrialisation, in which a country is presumed to have no inbound or outbound investment, in the first case because it has insufficient locational attractions, and in the second because its own firms possess few or no ownership advantages. Depending on its resources, government policy, the organisation of activity, and the strategy of firms, the OLI configuration changes so as first to attract inward investment in resource-based sectors, in the traditional and labour-intensive manufacturing sectors, in trade and distribution, in transport and communications, construction and perhaps in tourism.

Depending on the extent to which the country is able to create a satisfactory legal system, commercial infrastructure and business culture, and to provide the business sector with the transport and communications facilities and human resources they need; and depending on its government's policy toward inward direct investment (cf. Japan, which largely disallowed such investment in the 1960s, with Germany, which adopted an open-door policy toward it), its locational attractions will increase, and because foreign firms are likely to have more experience in manufacturing the goods and services now likely to be demanded (and have probably penetrated the local market by imports in any case) inward investment will continue to grow. Gradually it, and any investment by indigenous firms, will affect both supply and demand conditions for the products supplied by foreign firms and their desire to internalise their markets for the competitive advantages.

The improvement in the L advantages of countries may also help indigenous firms to upgrade their own competitive advantages. The growth of Japanese outward investment and, more recently, that of several developing countries is entirely consistent with a reconfiguration of the OLI advantages of indigenous firms brought about by the development process. Once again, changes in the value of both exogenous and endogenous variables affect each of these components. In this early stage, the role of the home government is especially important. In various of his writings, Terutomo Ozawa (1989, 1992 and 1996), has demonstrated the critical role of the Japanese government in influencing the ability of Japanese firms both to generate competitive advantages relative to their competitors, and to locate their value-added activities outside of Japan. It has also affected the strategy of Japanese companies themselves.

As countries move along their development path, the OLI configuration facing outward and inward investors continue to change. Some foreign (and domestic) firms, which found a country attractive to invest in because of its low labour costs or plentiful natural resources, no longer do so. In other cases, its L advantages have become more attractive as an indigenous technological infrastructure and pool of skilled labour is built up. This, in turn, makes it possible for domestic firms to develop their own O advantages and begin exporting capital. Next, as countries reach some degree of economic maturity, the OLI configuration facing their own firms may be such that their propensity to engage in outward direct investment exceeds that of foreign-based firms to engage in inward investment. Again, whether or not this happens rests on the strategy of firms and the policies of national governments to generate the competitive (and especially innovatory) advantages of their own firms and to make their own locations attractive to both domestic and foreign investors.

The final stage of the IDP occurs when there is a fluctuating balance between outward and inward direct investment. This arises when there is some degree of convergence between the level of development and the economic structure of countries, and also where firms engage in FDI, not only to exploit their existing O advantages in a foreign location, but also to augment these advantages by acquiring complementary assets or new markets. In the mid-1990s, this stage has been reached

by the more advanced industrial economies, whose wealth creation and productivity growth are increasingly based on their ability to harness and effectively utilise all forms of knowledge or intellectual capital. At this stage too, the role of government is often of critical importance in influencing the quality of L specific advantages; and in setting the competitive environment for their own firms to effectively exploit the opportunities offered by the global economy (Dunning and Narula 1996; Narula 1996). The illustration of the investment development path (IDP) introduces a dynamic element into the eclectic paradigm. Moreover, the concept of IDP is very relevant in explaining the recent growth of outward investment from Third World countries, especially from South Korea, Singapore, Taiwan, and Mexico (Dunning *et al.* 2001).

Andreff and Andreff (2006) in studying competition between incumbent and new European Union members for foreign direct investment utilized the IDP model and examined outward FDI from new European Union members (CEECs) over the period 1995-2003. The empirical result revealed that outward FDI from CEECs does not exhibit yet a similar competitive threat to the EU. According to the authors, a lower technological level at the moment is a handicap for their outward FDI.

4.3.6 The Product Life Cycle Theory

This hypothesis was developed by Vernon (1966) to explain the expansion of US MNCs after the Second World War. According to this hypothesis, *“products go through a cycle of initiation, exponential growth, slowdown and decline – a sequence that corresponds to the process of introduction, spread, maturation and senescence”* (Vernon, 1971).

The hypothesis postulates that firms indulge in FDI at a particular stage in the life cycle of the products that they initially produced as innovations. The following three stages are identified:

1. The initial production takes place at home, close to the customers and because of the need for efficient co-ordination between R&D and production units.

During this stage of the product life cycle the demand for the new product is price inelastic, and so the innovating firm can charge a relatively high price. As time passes, the product is improved, based on feedback from customers. Up to this point, demand has come from customers living in the home country.

2. The second stage is marked by the maturity and export of the product to countries having the next-highest level of income as demand emerges in these developed countries. As this demand continues to grow and competition emerges, the innovative firm resorts to FDI in these countries to meet local demand. At this stage, the home country is a net exporter of the product, while foreign countries are net importers.
3. The third stage is characterized by a complete standardization of the product and its production process, which is no longer an exclusive possession of the innovating firm. At this stage, price competition from other producers forces the innovating firm to invest in developing countries, seeking cost advantages. The home country starts to import the product from both domestic and foreign firms based in foreign countries. The home country becomes a net importer, while foreign countries are net exporters.

Hence, FDI takes place as the cost of production becomes an important consideration, which is the case when the product reaches maturity and standardization. FDI is thus a defensive move to maintain the firm's competitive position against its domestic and foreign rivals. The product life cycle hypothesis predicts that, over time, the home country where the innovative product first appeared switches from an exporting to an importing country. This prediction is consistent with the pattern of dynamic changes observed for many products. For example, personal computers were first developed by US firms (such as IBM and Apple Computers) and exported to foreign markets. When personal computers became standardized, the USA became a net importer from producers based in Japan, Korea and Taiwan. The

exporters include foreign firms as well as subsidiaries of US companies located in these countries.

It is noteworthy that Vernon's original theory was developed in the 1960s, when the USA was the unquestioned leader in R&D and product innovation. Now, product innovation takes place outside the USA, and new products are introduced simultaneously in many advanced countries. Thus, production facilities may be located in several countries right from the beginning, and the international system of production is becoming too complicated to be explained by a simple version of the product life cycle hypothesis. Vernon (1979) admits this by noting that, since the income and technological gaps between the USA and other industrial countries have narrowed, the simple product life cycle hypothesis has become less plausible. This is why the hypothesis has been extended to take into account not only labour costs but also other factor costs, and has been generalised to apply to the FDI of all developed countries. It should be borne in mind that the hypothesis was based originally on the US experience, and offered a useful explanation for the interaction between production, exports and FDI during the 1950s and 1960s. Petrochilos (1989) points out that this hypothesis is useful because it offers another interpretation of FDI, particularly for manufactured products that are characterized by advanced technology and high income elasticity of demand.

4.3.7 The Oligopolistic Reaction Theory

Knickerbocker (1973) suggests that, in an oligopolistic environment, FDI by one firm triggers a similar action by other leading firms in the industry in an attempt to maintain their market shares. He suggests that oligopolistic reaction increases with the level of concentration, and decreases with the diversity of the product. Lall and Streeten (1977) argue that the very structure of oligopolistic competition and equilibrium is such that none of the participants can afford to ignore what the others are doing. For example, a move by one firm to establish production facilities abroad may be interpreted by rivals to imply a threat to the status quo, thus inducing counter-moves. Vernon (1974) discusses three kinds of oligopolies (innovative, mature, and

senescent) and the different pressures they generate for the firms concerned. Agarwal (1980) argues that an implication of the oligopolistic reaction hypothesis is that the process of FDI is self-limiting, since the invasion of each other's home market leads to an increase in competition and a decline in the intensity of oligopolistic reaction. This implication, however, is incompatible with stylised facts. While it has led to increased competition in many industries, this increase has not resulted in a corresponding reduction in FDI. This hypothesis also fails to identify the factors that trigger the initial investment.

4.4 Other Theories of Foreign Direct Investment

Four Theories are presented under this heading:

1. The Internal Financing Theory
2. The Theory of Currency Area and the Effect of Exchange Rates
3. The Theory of Diversification with Barriers to International Capital Flows
4. The Kojima Theory

4.4.1 The Internal Financing Theory

Internal financing refers to the utilization of profit generated by a subsidiary to finance the expansion of FDI by a MNC in the country where the subsidiary operates. This hypothesis postulates that MNCs commit a modest amount of their resources to their initial direct investment, while subsequent expansions are financed by reinvesting profits obtained from operations in the host country. It therefore implies the existence of a positive relationship between internal cash flows and investment outlays, which is plausible because the cost of internal financing is lower. According to Froot and Stein (1991), one reason why external financing is more expensive than internal financing is informational imperfections in capital markets. The hypothesis seems to be more appropriate for explaining FDI in developing countries (at least) for two reasons: (i)

the presence of restrictions on the movement of funds; and (ii) the rudimentary state and inefficiency of financial markets.

Hartman (1985) provides a tax-based explanation as to why MNCs like internal financing. He argues that, because repatriated earnings of the subsidiary are typically the source of the tax liability in the home country, income tax should affect FDI differently, depending on the required transfers of funds from the subsidiary to the MNC. Hence, a firm should finance FDI out of foreign earnings to the greatest possible extent. That is, a firm's required foreign return is set at the point at which desired FDI just exhausts foreign earnings. As a result, Hartman draws a distinction between mature and immature foreign projects (or operations or subsidiaries), the latter being dependent on financing by the MNC without making any remittances. Guy Stevens (1969 and 1994) tested it on a sample of 71 US foreign subsidiaries and failed to find supportive evidence. Agarwal (1980) concludes that there is some empirical support for this hypothesis in the sense that FDI is determined partly by the subsidiaries' internally generated funds.

4.4.2 The Currency Area Theory and the Effect of Exchange Rates

Aliber (1970, 1971) put forward a hypothesis that attempts to explain FDI in terms of the relative strength of various currencies. This hypothesis postulates that firms belonging to a country with a strong currency tend to invest abroad, while firms belonging to a country with a weak currency do not have such a tendency. In other words, countries with strong currencies tend to be sources of FDI, while countries with weak currencies tend to be host countries or recipients of FDI. This hypothesis is based on capital market relationships, foreign exchange risk, and the market's preference for holding assets denominated in strong currencies. Aliber argues that a MNC in a hard currency area is able, based on reputation, to borrow at lower rates in a soft currency country than can local firms. In essence, the crucial assumption is that there is bias in capital markets, which arises because an income stream located in a country with a weak currency is associated with foreign exchange risk. Hence, the view arises that a strong currency firm may be more efficient in hedging foreign exchange risk.

According to Lizondo (1991), the currency area theory cannot account for cross investment between currency areas, for direct investment in countries in the same currency area, and for the concentration of FDI in certain types of industries. Dunning (1973) suggests that the currency area hypothesis adds to the industrial organization hypothesis, because country risk affects the relationship between the investing firms and their competitors, though it does not supplant it. Additional evidence regarding the relationship between exchange rate levels and FDI was presented by Caves (1988). He argued that exchange rates have an impact on FDI inflows through two channels. First, changes in the real exchange rate modify the attractiveness of foreign investment by changing a firm's real costs and revenues. The net effect on FDI is ambiguous, depending on certain characteristics of the firm's activity, such as the share of imported inputs in total costs and the share of output that is exported. The second channel is associated with expected short-run exchange rate movements. A depreciation that is expected to be reversed will encourage FDI inflows to obtain a capital gain when the domestic currency appreciates.

A more elaborate theory based on capital market imperfections, with similar implications to those of the currency area hypothesis, was developed by Froot and Stein (1991). They argued that a low real value of the domestic currency may be associated with FDI inflows owing to informational imperfections in the capital market that cause firms' external financing to be more expensive than their internal financing. Since the availability of internal funds depends on the level of net worth, a real depreciation of the domestic currency that lowers the wealth of domestic residents and raises that of foreign residents can lead to foreign acquisition of some domestic assets. Their analysis of U.S. data indicates that FDI inflows into the U.S. are negatively correlated with the real value of the dollar. Moreover, other types of capital inflows have not shown a similar negative correlation, so that this relationship is a distinctive characteristic of FDI, as expected from the theory. Moreover, Froot and Stein (1991) provide an empirical evidence of increased inward FDI with currency depreciation through simple regressions using a small number of annual US aggregate FDI observations, Stevens (1998) finds it quite fragile to specification.

Changes in exchange rates are bound, in theory, to have an effect on FDI. First, a depreciation of the domestic currency makes domestic assets more attractive for foreigners, while foreign assets become more expensive for residents in the home country. Thus, FDI inflows will increase. This may therefore attract *resource-seeking* and *efficiency-seeking* FDI. Another reason exchange rates are important for FDI is that FDI can be viewed as an alternative to exports. Thus, if the domestic currency appreciates against foreign currencies, MNCs based in the home country would find it difficult to export, as domestic goods become less competitive. If the appreciation of the domestic currency persists, the MNC may find it useful to move abroad, resulting in a rise in FDI. In this case, FDI can be viewed as a measure taken to hedge economic exposure to foreign exchange risk. It must be borne in mind, however, that the relevant exchange rate in this case would be the real exchange rate, since it is the rate that determines competitiveness and economic exposure. Moreover, the relationship between FDI and the exchange rate cannot be contemporaneous, as it takes time between the appreciation of the domestic currency and the decision to expand FDI, unless the decision is based on expectation. Given that the real exchange rate is determined by the nominal exchange rate and relative inflation, the latter is a factor that influences FDI flows.

Benassy-Quéré, Fontagné, and Lahréche-Révil (2001) studied bilateral FDI stock from 17 OECD countries to 42 developing countries over the period 1984-1996. They argue that as far as FDI is concerned, both the *level* and the *volatility* of the exchange rate have to be taken into account, since they affect FDI. The relationship is, however, ambiguous and depends on the destination of the goods produced. The effect of the level of the exchange rate depends on the destination of the goods produced. If the investor aims at serving the local market, then FDI and trade are substitutes, in which case an appreciation of the currency of the host country attracts FDI inflows. Alternatively, if FDI is aimed at re-exports, then FDI and trade are complements. In this case, appreciation of the currency of the host country reduces FDI inflows through lower competitiveness. The same argument applies for the exchange rate variability.

In general, various studies have produced results showing that FDI is affected by exchange rates. Caves (1988), Brzozowski (2006) produced results showing significant negative correlation between the level of the exchange rate (both nominal and real) and inflows of FDI. Froot and Stein (1991) obtained results indicating that FDI inflows to the USA are correlated negatively with the real value of the US dollar, although this was not the case for the other three countries examined. Benassy-Qu ere, Fontagn e, and Lahr eche-Revil (2001) showed that a depreciation of host country currency against the investing country currency increases inward FDI. Bajo-Rubio and Sosvilla-Rivero (1994), and Wang and Swain (1995), used an exchange rate variable in their estimated equations without a great deal of success.

4.4.3 The Theory of Diversification with Barriers to International Capital Flows

Agmon and Lessard (1977) argue that for international diversification to be carried out through firms, two conditions must hold: (i) there exist barriers or costs to portfolio flows that are greater than those associated with direct investment; and (ii) investors must recognize that multinational firms provide diversification opportunities that are otherwise unavailable. They tested the hypothesis that stock prices of firms with relatively large international operations are more closely related to the rest-of-the world market factors and less to the domestic-market factors than stock prices of firms that are essentially domestic. Their results were consistent with the second proposition.

4.4.4 The Kojima Theory

Kojima (1973, 1975, and 1985) views direct investment as providing a means of transferring capital, technology and managerial skills from the source country to the host country. This approach is described as being a “*macroeconomic approach*” or a “*factor endowment approach*”, as opposed to the “*international business approach*” to FDI. Kojima classifies FDI into two kinds:

1. The first is *trade-oriented*, which generates an excess demand for imports and an excess supply of exports at the original terms of trade. This kind of FDI leads to welfare improvement in both countries. Moreover, it would imply investment in industries in which the source country has a comparative disadvantage. This would promote trade and a beneficial industrial restructuring in both countries.
2. The second kind is the *anti-trade-oriented FDI*, which has exactly opposite effects to those of the first kind. Thus, anti-trade-oriented FDI has an adverse effect on trade it also promotes unfavourable restructuring in both countries.

Kojima argues that Japanese FDI has been trade-oriented, but not so the FDI of the USA. Thus, Kojima's hypothesis is based on the complementarity of trade and FDI, and it emphasizes the need for considering comparative costs.

4.5 Theories Based on Other Factors

There are other factors that have been used to explain FDI. These factors are:

1. Political Risk and Country Risk
2. Tax Policies
3. Trade Policies
4. Government Policies and Regulations
5. Agglomeration Economies
6. Institutions
7. Strategic and Long-Term Factors

4.5.1 Political Risk and Country Risk

Lack of political stability discourages inflows of FDI. Political risk arises because unexpected modifications of the legal and fiscal frameworks in the host country may change the economic outcome of a given investment in a drastic manner (Wafu 1998).

For example, a decision by the host government to impose restrictions on capital repatriation to the investor's home country will have an adverse effect on the cash flows received by the parent company. Wang and Swain (1995) use dummy variables to capture specific political events that may have an important impact on FDI. Ramcharan (1999) used the *Euromoney* political risk index to examine the effect of political risk on FDI for twenty-six countries.

Although the results produced by studies dealing with this factor have been mixed, Schneider and Frey (1985) concluded that models encompassing economic and political factors perform better than other models that do not contain political variables. These models also perform better than those utilizing indices designed to capture political and economic factors simultaneously. Guy Stevens (2000) makes such an attempt by integrating a number of political and other non-traditional economic variables into a standard theory of FDI based on the maximization of the expected value of the firm. The empirical results show that the generalized model that contains additional variables is superior to the conventional model in explaining US FDI in Argentina, Brazil, and Mexico. Stevens (2000) found the following non-traditional variables to affect FDI:

- (i) Exchange controls and repatriation restrictions on dividends to the parent firm,
- (ii) Devaluation in a fixed exchange rate system,
- (iii) Specific governments that appear hostile to FDI from the USA,
- (iv) Number of years a government is in power,
- (v) Pertinent legislation, and
- (vi) The debt crisis over the period 1982-89.

He found no support for the effect of the legality of the government, how it came to power, or even its rhetoric *vis-à-vis* FDI.

Sometimes the wider concept of "*country risk*" is used instead of political risk, as the former encompasses the latter, taking into consideration economic and credit indicators (Eaton, Gersowitz, and Stiglitz, 1992, Lehmann, 1999). In this case, economic factors pose economic risk because adverse developments in economic

indicators (such as an acceleration of the inflation rate and a depreciation of the currency) can affect cash flows adversely, and hence discourage FDI. What is under consideration is the possibility of an adverse economic or political measure, including changes in the 'rules of the game' (such as the possibility of raising the level of taxes). For example, *inflation* has been used by Schneider and Frey (1985) and by Bajo-Rubio and Sosvilla-Rivero (1994) to proxy the stability of macroeconomic policy. In both studies, a negative relationship was found between inflation and FDI. A similar result was detected from Australian data by Yang *et al.* (2000).

4.5.2 Tax Policies

Domestic and foreign tax policies affect the incentive to engage in FDI and the means by which it is financed. Numerous empirical studies have been conducted to examine the effect of international taxation on FDI. Jun (1989) identifies three channels through which tax policies affect the decisions taken by MNCs. First, the tax treatment of income generated abroad has a direct effect on the net return on FDI. Second, the tax treatment of income generated at home affects the net profitability of domestic investment, and the relative profitability of domestic and foreign investment. Third, tax policies affect the relative cost of capital of domestic and foreign investment.

Most of the literature on taxation effects of FDI, points to Hartman's papers (1984, and 1985) as the starting point of the literature, as these were the first to point out a way in which certain types of FDI may surprisingly not be very sensitive to taxes. Hartman (1985) in making a distinction between mature and immature foreign subsidiaries concludes that domestic tax rate on foreign income and the presence or otherwise of tax credit should be irrelevant to a mature foreign subsidiary. This is because domestic tax acts as an unavoidable cost.

Hines (1996) examined simultaneously the effect of international taxation on FDI, and the effect of substantial taxation on business location. He argued that previous studies had difficulty in finding any effect of state taxation on business location because of the problem of controlling for important unobservable variables. On the

basis of survey data obtained from the US Commerce Department, he estimated a model showing that high tax rates have a significantly negative effect on FDI. Specifically, he shows that investors who cannot claim credit for state tax payments reduce their investment shares by 9-11 per cent for every 1 per cent rate of taxation. However, he stresses that it is not possible with the use of cross-sectional data to test directly whether tax factors are an important part of the explanation for the 1980s surge in FDI in the USA. Swenson (1994) examined empirically how taxes shape FDI, and found that increased taxes boost inward FDI. While simple intuition might suggest that higher taxes should discourage both foreign and domestic investment.

In summary, the literature has pointed out that MNEs face tax rates at a variety of levels in both the host and home country and policies to deal with double taxation can substantially alter the effects of these taxes on a MNEs incentive to invest. Empirical approaches and data samples have differed a fair amount, so that there are still significant questions about how much taxes affect FDI. The literature has also only recently begun to examine other related taxes beyond corporate income taxes. For example, a paper by Desai, Foley and Hines (2004) finds evidence that indirect business taxes have an effect on FDI that is in the same range as corporate income taxes. In a similar vein, the effect of bilateral international tax treaties on FDI activity has been an unexplored issue empirically until recently. There are thousands of such tax treaties which negotiate reductions in countries' withholding rates among other things. Blonigen and Davies (2002 and 2004) find little evidence that these treaties affect FDI activity in any significant fashion.

4.5.3 Trade Policies

FDI may be undertaken to circumvent trade barriers such as tariffs because FDI can be viewed as an alternative to trade. This means that open economies without much restriction on international trade should receive fewer FDI flows. A real-life example of a move like this is Honda's establishment of production facilities in Ohio to circumvent the tariffs and quotas imposed by the US government. The surge in FDI in countries such as Mexico and Spain is attributed partly to the desire of MNCs to

circumvent the trade barriers imposed by NAFTA and the EU. Moore (1993) and Wang and Swain (1995) used a trade-weighted tariff rate to represent trade barriers, but it turned out to be an insignificant determinant of FDI. However, Bajo-Rubio and Sosvilla-Rivero (1994) found a significant effect of the tariff rate on FDI. Yang et al. (2000) used the ratio of trade to GDP as a measure of the “openness” of the economy. They found FDI flows to be related negatively to the degree of openness of the economy, suggesting that FDI is indeed used to circumvent trade barriers. Lipsey (2000) concludes that countries that are more open to trade tend to provide and receive more FDI.

Sometimes, the threat of “protectionism” by the host government triggers FDI. Blonigen and Feenstra (1996) argue that the literature on *quid pro quo* FDI suggests that FDI may be induced by the threat of protection, and that it may be used as an instrument to defuse protectionist threats. Their paper uses a panel data set of four-digit SIC level observations of Japanese manufacturing FDI into the USA in the 1980s to explore this hypothesis empirically. Strong support is found for the hypothesis that threats of protection lead to greater FDI flows. A rise in the expected probability of protection from 5 per cent to 10 per cent means a greater than 30 per cent rise in the next period’s FDI flows for an average industry.

Gastanaga, Nugent and Pashamova (1998), Yeyati, Stein and Daude (2003), Jaumotte (2004), Tobin and Rose-Ackerman (2005), Neumayer and Spess (2005) have also tested the impact of ‘openness’ to trade and membership in regional trade agreements on FDI inflows and found them to be important determinants. Blomstrom and Kokko (1997) separate the effects of regional trade agreements (RTAs) along two dimensions, i.e., the indirect effect on FDI through trade liberalisation and the direct effects from changes in investment rules connected with the regional trade agreements. According to them lowering interregional tariffs can lead to expanded markets and increase FDI but lowering external tariffs can reduce FDI to the region if FDI is tariff jumping.

4.5.4 Government Policies and Regulations

Most governments adopt policies aimed at both encouraging and discouraging inward FDI by offering incentives on the one hand, and disincentives (taking the form of restrictions on the activities of MNCs) on the other. The incentives offered by host governments to investing MNCs include the following:

- (i) Fiscal incentives, such as tax reductions, accelerated depreciation, investment and reinvestment allowances, and exemption from custom duties. It is arguable that fiscal incentives may be successful in attracting the new ‘footloose’ variety of sourcing investments, but not those of a more long-lived nature.
- (ii) Financial incentives, such as subsidies, grants and loan guarantees.
- (iii) Market preferences, including monopoly rights, protection from competition arising from imports, and preferential government contracts.
- (iv) Low cost infrastructure, fuel and energy.
- (v) The provision of information by means of agencies located in the capitals of the source countries.
- (vi) A framework for clear, efficiently implemented stable policies with respect to FDI.
- (vii) Flexible conditions with respect to local equity participation.

Some observers argue that these policies can distort economic activity severely, and reduce the efficiency of FDI. Moreover, gains from these policies tend to be made at the expense of other countries. There is a certain ‘beggar thy neighbour’ aspect to all these. It is arguable that incentives usually tend to benefit companies that would have

made the investment anyway, so the result is wasteful competitive bidding among host countries. It is the overall environment of a particular country (as constituted by its political, social and economic conditions) that attracts FDI. Incentives and concessions often help only in so far as they indicate a favourable environment. Otherwise, they simply cost the host government a part of the tax revenue and add little new FDI. Moreover, because the host government typically lacks the information needed to assess what incentives have to be offered to secure the underlying investment project, and because of the strong negotiating power of the MNCs, the latter are often in a position to obtain incentives in excess of their needs, and perhaps in excess of the benefits they bring to the host country.³⁹ Disincentives include a number of impediments that may range from the slow processing of the required authorization to the outright prohibition of foreign investment in specific regions or sectors. Moreover, MNCs may be required to operate in those sectors that are owned primarily by domestic investors. There are also some requirements such as the ruling that MNCs employ a minimum number of local workers, and restrictions on profit repatriation.

The empirical studies surveyed by Agarwal (1980) show that the incentives have a limited effect on the level of FDI, as investors base their decisions on risk and return considerations. On the other hand, disincentives seem to have a more definite impact than incentives on FDI. For example, Aharoni (1966) concluded from his survey that, at the initial stage of an FDI decision, the incentives are not considered by firms. According to Reuber (1973) the incentives may be of some help, particularly for small firms with limited experience, but their overall impact on FDI is marginal at best. They also argue that the variety of incentives granted by developing countries generally add to the costs of these investments for these countries without increasing their flows effectively, the main reason being that incentives are normally accompanied by disincentives such as various restrictions on ownership and size. It is also important to bear in mind that other factors are more influential for the project under consideration. Since the objective of the incentives is to correct an existing comparative disadvantage

³⁹ When, in the late 1970s, Ford wanted to build a new engine plant in Europe, it played one country against another (Spain, Belgium and the UK). Eventually, the UK agreed to pay nearly half the capital cost of the project.

of the host country, it is not surprising to find that their effectiveness is circumscribed. Bond and Guisinger (1985), and Banga (2003) investigate the effects of incentives on the location decisions of MNCs. The empirical results of Banga (2003) showed that fiscal incentives do not have any significant impact on FDI inflows to South, East and South East Asian economies.

It could happen that a government offers incentives for some kinds of FDI while imposing disincentives for other kinds. This is particularly the case with acquisitions versus Greenfield investment. Buckley and Casson (2000) use their model of entry mode to find an explanation as to why governments so often compete to attract inward Greenfield investment while taking a restrictive attitude towards acquisitions. The model reveals that market structure is a crucial factor in the choice between Greenfield investment and acquisitions. Governments prefer Greenfield investment because, unlike acquisitions, it leads to an increase in the local capacity and an intensification of competition.

One particular case of using incentives to offset disincentives is when the host government uses a package that includes trade-related investment performance (TRIP) requirements, which are seen by some as a significant obstacle to FDI. TRIP requirements can be defined as *“host government policies designed to encourage local purchase of inputs by foreign-owned firms, and policies to encourage these firms to export”* (Wallace, 1990). Thus TRIP requirements include two components: (i) local content; and (ii) export minima. These requirements should be viewed as disincentives to FDI, because the local content requirements may lead to increased cost, and decreased earnings, which makes the underlying project less competitive. Similarly, export minima may lead to lower earnings, adversely affecting the attractiveness of FDI. Normally, TRIP requirements are combined with incentives such as preferential tax status, access to foreign exchange, and import protection. There are reasons why the host country may impose TRIP requirements: (i) they represent an explicit commitment to increasing the supply of foreign exchange, (ii) they can correct market distortions, and (iii) they could be used by the host government as a defensive measure. Wallace (1990) argues that while TRIP requirements are not attractive on

economic efficiency grounds, they are not a significant obstacle to FDI. The widespread existence of favourable *quid pro quo* type policies combining incentives and disincentives is the single most important reason for believing that TRIP requirements are not a major impediment for FDI.

4.5.5 Agglomeration Economies

Another important factor for explaining the geographical distribution of FDI is agglomeration economies. The theory of agglomeration economies suggest that once countries attract the first mass of investors, the process will be self-reinforcing, without needing a change in policies. Foreign investors may be attracted to countries with more existing foreign investment. Being less knowledgeable of a country's environment, foreign investors may view the investment decisions by others as a good signal of favourable conditions and invest there too, to reduce uncertainty. Furthermore, recent research has shown that FDI tends to cluster in particular locations "*agglomeration*" effect (Kamaly, 2003). In this case, FDI flows depend on a country's past stock of FDI, meaning that countries that have been successful in attracting FDI in the present are more likely to do so in the future. In fact, most empirical studies in the literature have used the past stock of FDI (the one-year lagged FDI stock) as a good predictor of current FDI. When agglomeration economies are present, new investors mimic past investment decisions by other investors in choosing where to invest. By locating next to other firms, they benefit from positive spillovers from investors already in place. The common sources for these positive externalities are knowledge spillovers, specialized labour, and intermediate inputs (Krugman, 1991a, and b).

The theoretical literature on the *new economic geography* identifies three sources of positive externalities that lead to the spatial clustering of investors.

1. First, technology spillovers can be shared among foreign investors among various industries. General and/or technical information about how to operate efficiently in the host country comes from the direct experiences of

investors. This knowledge can be passed onto other foreign firms by informal communication. To benefit from such spillovers, foreign firms have to locate close to each other (Markusen, 1990).

2. Second, industry-specific localization arises when firms in the same industry draw on a shared pool of skilled labour and specialized input suppliers (Head, Ries and Swenson, 1995).
3. Third, the theory of new economic geography emphasizes backward and forward linkages as a source of agglomeration (Krugman, 1991a, and b). Users and suppliers of intermediate inputs cluster near each other because a larger market provides more demand for a good and a larger supply of inputs.

Cantwell (1989, 1995, 1999; Cantwell and Jane 1999), while analyzing cross-border technological development and sourcing, observed through international business operations that MNCs in a high-tech/R&D based industry are not merely involved in technology transfer and knowledge spillovers but more importantly are increasingly engaged in new “*knowledge creation*” via cross-border network of R&D facilities. In fact, this trend is accelerating as more and more R&D-based industries are involved in overseas production of knowledge itself – in addition to overseas production of products. The cumulative causation (both *virtuous* and *vicious* circles) between the technological activities of MNCs and the international competitiveness of an open economy may be intensified (Cantwell, 1987). A virtuous circle occurs because inward FDI is likely to be attracted into innovative industries caught up in a virtuous circle in the first place, industries with local R&D facilities and a rising indigenous technological capacity, and because newly established foreign affiliates increase technological dissemination to suppliers and customers and spur local rivals to a higher rate of innovation. This virtuous circle is nothing but a powerful engine of MNC-driven endogenous growth. Here, the size of a firm and the size of the market attainable by way of expanding multinationality of the firm also give strong micro-economic incentives to innovate, because the firm’s enlarged operations across international markets facilitate transfer of intangible assets at nominal marginal costs.

On the other hand, a vicious circle may also occur as a result of MNC's market power, which may drive out local competitors and hinder the technology creation of local suppliers. Cantwell (1987) summarizes: "*The overall conclusion to be drawn from the basic model is that, as a long run process, an internationally trading industry will gradually become increasingly divided into some dynamic and some stagnant production locations. The former will be characterized by a high proportion of research intensive activity and a relatively steep technological progress function, the latter by a low proportion of research linked production and a comparatively shallow technical progress function.*" (Cantwell, 1987, p. 132).

Cantwell's analysis thus directly leads to the notion of *locational agglomeration of innovative activities*. This notion has only recently begun to be explored by international business scholars (Porter, 1990, Dunning, 1991, 1996, and 1997a; Nachum 1999, and 2000), although conventional economics has long been familiar with it ever since Alfred Marshal (1920) conceptualized an "*industrial district*", and a revival of interest in it has occurred with the work of Krugman (1991a, and b). An idea of cluster-based development strategies is discussed in Enright (2004). The creation of competitive advantages by MNCs through geographical agglomeration of innovation with all its multifarious aspects is explored in a conference volume (Dunning 2000b) from international business perspectives. For example, the volume contains Gray and Dunning (2000) which initiates 'a theory of regional policy' by exploring how a particular macro-region interacts with micro-regions in generating virtuous or vicious circles in industrial and service agglomeration through their policies and economic activities. One should remember, however, that forces of agglomeration work in both ways, positively and negatively. Diseconomies occur in terms of deteriorations in the environment (pollution and ecological destruction) and social infrastructure (congestion, crimes and rising housing costs, etc.).

There is much evidence on the value of agglomeration economies. A seminal work by Wheeler and Mody (1992) makes a strong case for agglomeration (and market size) in U.S. investors' location decisions. Head, Ries, and Swenson (1995) find industry-level agglomeration economies play an important role in the location choice

of Japanese manufacturing FDI in the United States. Barrel and Pain (1999) find similar results on U.S. investment in Europe. Cheng and Kwan (2000) report a similar effect of agglomeration in China. Mody and Srinivasan (1998) and Lehmann (1999) find that agglomeration effects are a strong determinant of FDI in developing countries. Mucchielli, Mayer and Crozet (2003) studied the location choice by foreign investors in France. Their study focused on the characteristics of agglomeration effects in France. They found strong evidence of positive spillovers between firms and identified detailed patterns of clustering assessing the countries of origin and the industries for which those spillovers are the most substantial. Campos and Kinoshita (2003) find strong support for agglomeration economies as an important determinant of FDI in 25 transition Central European and former Soviet Union countries.

4.5.6 Institutions

One of the recent developments in the literature on FDI determinants is the incorporation of “*institutional quality*” in modeling the location decision of foreign firms. Theoretical and empirical findings suggest that host country institutions influence investment decisions because they directly affect business operating conditions (Wei and Wu, 2001, and Campos and Kinoshita 2003). Alfaro, Kalemli-Ozcan, and Volosovych (2005) argue that institutional quality is an important determinant of international capital flows and investment. Moreover, the quality of institutions is an important determinant of FDI activity, particularly for less-developed countries for a variety of reasons. First, poor legal protection of assets increases the chance of expropriation of a firm’s assets making investment less likely. Poor quality of institutions necessary for well-functioning markets (and /or corruption) increases the cost of doing business and, thus, should also diminish FDI activity. And finally, to the extent that poor institutions lead to poor infrastructure (i.e., public goods), expected profitability falls as does FDI into a market.

The cost of investment consists of not only the economic costs of investment, but also the non-economic costs, such as bribery and time lost in dealing with local authorities. Moreover, institutions underpin local business operating conditions, but

they differ from “physical” supporting factors such as transport and communication infrastructures. The basic notion is that less corruption, a fair, predictable, and expedient judiciary, and an efficient bureaucracy help attract FDI (Wei and Wu, 2001).

While these basic hypotheses are non-controversial, estimating the magnitude of the effect of institutions on FDI is difficult because there are not any accurate measurements of institutions. Most measures are some composite index of a country’s political, legal and economic institutions, developed from survey responses from officials or businessmen familiar with the country. Comparability across countries is questionable when survey respondents vary across the countries. In addition, institutions are quite persistent, so there is likely to be little informative variation over time within a country (Blonigen, 2005). For these reasons, cross-country FDI studies often include measures of institutions and/or corruption. In other words, data limitation has impeded extensive testing of these ideas, constraining existing studies to focus on just one aspect of the issue, normally corruption.

Wei and Wu (2001) studied the impact of corruption on a country’s composition of capital inflows for 103 countries over the period 1980-1996. The importance of this composition was recently highlighted by the currency crises in East Asia, Russia and Latin America. They show that a variety of corruption indices are strongly and negatively correlated with FDI and that corruption affects the composition of capital inflows in a way that is not favourable to a country. Further, corruption could also lead to a financial crisis by weakening domestic financial supervision and producing a deteriorated quality of banks’ and firms’ balance sheets.

Campos and Kinoshita (2003) examined the importance of institutions as determinants of FDI for 25 transition economies in Central Europe and the former Soviet Union. They used the institutional variables ‘rule of law’ and ‘quality of bureaucracy’. Their econometric results indicated that countries with good institutions managed to attract more inflows of FDI. Poor quality of bureaucracy is found to be a deterrent to foreign investors as the increased transaction costs adversely affect profitability of investment projects. A similar argument is made with respect to the rule

of law, which was also found to be an important determinant of FDI in transition economies.

Meyer and Jensen (2005) argue that the 1990s have been a period of extraordinary politics in Central and Eastern Europe (CEE). They discuss how the transition from state to market has created bureaucratic barriers to entry, but also windows of opportunity for FDI. The high costs and high investment risks in CEE are a reflection of the institutional development. Thus, inflows of FDI have been largest in those countries that made most progress in establishing a market-oriented institutional framework. They argue how aspects of the institutional framework and FDI policy affect diverse types of investment projects.

Hallward-Dreimeier (2003), Tobin and Rose-Ackerman (2005), and Neumayer and Spess (2005) while analysing the impact of BITs on FDI flows to developing countries, examined empirically whether the quality of domestic institutions is an important determinant for the effectiveness of a BIT in attracting FDI. Their empirical analyses included different indicators of institutional quality in separate estimations together with interaction effects with the BIT variable. The indicators of institutional quality were compiled from the International Country Risk Guide (ICRG), published by the Political Risk Services (PRS) Group. They used the investment profile index, the index of government stability, index of rule of law and order, corruption, as well as ICRG's composite political risk index. Another indicator used for institutional quality was the political constraints index developed by Henisz (2000). Also the KKZ measures of the rule of law, and government effectiveness were used by these studies. By using an interaction term in their empirical analyses, they tried to test whether BITs act as a substitute or complement for domestic institutions in attracting FDI. Hallward-Dreimeier (2003) found that countries with weak domestic institutions, including protection of property, have not gotten significant additional benefits; a BIT has not acted as a substitute for broader domestic reform. Rather, those countries that are reforming and already have reasonably strong domestic institutions are most likely to gain from ratifying a treaty. Tobin and Rose-Ackerman (2005) also found that strong

domestic institutions and strong property rights enforcement in developing countries are preconditions in order to get benefit from BITs and attract FDI.

4.5.7 Strategic and Long-Term Factors

There is a set of strategic and long-term factors that have been put forward to explain FDI. Reuber (1973) lists the following factors as being instrumental to the decision to invest abroad:

1. The desire on the part of the investor to defend existing foreign markets and foreign investments against competitors.
2. The desire to gain and maintain a foothold in a protected market or to gain and maintain a source of supply that in the long run may prove useful.
3. The need to develop and sustain a parent-subsidiary relationship.
4. The desire to induce the host country into a long commitment to a particular type of technology.
5. The advantage of complementing another type of investment.
6. The economies of new product development.
7. Competition for market shares among oligopolists and the concern for strengthening of bargaining positions.

Some economists argue that these factors have indirect, longer-term and wider consequences for FDI. They are also directly relevant to the profitability of the group as a whole through their influence on the streams of future income.

4.6 Theories of Entry Modes

Theories of FDI deal implicitly with the mode of entry into foreign markets. In the 1960s, theories of FDI concentrated on the choice between exports and FDI. In the 1970s, the internalisation hypothesis identified other modes of entry into a foreign market, including licensing, franchising and “arm’s-length” arrangements such as subcontracting. In the 1980s, M&A emerged as an important mode of entry, and so the choice became between acquisitions and Greenfield FDI. Buckley and Casson (2000) distinguish between exporting, licensing, and FDI as:

1. Exporting: is located domestically and controlled administratively
2. Licensing: is foreign-located and controlled contractually
3. FDI: is foreign-located and controlled administratively

4.6.1 FDI vs. Exporting

The issue of advantages of direct investment over exporting has been dealt with extensively in the literature. The question that arises in this respect is: why do large firms exploit the oligopolistic advantages by undertaking the trouble and risk of organizing production abroad rather than by exporting? Lall and Streeten (1977) identify factors that affect between exports and FDI:

- (i) Production and transportation costs, as FDI enables to exploit cost advantages.
- (ii) Government policy in the host country with respect to trade barriers.
- (iii) The marketing factor enables FDI to service destination markets in a better way.
- (iv) Oligopolistic reaction: a move by one oligopolistic firm induces others to follow.
- (v) Product cycle suggested by the product life cycle hypothesis.

4.6.2 FDI vs. Licensing

Several factors have been identified also to make FDI more attractive than licensing. Licensing is defined by Lall and Streeten (1977, in Moosa, 2002, p.60) as the sale of technology, brand names, patents, management services, or other similar assets.

FDI is preferred to licensing if:

- (i) Host country is politically stable,
- (ii) Technology is new and tightly controlled,
- (iii) Firm is large and more internationally involved,
- (iv) Firm's sources of power are broadly based, and
- (v) Absorptive capacity of the license is low (p. 60).

Conversely, licensing will be preferred over FDI if:

- (i) Technology is diffused widely,
- (ii) Host market is small and risky,
- (iii) Firm is inexperienced, risk averse or nationally-oriented,
- (iv) Advantage of the firm is specific, and
- (v) Potential licensee is big and capable (pp.60).

4.6.3 Joint Ventures

International joint ventures have also emerged as an important entry mode. Buckley and Casson (2000) summarize the conditions that are conducive to the establishment of joint ventures, including:

- (i) The possession of complementary assets.
- (ii) Opportunities for collusion.
- (iii) Barriers to full integration.

Although MNCs prefer to have wholly-owned or majority-controlled subsidiaries, there are reasons why they would agree to take part in joint ventures:

- (i) Government policies in many developing countries make joint ventures the only available mode of entry.
- (ii) The joint venture partners may provide complementary skills.
- (iii) Because joint ventures can be used as a means of alleviating country risk, particularly the risk of takeover. Joint ventures may also be attractive in cases where the project is too big for the MNC.

4.7 Conclusion

The literature on FDI is massive, and there is no alternative here but to be selective. Nevertheless, this chapter tried to present a comprehensive survey of the theories of FDI. The different theories explaining the determinants of FDI were classified under four major headings: theories assuming perfect markets, theories assuming imperfect markets, other theories, and theories based on different factors. Theories assuming perfect markets discussed the differential rates of return hypothesis, the portfolio diversification hypothesis, the market size hypothesis, and the growth prospect hypothesis. Under the classification of theories assuming imperfect markets the following important hypotheses were elaborated: the industrial organization hypothesis, the internalisation hypothesis, the location hypothesis, Dunning's eclectic theory, the investment development path theory, the product life cycle hypothesis, and strategic or the oligopolistic hypothesis. Next, it elaborated other theories explaining FDI determinants such as the internal financing hypothesis, the currency area and the effect of exchange rates on FDI, the hypothesis of diversification with barriers to international capital flows, and the Kojima hypothesis. Furthermore, the chapter discussed other major factors that determine FDI. These factors include political risk and country risk factors, tax policies, government policies and regulations, agglomeration effects, quality of host country institutions, and strategic and long term factors. Finally, the chapter elaborated the different entry modes for multinationals, distinguishing between exporting, licensing and FDI.

5 The Proposed Theoretical Model

“The purpose of the eclectic paradigm is not to offer a full explanation of all kinds of international production but rather to point to a methodology and to a generic set of variables which contain the ingredients necessary for any satisfactory explanation of particular types of foreign value-added activity.”

(John Dunning, 2003, p. 29)

“One of the key elements in an investment decision will be the degree of ‘country risk’, a factor that will be weighed against other considerations.”

(UNCTAD, 2004b, p. 230)

5.1 Introduction

For the analysis of FDI activity in the four Central European countries, The Czech and Slovak Republics, Hungary and Poland (CEC4), the study proposes to adopt an “integrated” theory, integrating the “eclectic” theory with the “country risk” theory. The integration of the “eclectic” theory with that of “country risk” poses no major problem in principle. The argument goes on that the integration of the two theories provides answers to a complex set of questions pertaining to FDI. Moreover, the factors of the “integrated” theory can be utilized also as “pull” factors within the “pull-and-push approach” which is widely used in the capital flow literature.

It has to be mentioned also that the common denominator in all the theories that explain cross-border foreign investment is that the most important reason for undertaking investment is profit-making, and FDI is no exception (Moosa, 2002, and 2003). More importantly, however, is that, the FDI decision does not only depend on return and profit-making, but also on risk. Instead of maximizing the rate of return per se, the objective could be to maximize the rate of return per unit of risk. Therefore, risk constitutes a very important element in FDI decisions.

5.2 The Proposed “Integrated” Theory

For the purpose of constructing the theoretical framework of the study, the forthcoming analysis elaborates in detail both the *Eclectic* and *CountryRisk* theories.

5.2.1 The Eclectic Theory

The Eclectic Theory or the “OLI Paradigm” developed by John Dunning (1977, 1979, and 1988a, and b) integrates three theories:

1. The Industrial Organisation Theory (Ownership Advantage),
2. The Location Theory, and
3. The Internalisation Theory

According to John Dunning, FDI emerges due to *Ownership*, *Location*, and *Internalisation* advantages. The three types of advantages are equally important – as Dunning (1998) writes: “*The OLI triad of variables determining FDI may be likened to a three-legged stool; each leg is supportive of the other*”.

- *The Theory of Ownership* advantages refers to those assets owned by a firm that allow it to compete successfully in overseas markets, despite – in comparison with local firms – a lack of knowledge of the local market and the costs of setting up a foreign affiliate. Ownership advantages usually comprise superior technology or management knowledge.

- *The Theory of Location* advantages are those benefits that a host country can offer a firm: large markets, growth prospects, developed and efficient financial markets, low labour and production costs, good infrastructure, etc...
- *The Theory of Internalisation* refers to transaction costs, and occurs when it is cheaper to exploit ownership and location advantages through FDI rather than exporting.

Dunning's *Eclectic* theory gave location issues explicit importance by combining them with firm-specific advantages and transaction cost elements (Dunning, 1993a, and b). While ownership and internalisation advantages are investor specific determinants, the location advantage is specific to the host country. In this respect, UNCTAD *World Investment Report 1998: Trends and Determinants of Foreign Direct Investment, Chapter IV*, developed explicitly Dunning's eclectic theory. It presented with detail "Host Country Determinants of Foreign Direct Investment". UNCTAD (1998a) presented the main ideas that come forward in this literature in a systematic way by categorizing the location determinants of FDI into three main groups:

1. Economic Determinants,
2. Host-Country Policy Framework for FDI, and
3. Business Facilitation.

Following Dunning (1993a, and b), the "Economic Determinants" are broken down by UNCTAD (1998, p. 91) into three sub-groups:

- (i) *Market-Seeking*: (Market Size and Growth Prospects) Factors like market size, prospects for market growth, and the degree of development and per capita incomes of host countries are important determinants in the location decision made by MNEs. Host countries with larger market size, faster economic growth and a higher degree of economic development will provide better opportunities for enterprises to exploit their ownership advantages and creates possibilities for economies of scale. FDI attracted by these advantages is called "market-oriented".

- (ii) *Resource/Asset-Seeking*: (Physical, Financial, and Technological Infrastructure) Differences in infrastructure, such as transportation (highways, railways, power, ports, airports), the level of telecommunication services, high local technological capabilities - availability of skilled labour and strategic assets such as technological and innovative assets e.g. brand names - has become important determinants in the location decision of MNEs.
- (iii) *Efficiency-Seeking*: Factor cost advantages, availability of natural and human resources are a driving force behind FDI. Efficiency seeking FDI seeks the use of those comparative advantages related to low labour costs - adjusted for productivity.

Table 5-1: Host Country Determinants of FDI

Host Country Determinants	Type of FDI Classified by Motives of MNCs	Principal Economic Determinants in Host Countries
I. Policy Framework for FDI Economic, Political and Social Stability Rules regarding entry and operations Standards of treatments of foreign affiliates Policies on functioning and structure of markets (especially competition and M&A policies) International Agreements on FDI Privatization Policy Trade Policy and coherence of FDI and trade policies Tax Policy II. Economic Determinants III. Business Facilitation Investment promotion Investment incentives Hassle costs (related to corruption, administrative efficiency, etc.) Social amenities (bilingual schools, quality of life, etc.) After-investment services	A. Market-Seeking	Market size and per capita income Market growth Access to regional and global markets Country-specific consumer preferences Structure of markets
	B. Resource/Asset-Seeking	Raw materials Low-cost unskilled labour Skilled labour Tchnological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters Physical infrastructure (ports, roads, power, telecommunication)
	C. Efficiency-Seeking	Cost of resources and assets listed under B, adjusted for labour productivity Other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products Other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products Membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: Extracted from UNCTAD, *World Investment Report*, 1998, pp.91, New York and Geneva: UN.

The above table, extracted from UNCTAD, suggests that “Host Country Determinants of FDI”, beside the “Economic Determinants” are affected by economic and political stability, rules regarding entry of operations, standards of treatment of foreign affiliates, and international agreements on FDI. Therefore, according to the eclectic theory, as presented by UNCTAD, FDI is determined by both “Economic Determinants” and “International Investment Agreements”.

5.2.2 The Country Risk Theory

The Country Risk Theory, a very important theory in international finance, explains also international cross-border foreign investment by giving location issues explicit importance.

5.2.2.1 The Concept of Country Risk

International investments between residents of different countries are subject to risks. Each country has its own distinct set of economic and financial conditions reflecting its human and natural resources, and the way these resources are managed. Since international economic and financial activity is organised around the concept of national sovereignty, where each country has its own economic, financial, political, and legal organization which determine the resource allocation and income distribution within the geographic area it controls, events or anticipated events at the national level can have serious effects on the “investment climate” in the country where they locate.

The analysis can be extended further to include economic, political, social, geographic, and strategic considerations likely to affect the outcome of investments between resident and non-resident economic agents. Economic output, growth, inflation, fiscal deficit, interest rates, exchange rates, restrictions on profit repatriations and remittances, expropriations, revolutions, natural catastrophes, wars, strikes are some of the most obvious examples that come to mind. As a concept, then, international or cross-border investment risk is vast and complex. It refers to the volatility of returns on international investments caused by events associated with a

particular country. The concept of “country risk” began to be widely used in the 1970s in response to the banking sectors’ efforts to define and measure its exposure to loss in cross-border lending. The literature flourished after the international debt crisis of the 1980s.

5.2.2.2 The Nature of Risk

Before getting into the specifics of risk associated with international investments, it is important to develop a precise definition of what exactly is meant by the word “risk”. Risk can have different meanings in different contexts. For some authors, risk is defined as a performance variance, whether it impacts the firm positively or negatively. Another approach analyses risk as a negative outcome. Thus, the notion of risk has different meanings and may be understood either as a performance variance or just as the likelihood of a negative outcome that reduces the initially expected return. In finance, the focus is on the effects of risk on the valuation of assets and liabilities. One measure of risk might be the probability that the return on an investment will fall below a certain level.

5.2.2.3 Diversification and Risk

Diversification is an important factor in measuring risk. In finance diversification means reducing risk by not putting all wealth into one asset, client, transaction, or country. Risk can be classified as:

- *Systematic Risk*: refers to risk that can not be eliminated by diversification.

- *Unsystematic Risk*: refers to risk that can be eliminated by diversification.

The portfolio diversification hypothesis, discussed in chapter four, elaborated explicitly the relationship between risk, diversification, and the choice among various projects.

5.2.2.4 Definition of Country-Specific Risk

As a term, it has been shrouded in conceptual confusion from the beginning, often referring to transfer risk, sovereign risk, political risk, economic risk, financial risk, or any other type of risk that could affect the willingness or ability of an economy or government to honour its financial obligations. In fact, the confusion existed because it was unclear what exactly was supposed to be measured. The definition proposed by Meldrum (2000) perfectly reflects these characteristics: *“All business transactions involve some degree of risk. When business transactions occur across international borders, they carry additional risks not present in domestic transactions. These additional risks, called country risks, typically include risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography and currencies. Country Risk Analysis (CRA) attempts to identify the potential for these risks to decrease the expected return of a cross-border investment.”*

This definition joins the very early of Gabriel (1966) or Stobaugh (1969a, and b) that were concerned with how the “investment climate” in a foreign country may differ from the “investment climate” at home. It is worth noting that country risk exist whatever the level of economic development of the country in question. Even the most economically advanced nations may generate a substantial degree of country risk.

5.2.2.5 Types of Country Risk

Country Risk can be broken down into four major components:

- a. Economic Risk
- b. Financial Risk
- c. Currency Risk
- d. Political Risk

The economic, financial and currency components are market-based and correspond to well-known concepts in modern economic and financial theory. Political risk is broader and refers to the possibility or probability that events and decisions that

are unfavourable to investors' interests will be taken at the political level. Political decisions will have consequences for the economic, currency and financial situation, just as the economic, currency, and financial situation will have consequences on the political climate.

a. Country Economic Risk

Country economic risk is analogous to *operation risk* in corporate finance. It refers to the volatility of macroeconomic performance, which is often measured by real gross domestic product (GDP) and growth. It is an important risk element in international investments because a country's macroeconomic environment plays a fundamental role in determining the outcome of individual investments undertaken within its borders. Generally speaking, a volatile macroeconomic environment is likely to generate volatility in the profits of resident firms and financial institutions, thereby increasing their exposure to risk.

b. Country Financial Risk

Country financial risk is analogous to *financial risk* in corporate finance. Country financial risk refers to the ability of the national economy to generate enough foreign exchange to meet payments of interest and principal on its foreign debt. The ability to meet payments of interest and principal on foreign debt depends on the extent to which the country's assets are financed with foreign loans, and the amortization schedules of foreign loans. The link between macroeconomic financial risk and GDP is explicit. No country possesses the range of consumer goods, investment goods, raw materials, and technological know-how necessary to attain economic self-sufficiency. Some level of imports is required to assure acceptable levels of output and consumption. Imports can only be obtained by exporting or by foreign borrowing. Foreign borrowing, however, is nothing more than a temporary solution since what is borrowed must eventually be paid back with interest. Therefore, in the long run, exports are the only means of acquiring the necessary imports. They must be also large enough to pay interest and principal on the outstanding foreign debt. If they are not, the foreign exchange will not be available to meet payments on debt service.

The more volatile the country's economic performance, that is, the higher its economic risk, the more likely it is that in any given year the economy will be unable to generate the foreign exchange necessary to meet foreign interest and principal payments. Analysts focus on a series of specific ratios to assess a country's long-term solvency such as debt service to exports (TDS/XGS), total external debt to GDP (EDT/GDP), total external debt to exports (EDT/XGS), and ratios of reserves to imports (RES/MGS), and reserves to external debt (RES/EDT), as liquidity indicators, to assess country creditworthiness (Ul Haque, Kumar, Mark and Mathieson, 1996). Country financial risk affects all types of international investments. It depends on three parameters:

1. The total amount of external debt which determines the size of the interest payments.
2. The maturity structure which determines the size and timing of principal payments.
3. The country's economic risk which determines the probability of default due to fluctuations in the country's overall economic performance.

c. Currency Risk

Currency risk is the most widely-known component of country risk. It can be defined by the *level* and *volatility* of the exchange rate. The exchange rate has major consequences on a country's level and composition of output and consumption, as well as on its overall economic well-being. It also has major consequences for non-residents investing in the country or doing business with it. Apparently profitable transactions can suddenly turn sour if the exchange rate moves in the wrong direction.

d. Political Risk

The various risks that are related to cross-border direct investment are broad and complex. The return on the investment is not based only upon the market or the host country's ability to generate foreign exchange to service its obligations. The balance of

payments, the reserves, and the debt servicing ratios are no longer the key variables behind the market's liquidity and solvency. Other parameters get into the picture, such as the political situation, loose regulatory framework, barriers to entry and operations, standards of treatment to foreign investors, restrictions on repatriation of profits and remittances, dispute settlement mechanisms, expropriation, nationalization, etc. According to an international survey of risk related to investors conducted by MIGA (Multilateral Investment Guarantee Authority), approximately 50 percent expressed the view that political risk is more of a concern today than five years ago (MIGA, 2002).

(i) The Concept of Political Risk

The concept of political risk has been widely analysed. There is no general agreement on exactly what political risk assessment is supposed to measure. David Raddock (2001) writes: "*The apparent political threats to the financial well-being of an enterprise stem from such government actions as expropriation or the imposition of crippling legal restrictions that will lead to expropriation, freezing of foreign company's assets or insistence on divestment, a government's failure or the sort of paralysis that can induce political uncertainty, restrictions on repatriation of profits, social confusion or chaos, and disruptions from various types of civil disorders including strikes, terrorism, and revolution.*"

Clark and Marois (1996) make a distinction between *transfer risk* (potential restrictions on transfer of funds, products, technology, and people), *operational risk* (uncertainty about policies, regulations, governmental administrative procedures which would hinder results and management of operations in the foreign country), and risks on control of capital (discrimination against foreign firms, expropriations, forced local shareholding, etc.)

(ii) Sources of Political Risk

The motivating factors behind political risk are diverse. Ideology, for example, is a major motivation. It generated the Soviet expropriation of foreign investors, to turn the Soviet Union and its satellite countries into planned economies and was a major source

of world conflict during the years of the Cold War. Some authors distinguish between political events such as war, revolution, riots, strikes, etc., and political decisions in the forms of laws or decrees. Wafo (1998) write: *“Political risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially foreign owned business property”*.

(iii) The Effects of Political Risk on Foreign Direct Investment

Political events and decisions affect foreign investments and operations in several ways. They include expropriation, confiscation, nationalization, forced-shareholding, control of prices, foreign exchange, remittances and repatriation of profits. Besides the consequences on ownership and profits, political risk can also affect the security of physical assets, intellectual property and personnel. In fact, these issues are becoming more important in the assessment of foreign investment risk. Physical and intellectual assets must be protected or insured against damage and destruction. Intellectual property is especially vulnerable to damage and loss. Patent and license abuses, pirated merchandise, imitations and fakes, not to mention industrial espionage and computer viruses, are some of the most obvious examples that come to mind (Bouchet, Clark and Gros Lambert, 2003).

5.3 The Integration Mechanism of the Two Theories

According to the Eclectic theory - as presented by UNCTAD - FDI in a host country is determined by both “economic determinants” and “international investment agreements”. On the other hand, according to the Country Risk theory, as foreign investors extend their operations across borders and regulatory regimes, they face a complex set of risks. The critical risks that affect the operations of foreign direct investors in a host country range from government regulation to political and economic instability (A.T. Kearney, 2003, 2004, and 2005).

Country risk consists of two major components: “macroeconomic risk” and “political risk” factors:

- *Macroeconomic risk*: is related to the “economic conditions” of a host country, which affect the operations of foreign investors, hence affecting the location advantages for FDI. In its turn macroeconomic risk consists of economic, financial, and currency risks.
- *Political risk*: is related to the political “events” and “decisions” in a host country. Since IIAs are related to “political decisions” made by a host country they are viewed by foreign investors as instruments reducing the political risk related to their investments.

Thus, according to the Country Risk theory, FDI in a host country depends on both “economic conditions” and “international investment agreements”. Turning to the “pull-and-push approach”, the “pull-factors” are related to the economic conditions of a host country and are thought of as country-specific factors and conditions influencing the interest of foreign investors in that country (Fernandez, 1996). Thus, “macroeconomic” factors and “political decisions” are considered as “pull-factors”. Therefore, both theories, Eclectic and Country Risk, can be integrated to explain FDI. Furthermore, this “integrated” theory can be utilized also as “pull-factors”.

5.4 The “Integrated” Theory and FDI in CEC4

Until recently, there was a strong consensus in the literature that FDI occurs due to specific locations mainly because of strong economic fundamentals in the host countries for example, large market size, and stable macroeconomic environment. However, with the growing integration of the world markets and the rising pressures of globalisation induced competitiveness, the location advantages based on only the “economic conditions” may not be able to sustain their strength of attracting FDI. Free markets do not always ensure efficient and equitable outcomes, particularly in countries with weak markets and institutions, such as the Central European countries in the late 1980s and the early 1990s. The groundwork for making markets work well – sound legal systems, clear and enforceable rules of the game, responsive market institutions – has to be laid down by host country governments. The basic point here is

that, in the real world of imperfect markets, governments have a major role to play. They can influence FDI in many ways with varying degrees of intervention, control and direction.

Within this framework, soon after the fall of the Berlin Wall in 1989, the CEC4 having realised the potential positive impact of FDI on their economies, have considerably lowered barriers to investment, opening up more and more sectors to FDI. These countries could have been motivated in part by macroeconomic problems, for instance the need to reduce the high external debt (in case of Hungary and Poland), to increase the low growth rate, or to restructure and modernize their economies. Moreover, governments in CEC4 have realized that the best way of attracting and drawing benefits from FDI is not always passive liberalization (an “open door” policy). Liberalization can help get more FDI, but alone it is not enough. Attracting FDI in a highly competitive market for investment now requires stronger location advantages and more focused efforts by governments. Their focus, therefore, has shifted to international investment policies, in addition to economic policies, with the objective of attracting FDI.

Countries can attract FDI in many ways. The most important point is the “investment environment” and “attitude towards foreign investors”. Since the late 1980s, the number of BITs concluded by CEC4 witnessed a sharp increase. This reflects the fact that these countries have moved towards “market-friendly” policies – having stable and non-discriminatory rules on business entry and exit. Their objective was to provide international legal protection, reduce obstacles, create “investor-friendly” settings and promote FDI. BITs are heralded by their proponents as an important means of attracting new FDI. They are considered as providing international legal protection and protecting foreign investment against political risk in the host country.

To explicitly capture the role played by international investment agreements (IIAs) in determining FDI in CEC4, the study proposes to present the theoretical model by integrating factors of the Country Risk with that of the Eclectic theory.

5.5 Model Specification

Based on the above theoretical argument the following economic model is specified and utilised in the forthcoming analysis:

$$FDI_{\text{Activity in CEC4}} = f \{ \text{Country Risk}_{\text{CEC4}}, \text{Int'l Competitiveness}_{\text{CEC4}} \} \quad (1)$$

Where,

$$\text{Country Risk}_{\text{CEC4}} = f \{ \text{Macroeconomic Risk}_{\text{CEC4}}, \text{Political Risk}_{\text{CEC4}} \} \quad (2)$$

$$\text{Int'l Compet.}_{\text{CEC4}} = f \{ \text{Real Effective Exchange Rates}_{\text{CEC4}}, \\ \text{Relative Unit Labour Cost}_{\text{CEC4}}, \text{Labour Quality}_{\text{CEC4}} \} \quad (3)$$

$$\text{Macroeconomic Risk}_{\text{CEC4}} = f \{ \text{Economic Risk}, \text{Financial Risk}, \text{Currency Risk} \} \quad (4)$$

$$\text{Political Risk}_{\text{CEC4 related to FDI}} = f \{ \text{Removal of Restrictions on FDI, e.g.,} \\ \text{Admission and Establishment, Entry and Exit Regulations} \\ \\ \text{Standards of Treatment to Foreign Investors, e.g.} \\ \text{National Treatment, Most -Favoured -Nation Treatment, Fair and Equitable Treatment} \\ \\ \text{Protecting Foreign Investors, e.g. Property Rights, Nationalization,} \\ \text{Expropriation, State-State and Investor-State Dispute Settlement,} \\ \\ \text{Repatriation of Capital, Profits and Dividends, e.g.} \\ \text{Transfer of Funds} \\ \\ \text{Transparency} \} \quad (5)$$

Since the factors of Political Risk in (5) are all issues covered by international investment agreements (IIAs), then rewrite (5) and get the following expression:

$$\text{Political Risk}_{\text{CEC4 related to FDI}} = f \{ \text{International Investment Agreements} \} \quad (6)$$

(Bilateral Investment Treaties, Regional and
Multilateral Investment Agreements)

The economic model that acts as the basis for the determinants of FDI in CEC4 is derived from (1), and is specified as:

$$\text{FDI}_{\text{Activity in CEC4}} = f \left\{ \text{Economic Risk}_{\text{CEC4}}, \text{Financial Risk}_{\text{CEC4}}, \text{Currency Risk}_{\text{CEC4}}, \right. \\ \left. \text{Bilateral Investment Treaties}_{\text{OECD}}, \text{Regional Investment} \right. \\ \left. \text{Agreement}_{\text{OECD Code of Liberalization of Capital Movements}}, \text{Multilateral} \right. \\ \left. \text{Investment Agreements, RULC, Labour Quality}_{\text{CEC4}} \right\} \quad (7)$$

Based on their susceptibility to change, the two categories of country risk – macroeconomic and political - may affect FDI over different time periods. It may take a long time to change the “macroeconomic risk” factors of the host country, for example, market size, growth, inflation, financial institutions’ level of development and efficiency, and external debt position, may take a long time to change.

On the other hand, the “political risk” factor, the conclusion of BITs to encourage FDI flows from a particular country, may have an impact both in the short run as well as in the medium run. For example, removal of restrictions, entry and exit regulations, standards of treatment, repatriation of profits, may have a more immediate effect, and encourage and promote foreign investment.

International obligations would help reduce investor risk perceptions and narrow the gap between the actual risk of policy instability that may be suggested by a host country’s domestic legislation, and the risk as perceived by foreign investors. If multilateral disciplines further reduced obstacles to FDI beyond what other IIAs do, this (plus the right economic determinants) would presumably lead to higher investment flows. Even then, however, multilaterally agreed investment rules would not by themselves guarantee higher FDI flows. Nor would it be possible to predict the geographical distribution of FDI flows, because this would be determined first and foremost by the economic fundamentals of individual locations (Singh, 2001, and UNCTAD, WIR 2003).

The focus of the study is on international investment agreements (IIAs) concluded by the CEC4, particularly, BITs, after controlling for the economic fundamentals as alternative explanations. Bilateral investment treaties OECD stands for the impact of BITs concluded between CEC4 and OECD countries. Regional investment agreement OECD Code stands for the impact of OECD *Code of Liberalisation of Capital Movements*, accepted by the CEC4. Multilateral investment agreements stand for the impact of WTO membership and for accepting the investment related provisions of the WTO.

The model utilizes also the crucial “eclectic” theory factors such as “international competitiveness” of a host country. *Efficiency-seeking FDI* and *resource-seeking FDI* are related to the “international competitiveness” of a host country. International competitiveness is indicated by the relative unit labour cost of CEC4 *with respect to* OECD countries, and the quality of labour force in CEC4.

5.6 Hypotheses Formulation

5.6.1 Macroeconomic Risk

Macroeconomic risk is related to the fundamentals of the economy. Sound macroeconomic fundamentals are necessary conditions to attract international capital flows and investments. FDI faces variability of basic macroeconomic factors – economic performance, growth, inflation, budget deficit, interest rates, exchange rates, etc. - across countries. Volatility of macroeconomic factors creates both problems and opportunities for international investors, requiring them to manage the risk inherent in volatile countries, but also presenting the opportunity of moving production to lower cost facilities. Thus, stable macroeconomic environment implies less investment risk. Macroeconomic risk works at the macroeconomic level, and consists of three major components: (a) economic risk, (b) financial risk, and (c) currency risk.

5.6.1.1 Economic Risk

(i) Macroeconomic Performance (GDP and Growth)

Country economic risk refers to the volatility of macroeconomic performance, which is often measured by real gross domestic product (GDP) and growth. It is an important risk element in international investment because a country's macroeconomic environment plays a fundamental role in determining the outcome of individual investments undertaken within its borders. Generally speaking, a volatile macroeconomic environment is likely to generate volatility in the profits of resident firms and financial institutions, thereby increasing their exposure to risk. Therefore, it is expected that:

***Hypothesis 1:** The higher the economic performance of a host country indicated by real GDP and Growth, the higher the foreign investment inflows. GDP indicates also the market size of an economy. Foreign direct investment is positively related to host country market size. Therefore, the larger a host country's market size, the higher the FDI.*

(ii) Macroeconomic Stability (Price Stability): Inflation

Macroeconomic stability is an important determinant of foreign investment. One indicator of a stable macroeconomic environment is a record of price stability. Low inflation signals to investors how committed and credible the government is. Furthermore, high inflation indicates the failure of the Central Bank to conduct appropriate monetary policy (Schneider and Frey, 1985). It indicates domestic policy failures that discourage both savings and investment. Where inflation rates are high, potential direct investors may perceive difficulty even in making short-term pricing decisions. Inflation also may inhibit export sales from the country, thus making *resource-seeking* FDI less attractive. For these reasons, foreign investors may avoid making investments in countries with high inflation. Therefore, it is expected that:

Hypothesis 2: The higher the inflation rate of a host country - measured as percentage change in consumer prices - the lower the foreign investment inflows.

(iii) *Financial Institutions' Level of Development and Efficiency*

Measures that aim to deepen the financial sector and open services to foreign capital create a favourable environment for FDI. The deeper a country's financial institutions and markets, the more capital flows the country attracts. Furthermore, for FDI, deeper financial institutions and markets may allow foreign firms to finance short-term – and long-term transactions more easily and meet capital needs in the local market (Alfaro et al. 2004). Economies with developed financial systems are able to attract more FDI. Therefore, it is expected that:

Hypothesis 3: The better developed and efficient are the financial institutions of a host country, the higher the foreign investment inflows.

5.6.1.2 Financial Risk and Country Creditworthiness

A country's financial risk involves an assessment of a country's foreign financial obligations compared to its ongoing and prospective economic situation. The ability to meet payments of interest and principal of foreign debt is an indicator of financial health and creditworthiness of a host country, thereby affecting its attractiveness for foreign investment. Thus, foreign investment decisions are affected by the financial health of a host country which is usually indicated by its external debt management ability.

(i) *External Debt Position*

Ratios such as total external debt to export revenues (EDT/XGS), total external debt to output (EDT/GNI), and total debt services to export revenues (TDS/XGS) indicate a country's ability to manage its external debt obligations. Generally, these

ratios are used by financial analysts to assess the financial health and creditworthiness of an economy (Nagy, 1979, Euromoney Magazine, Economist Intelligence Unit (EIU), International Country Risk Guide (ICRG), Ul Haque, Mark and Mathieson, 1997, and 1998). Therefore, it is expected that:

Hypothesis 4: *The lower the external debt obligations of a host country relative to its output and exports (EDT/GNI, EDT/XGS, TDS/XGS), the higher its creditworthiness, therefore the higher the foreign investment inflows.*

(ii) International Liquidity Position

The ratios reserves in months of imports (RES/MGS), and reserves to total external debt (RES/EDT) complement the leverage ratios and resemble liquidity ratios in corporate finance. The liquidity ratio RES/MGS measures a country's ability to maintain import levels with current cash in hand. The ratio RES/EDT measures ability to meet external debt with current cash in hand. Therefore it is expected that:

Hypothesis 5: *The higher the international liquidity position of a host country reflected by the ratios RES/MGS (import coverage period), and /or RES/EDT (reserves to external debt), the higher its creditworthiness, therefore the higher the foreign investment inflows.*

5.6.1.3 Currency Risk (Exchange Rate Risk)

Real Exchange Rates

Another particular kind of macroeconomic instability is that of exchange rates. The exchange rate has major consequences for non-residents investing in a host country. Apparently profitable transactions can suddenly turn sour if the exchange rate moves in the wrong direction. Theoretically, exchange rate *levels* and *volatility* have an important influence on FDI activity, but their impact is ambiguous. The effect of the level of the exchange rate depends on the destination of the goods produced and the

motivation for FDI. If the investor aims at serving the local market, then FDI and trade are substitutes, in which case an appreciation of host country currency attracts FDI inflows. Alternatively, if FDI is aimed at re-exports, then FDI and trade are complements. In this case, appreciation of host country currency reduces FDI inflows through lower competitiveness (Benassy-Quéré, Fontagné, and Lahréche-Revil, 2001, Fontagné and Pajot, 2002).

Concerning to currency depreciation, there is mixed evidence on the impact of depreciation of real exchange rate of host country currency on FDI inflows. Foreign investors may gain or lose from a depreciating exchange rate. In terms of gain, they may have more buying power in host countries. Thus, they can gain a larger foreign capacity for the same amount of home-country capital. Further, they can produce more cheaply when a real exchange rate depreciates; thus, they can export more easily and gain from resource-seeking FDI. However, foreign investors may lose because they must incur costs to prevent transaction and translation losses when currencies depreciate. If they believe that depreciation will continue after they enter a country, they may conclude the costs will be too high to justify their investments (Trevino, Daniels, and Arbelaez, 2002).

In fact, findings by various researchers (Froot and Stein, 1991, Trevino, Daniels and Arbelaez, 2002, Banga, 2003, Brzozowski, 2006) are mixed in terms of investors' reactions to exchange rate depreciation. Because of its ambiguous effect, therefore:

Hypothesis 6: *Real effective exchange rate level is not expected to have an impact on FDI.*

5.6.2 Political Risk

Political stability and the regulatory regime can make a location more or less attractive for foreign investors. International obligations – BITs, regional investment agreements such as the OECD *Code of Liberalization of Capital Movements*, international monetary agreements, such as the *Articles of Agreement of the International Monetary Fund* (IMF), and an international trade agreement, such as *WTO membership* - would help reduce investor political risk perceptions and narrow the gap between the actual risk of policy instability that may be suggested by a host country's domestic legislation, and the risk as perceived by foreign investors (UNCTAD, *WIR*, 2003)⁴⁰. Why political risk? Because, IIAs between two countries or between a country and an international organization is a political decision; and political risk is related to the political events and / or decisions.

(i) *Bilateral Investment Treaties (BITs)*

Countries with weak markets and institutions are a concern for foreign investors. Given the weakness of the domestic political / legal environment in CEC4 in the early stages of their transition (1980s), foreign investors seek alternatives tailored to their needs. This is what BITs do. They provide enforceable rules to protect foreign investment and reduce the political risk faced by investors. BITs have become an increasingly important vehicle for promoting and protecting international investment flows by providing international legal security to foreign investors. Typically BITs establish international rules concerning the treatment of foreign investors and their investment by host countries, including national treatment and most-favoured nation treatment, prompt, adequate and effective compensation in the case of expropriation, and free movement of capital and other financial flows related to the investment. In addition, BITs include rules on dispute settlement, both with regard to state-state

⁴⁰ On the other hand (and this applies to the bilateral and regional levels as well), risk reduction can also be achieved through investment contracts between TNCs and host countries (as is common practice in some primary industries). These contracts typically have legally binding protection provisions over and above those in applicable bilateral or regional agreements, not to say in domestic legislation. In multi-country investment projects like large infrastructure developments, host countries may enhance investor security by supplementing existing BITs with an intergovernmental agreement committing them to certain standards and incorporating these into the investment contracts with the investors.

arbitration and investor-state arbitration. BITs could signal that a host country's attitude towards foreign investment has changed and its "investment climate" is improving. Foreign investors consider BITs as a hedging instrument against political risk in a host country. The analysis of BITs leads to two main suppositions regarding their implications for Central European countries (CEC4):

1. The four Central European countries (CEC4) signed BITs in an effort to attract greater amounts of FDI,
2. BITs serve as a substitute for a stable "investment environment".

Therefore, if BITs actually have these effects, it is expected the following:

Hypothesis 7: *Foreign investment inflows will be positively related to bilateral investment treaties (BITs) concluded between a foreign investor's home country and a host country.*

(ii) Regional Investment Agreement: OECD Code of Liberalization

The CEC4 being OECD members (in mid 1990s) are committed to provide non-discriminatory treatment to inward direct investment and related financial flows by virtue of the legally binding *OECD Code of Liberalization of Capital Movements* as a regional investment agreement. Therefore, it is expected that:

Hypothesis 8: *Foreign investment inflows will be positively related to a regional investment agreement concluded by a host country.*

(iii) International Monetary Agreement: The IMF Article VIII

The CEC4 accepted in 1995 the *IMF Articles of Agreement - Article VIII* – concerning current account liberalization. Therefore, it is expected that:

Hypothesis 9: *Foreign investment inflows will be positively related to an international monetary agreement, such as the IMF Article VIII, concluded by a host country.*

(iv) International Trade Agreement: WTO Membership

To the extent that trade and FDI are related (approximately one third of global trade is intra-firm trade), all WTO agreements hold relevance for foreign investors, even when these do not address investment issues, per se. This being said, the current investment architecture of the WTO can be conceptualized as a continuum across which one finds agreements and provisions with different levels of relevance to foreign investment and foreign investors. The CEC4 gained WTO membership in 1995. Therefore it is expected that:

Hypothesis 10: *Foreign investment inflows will be positively related to a host country's membership of an international trade organization such as the WTO.*

5.6.3 International Competitiveness

(i) Relative Unit Labour Cost

Cost factor advantage is a driving force behind FDI. Especially FDI oriented towards exports seeks to use those comparative advantages related to low labour costs. Therefore, it is expected that:

Hypothesis 11: *The lower the relative unit labour cost adjusted for productivity of a host country, the higher the foreign investment inflows.*

(ii) Quality of Labour Force

Availability of human resources and skilled labour is a driving force behind resource-seeking and efficiency-seeking FDI. Availability of skilled labour indicates how well countries are placed to profit from technological and scientific progress. Therefore, it is expected that:

Hypothesis 12: *Foreign investment inflows are positively related to the quality of the labour force in a host country.*

5.6.4 Other Factors

Trade and Openness to International Markets

A number of studies have suggested that foreign investments in countries are positively related to indicators of “openness” (*measured as exports plus imports of both goods and services to GDP*). Foreign investors prefer countries with relatively liberal trade regimes, possibly within free trade arrangements. However, depending on the type of FDI, the level of openness of a host country could have a positive or negative impact on a country’s ability to attract FDI. FDI focused on exploiting the local market would be attracted to a country with a less open economy, and FDI focused on exports (export-oriented FDI) would be positively related to openness. Because of the opposing nature of the theory, therefore:

Hypothesis 13: Openness (Trade/GDP) is not expected to have an effect on foreign direct investment inflows.

5.7 Conclusion

This chapter presented the proposed theoretical framework of the study. It constructed the theoretical model by integrating two important theories, the theory of country risk with Dunning’s eclectic theory. It provided an explicit explanation for the factors of country risk, explaining in detail macroeconomic and political risk factors. It explained also in detail Dunning’s eclectic theory (OLI Paradigm), which is based on three theories: the internalization theory, the location theory, and the theory of ownership. Then, it presented an argument about the integration mechanism of the two theories. Next, it explained and justified how this “integrated” theory can be utilized to explain FDI in CEC4. It specified the economic model of the study. Finally, the chapter formulated the different hypotheses that the study aims to test.

6 Empirical Framework

6.1 Introduction

There is a broad empirical literature on the determinants of FDI. A review of the literature shows that there is no clear agreement on the factors that determine FDI inflows. Studies use diverse variables and often come to opposing findings on the relationship between certain variables and FDI. Chapter five presented the conceptual (theoretical) framework of the study. It integrated Dunning's "eclectic" theory with the theory of "country risk". These two theories have been the most successful in explaining FDI. In addition, the factors of both "eclectic" and "country risk" theories can be utilized also as "pull-factors" within the "pull and push approach" that has been widely adopted in the empirical literature on capital flows. Thus, to specify a reasonable model for examining the impact of IIAs on FDI in CEC4, the empirical analysis adopts the "integrated" theory.

The purpose of this chapter is to examine empirically the impact of IIAs on inward FDI in CEC4, focusing on the impact of BIT ratification. Outward FDI from CEC4 is not included in the empirical analysis, because as mentioned in chapter two, there are some outward FDI from CEC4 but data available cover few years (Tables 2-18, 2-19, 2-20, and 2-21). Due to the paucity of data, empirical analysis of the impact of IIAs on outward FDI is thus not expected to provide statistically significant results.

6.2 Empirical Analysis: Impact of BIT Ratification

Since the late 1980s, the CEC4 started to conclude BITs extensively with the OECD countries (Tables 3-8, 3-9, 3-10, 3-11 and 3-12). Data available suggest that the majority of FDI in CEC4 originates from the OECD area (Tables 2-10, 2-11, 2-12, 2-13, 2-14, 2-15, 2-16, 2-17 and Charts 2-5, 2-6, 2-7 and 2-8). By the mid 1990s, most of the BITs concluded between OECD countries and CEC4 had been *ratified* (entered into force) and the share of FDI in CEC4 under a treaty was almost 100 percent. This increase in FDI towards countries with a BIT is largely explained by compositional shifts; as more country pairs ratify treaties, the amount of FDI flows covered increases. As the rationale for a host to ratify a BIT is most applicable for countries where “political risk”, “institutional quality”, “investment environment”, and “property rights” are generally weaker than in OECD countries, this focus facilitates the testing of the hypothesis that the lowering of political risk, providing international legal protection and strengthening of property rights significantly affects bilateral FDI activity.

Foreign investors have many other considerations for deciding whether or not to invest in a country. They are concerned with the “economic conditions” - market size, growth prospects, macroeconomic stability (inflation, and exchange rates), financial system’s level of development and efficiency, the presence of a dynamic private sector, relative labour costs, availability of skilled labour, infrastructure, etc...

For this reason, the empirical analysis addresses the hypothesis that the *ratification* of a BIT signed by a CEC4 with a particular OECD country merely reassures OECD home country investors, thus encouraging investment only if an investor’s home country has signed a BIT with the host country. If this is the case, the analysis expects bilateral FDI inward activity to increase with the ratification of a treaty. However, the strength of the signal could be related to the “economic conditions” and the “international competitiveness” of the host country.

For the purpose of the empirical analysis of the impact of BITs on FDI in CEC4, the study uses data on bilateral FDI activity from the OECD *International Direct Investment Statistics*. The data set covers FDI inward stocks and inflows from 22 OECD source countries, to CEC4 host countries, from 1992 to 2003 included. This is the period for which data are available. Since the OECD area is the source of over 90 percent of FDI activity in CEC4, the study covers the majority of FDI in CEC4 that are covered by BITs.

Noteworthy to mention that since the purpose of a BIT between two countries is the “reciprocal” encouragement, promotion and protection of investments in each others’ territories by companies based in either country, one would expect that outward FDI from CEC4 to the 22 OECD countries to increase also. But data available on outward FDI from CEC4, described in chapter two, suggest that there are some outward FDI from CEC4 but they are negligible and cover few years. Due to the paucity of data, an empirical examination is thus not expected to provide statistically significant results. For this reason, the empirical analysis focuses on bilateral inward FDI in CEC4 from the 22 OECD countries.

One of the major obstacles in the empirical analysis of the impact of BITs on inward FDI in CEC4 is data constraints. One strategy to minor this problem is to use *panel data methodology* in the estimation process. This methodology is able to produce superior results, and thus more precise conclusions. There are several benefits from using panel data. The first benefit from moving to panel data is the ability to exploit the time-series and cross-sectional variation in the data. Second, panel data suggest that countries are heterogeneous. Time-series and cross-section studies not controlling for this heterogeneity run the risk of obtaining biased results. Third, they give more informative data, more variability, less collinearity among variables, more degrees of freedom and more efficiency. Fourth, they are better able to identify and measure effects that are simply not detectable in pure cross-section or pure time-series data. They prevent an estimation bias related to the specification of FDI invariant determinants (like the distance variable, a common border, or a common language

dummy) since these determinants are accounted for in the bilateral specific effect⁴¹. Finally, panel data allows control more easily the correlation between some explanatory variables and the error term (Baltagi, 1998, and 2001). Thus, panel data methodology answers the “good” economic policy question: does the ratification of a BIT between a source-host country pair increases bilateral inward FDI activity in the host CEC4?

6.2.1 Econometric Model

The economic model for FDI activity in CEC4 was specified in chapter five by the following equation:

$$FDI_{\text{Activity in CEC4}} = f \left\{ \text{Country Risk}_{\text{CEC4}}, \text{Int'l Competitiveness}_{\text{CEC4}} \right\} \quad (1)$$

The formal econometric model is derived from (1) and is specified as:

$$\begin{aligned} \ln (FDI_{ijt}) = & \alpha + \gamma_1 BIT_{ijt} + \beta_1 \ln (GDP_{jt}) + \beta_2 Growth_{jt} + \beta_3 \ln (INFL_{jt}) + \beta_4 REXR_{jt} \\ & + \beta_5 RULC_{jt} + \beta_6 EDU2_{jt} + \delta \text{Financial Institutions}_{jt} \\ & + \theta \text{Creditworthiness}_{jt} + \mu_{ij} + \varepsilon_{ijt} \end{aligned} \quad (2)$$

FDI is assumed to depend upon host country’s market size (*GDP*), economic growth (*Growth*), macroeconomic stability indicated by both inflation rate (*INFL*) and real effective exchange rate (*REXR*), financial institutions’ level of development and efficiency (*Financial Institutions*), creditworthiness (*Creditworthiness*), international competitiveness reflected by the relative unit labour cost with respect to OECD countries (*RULC*) and quality of labour force indicated by the proportion of labour force having attained secondary education (*EDU2*).

⁴¹ This justifies the reason for not using the gravity model for the econometric specification.

In addition, a group of dummies are added to capture the impact of IIAs. BIT stands for bilateral investment treaties, (*OECD*) for a regional investment agreement indicated by the *OECD Code of Liberalization of Capital Movements*, (*IMF*) for an international monetary agreement indicated by the acceptance of *IMF Articles of Agreement: Article VIII*, and (*WTO*) for a multilateral investment agreement.

The model uses the *natural logarithm*, abbreviated *ln*, of the dependent variable (FDI_{ijt}) and some of the explanatory variables to reduce the skewness in data distribution. The subscript (*i*) stands for the source country, (*j*) the host country, and (*t*) the time. μ_{ij} represents time-invariant unobserved country-pair specific effects. ε_{ijt} represents the omitted other influences on FDI activity.

The formal econometric model (2) represents the *Baseline Model*. It examines the impact of (*BIT*) on FDI, in addition to economic, financial, creditworthiness, and international competitiveness variables. Next, the dummy variables (*OECD*), (*IMF*), and (*WTO*) are added to the Baseline Model, to capture the impact of a regional investment agreement, an international monetary and multilateral investment agreements on FDI. This will check the *robustness* of the estimation results of the Baseline Model, and is specified as:

$$\begin{aligned} \ln(FDI_{ijt}) = & \alpha + \gamma_1 BIT_{ijt} + \gamma_2 OECD_{jt} + \gamma_3 IMF_{jt} + \gamma_4 WTO_{jt} \\ & + \beta_1 \ln(GDP_{jt}) + \beta_2 Growth_{jt} + \beta_3 \ln(INFL_{jt}) + \beta_4 REXR_{jt} + \beta_5 RULC_{jt} \\ & + \beta_6 EDU2_{jt} + \delta Financial\ Institutions_{jt} + \theta Creditworthiness_{jt} + \mu_{ij} + \varepsilon_{ijt} \quad (3) \end{aligned}$$

BIT Interaction with Financial Depth and Efficiency

In the case of the above two models (2) and (3), the reasoning is that a host country signs BITs in order to attract FDI. That is, BITs are often justified by an emerging country as a signal that they will protect foreign investment by providing international legal protection, thereby strengthening the “investment environment”. However, the credibility of this signal will be affected by the “*quality of institutions*”

of the host country. Institutions are the rules of the game in a society (North, 1990, and 1991). Institutions affect economic performance through their direct effect on business operation conditions and investment climate. The study emphasizes on the role of “financial institutions” and argues that the lack of development of local financial institutions can limit a country’s ability to take advantage of FDI. Within this framework, the study in a further analysis, examines empirically whether the effect of BITs changes significantly with the level of development and efficiency of financial institutions. It examines empirically the impact of the interaction of BIT with financial institutions’ depth and efficiency on FDI. The purpose is to test whether or not BITs exert different impact on FDI in well developed and efficient financial institutions. The econometric model including an interaction term is specified as:

$$\begin{aligned} \ln(\text{FDI}_{ijt}) = & \alpha + \gamma_1 \text{BIT}_{ijt} + \beta_1 \ln(\text{GDP}_{jt}) + \beta_2 \text{Growth}_{jt} + \beta_3 \ln(\text{INFL}_{jt}) + \beta_4 \text{REXR}_{jt} \\ & + \beta_5 \text{RULC}_{jt} + \beta_6 \text{EDU2}_{jt} + \delta \text{Financial Institutions}_{jt} \\ & + \gamma_2 (\text{BIT}_{ijt} * \text{Financial Institutions}_{jt}) + \mu_{ij} + \varepsilon_{ijt} \end{aligned} \quad (4)$$

Equation (4) represents the model with an interaction term. An interaction term is added to capture the impact of BIT in the presence of financial institutions. All the variables are the same as in the baseline model.

6.2.2 Variables and Sources

Dependent Variable

As dependent variable for the empirical analysis, the study uses *bilateral FDI inward stock and inflows* from 22 OECD source countries into each CEC4 host country over the period 1992-2003. Appendix A supplies further details on the covered 22 OECD source countries and the 4 host CEC4 countries. Data limitation on bilateral FDI activity necessitates the adoption of an *un-balanced panel data*⁴².

⁴² A panel data set where certain years (or periods) of data are missing for some cross-sectional units.

The empirical analysis examines the dependent variable (FDI_{ijt}) in two different ways:

1. First, as the *inward stock or inward position* of FDI of a specific OECD source country (i) in a host CEC4 (j), in year (t). To the extent that FDI flows may be reversible, FDI stock provides a better measure of the actual “inflow of FDI”. The data set of FDI inward stock consists of 704 observations, majority having positive values. Only 5 values have negative signs, and 19 are blank. According to OECD’s explanation, the blank values represent nil or negligible values. Using the natural logarithm of FDI inward stock generates 24 missing observations in the panel data, because the natural logarithm of a negative number or a zero is undefined.
2. Second, as the *level of bilateral inflows* from a specific OECD source country (i) into a host CEC4 (j) in year (t). The data set on FDI inflows consists of 578 observations, 63 having negative signs, and 25 blank values. Negative FDI inflows imply ‘instances of reverse investment or disinvestment’ (UNCTAD 2000b, p. 292). Using the natural logarithm of FDI inflows generates 88 missing values in the panel data.

The period of data set available for FDI inward stock is different from that of FDI inflows. Appendix B provides details for both FDI inflows and stock. Due to this difference in the period of data for FDI inward stock and inflows, and the existence of a great number of negative values in FDI inflows, regressions using FDI inward stock have different number of observations from that of using FDI inflows. The results of the regressions for both models will be reported in section 6.2.5.

In a further analysis, to check the robustness of the estimated results, the empirical analysis examines the dependent variable (FDI_{ijt}) by recoding the negative and blank values of FDI. For negative and blank values of FDI inflows and stock, the study has recoded their logarithm as zeros [$(FDI_{ijt}) = 1$ for all $(FDI_{ijt}) \leq 0$, this implies $\ln(1) = 0$]. Then the number of observations in the panel data is increased. The results of recoded FDI inflows and FDI inward stock are reported in Appendix E.

Data are from the OECD *International Direct Investment Statistics Yearbook 2004*, which covers the years 1992-2003. Original values are in national currencies. Conversion to US\$ is made by using the current exchange rates provided by annex III at the end of OECD's yearbook. They are converted to constant 2000 US\$ by using the US GDP deflator from the World Bank *World Development Indicators*. This procedure ensures that the valuation of the constant price FDI level or stock is not affected by movements in the nominal exchange rate of the host country. That is, this approach eliminates source-host bilateral exchange rate changes. The regressions use the *natural logarithm* of the dependent variable (FDI_{ijt}) in constant 2000 US\$.

Explanatory Variables

The explanatory variables on the right hand side of equation (2) are the variables specific to both *Country Risk* and *Eclectic* theories' frameworks. They can be utilized also as "pull- factors" within the "pull and push" approach.

i. Bilateral Investment Treaties (BIT)

The explanatory variable BIT_{ijt} is the *focus variable*, a measure of bilateral investment treaty *ratified* between OECD source country (i) and a CEC4 host country (j) in year (t). There are substantial measurement issues that determine how to define this variable. One can observe when countries make bilateral investment treaties with each other, but these treaties certainly differ from each other along many dimensions which are very difficult to quantify. In addition, the same treaty on paper can have different consequences for different pairs of countries depending on the unilaterally-adopted practices of countries before entering the treaty.

Because of these difficulties, this study measures investment treaty activity as a *binary variable* taking the value of "1" if two countries have a bilateral investment treaty in place in year (t) and after, "0" otherwise. Hence, a dummy is included in a

panel regression that takes the value of “1” once a BIT has been ratified⁴³ between a pair of source-host countries. The significance of the coefficient on this variable is then a test of the importance of the treaty.⁴⁴ As a result, it will be able to estimate the impact of BITs. Hallward-Driemeier (2003), and Egger and Pfaffermayr (2004a) have used a BIT variable in the same way.

Data on BITs are available from a listing published by UNCTAD *international investment instruments online (electronic) database* (<http://www.unctad.org/iaa>) that documents the parties to every bilateral investment treaty, the date of signature, and the date of entry into force.

ii. Market Size and Growth Prospects: GDP and Growth

Market size is universally accepted as the leading determinant of FDI inflows. FDI attracted by this factor is called *market-seeking FDI* (Dunning, 1993a). Many studies have used Gross Domestic Product (GDP) as an indicator of the “size” of an economy. This study follows them and uses this variable as an indicator for market size, and expects to have a positive impact on inward FDI. The proxy used is the natural logarithm of host country GDP in constant 2000 US \$.

Beyond market size, there is general disagreement on the determinants of FDI. Theoretically, the rate of growth of a country’s economy (*Growth*) would seem to be important for attracting FDI, as a fast growing economy in the present would indicate future market potential (Schneider and Frey, 1985, Tobin and Rose-Ackerman, 2005, Neumayer and Spess, 2005). The expected relationship between the economy’s rate of

⁴³ UNCTAD publishes both the date of signing of BITs and the date it was ratified. The distinction is important as the treaty only goes into effect once it is ratified – and there are several cases where ‘signed’ treaties have never been ratified. The thesis uses the date of ratification of the BIT in all the empirical work.

⁴⁴ This thesis does treat all BITs equally, when in fact there are some differences between them. The general point that BITs strengthen property rights holds across all of them. It is possible that there would be more of an effect if one looked only at those treaties with the strongest investor protections. Given this would require reading and devising an index measure of tens of BITs, it is beyond the scope of this study. However, if BITs are acting as a substitute for property rights, one would expect that the stronger clauses would be included in treaties with countries that have lower domestic property rights. That there is no evidence that these countries receive additional FDI after signing a BIT would indicate that the effort to classify individual BIT terms is unlikely to be fruitful.

growth and FDI is positive. Proxy used is real GDP growth (annual %). Data for both GDP and GDP growth are from the World Bank *World Development Indicators*.

iii. Macroeconomic Stability

- *Inflation Rate: INFL*

Inflation rate (*INFL*) is a proxy for macroeconomic stability. High inflation rate indicates domestic policy failure that discourages both savings and investment. Where inflation rates are high, potential direct investors find difficulty even in making short-term pricing decisions. Considering that investors prefer to invest in more stable economies, that reflect a lesser degree of uncertainty, it is reasonable to expect that inflation would have a negative effect on FDI (Schneider and Frey, 1985). The proxy used is the natural logarithm of inflation, consumer prices (annual %). Data are from World Bank *World Development Indicators*.

- *Real Effective Exchange Rate:REXR*

Real effective exchange rate (*REXR*) is another proxy for macroeconomic stability. It captures the effect of real exchange rate level on FDI activity. *REXR* is an index with base year 2000. An increase in the index indicates an appreciation of host country's currency, while, a decrease indicates a depreciation. The expected effect may differ by the type and motivation of investment regarding local market or export orientation. Because the effect of exchange rate level on FDI is ambiguous, the study does not predict a particular sign. Data are from the World Bank *World Development Indicators*.

iv. Financial Institutions' Level of Development and Efficiency

The study employs various ratios used by the World Bank for the assessment of a country's financial system's size, level of development and efficiency. Different specifications are used to examine separately the impact of each financial indicator on inward FDI in CEC4. Data are from the World Bank *World Development Indicators*.

- *Liquid Liabilities M3 (% of GDP): M3/GDP*

Liquid liabilities of the financial system, also known as broad money, or *M3*, are a general indicator of the size of financial intermediaries relative to the size of the economy without distinguishing between different financial institutions, or an overall measure of financial sector development. It includes three types of financial institutions: (a) the Central Bank, (b) deposit money banks, and (c) other financial institutions. A well developed financial system indicates favourable business operation condition and investment environment. Thus, the expected relationship between financial system's level of development (*M3/GDP*) and FDI is positive. It is employed in natural logarithm in all regressions, as indicated in the tables.

- *Domestic Credit Provided by the Banking Sector (% of GDP): BANKCR*

The ratio of domestic credit provided by the banking sector to GDP is a measure of the development and growth of the banking system because it reflects the extent to which savings are financial. It includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. Because the banking system represents the financial intermediaries, the growth of the banking system, reflects the level of development of financial intermediaries, and is an indicator of financial depth. The banking sector includes: (a) monetary authorities, (b) deposit money banks, and (c) other banking institutions for which data are available. Examples of other banking institutions include savings and mortgage loan institutions, and building and loan associations.

The ratio (*BANKCR*) is important in the sense that credit is an important link in the money transmission process; it finances production, consumption, and capital formation, which in turn affects the level of economic activity. Foreign investors' decisions are affected by host country credit conditions, as they can have access to complementary local finance more easily, and face lower transaction costs for local financial services. Moreover, their customers too, are more likely to have access to bank credit, which should accelerate the demand for their products that are often bought on credit. Therefore, the study expects *BANKCR* to have positive impact on inward FDI to CEC4. It is employed in natural logarithm in all regressions.

- *Interest Rate Spread (lending rate minus deposit rate % points): INTSPREAD*

No less important than the size and depth of the financial sector is its efficiency, as indicated by the margin between the cost of mobilizing liabilities and the earnings on assets - or the interest rate spread. Interest rate spread is the interest rate charged by banks on loans to prime customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. A small spread indicates that the market considers its best corporate customers to be low risk (World Bank, *World Development Indicators*). Interest rates reflect the responsiveness of financial institutions to competition and price incentives. Narrowing of the interest rate spread reduces transaction costs, which lowers the overall cost of investment and is therefore crucial for investment decisions.

The interest rate spread, also known as the intermediation margin, is a summary measure of a banking system's efficiency or financial efficiency. It indicates also the "quality" of financial institutions (Andreff and Andreff, 2006). For the CEC4, a narrow spread means that financial sector reforms are advanced enough to have banking sector or financial institutions that can be compared to the EU ones or that complies with the *acquis communautaire* (Andreff and Andreff, 2006). Thus, the study expects *INTSPREAD* to have a positive impact on inward FDI in CEC4. Interest rates are expressed as annual averages

- *Real Interest Rates (%): REALRATE*

Real interest rate is the lending interest rate adjusted for inflation as measured by the GDP deflator. A negative real interest rate indicates a loss in the purchasing power of the principal. Although FDI relies on foreign capital, lending interest rates (local cost of borrowing), might be very important for foreign investment decisions. The impact of lending interest rates on FDI inflows is found to be ambiguous in nature and statistically insignificant by many studies (Banga, 2003). On one hand, it can be argued that a host country's cost of capital has a direct impact on domestic consumption. Thus, the lower the interest rates, the higher the domestic consumption and hence the higher the FDI inflows. Alternatively, it can be argued that high lending interest rates may have a positive impact on FDI inflows, in the sense that, the higher

the cost of capital in a host country, the more capital is brought in by foreign investors. The high local cost of capital, might lower domestic investment and create opportunities to foreign investors. In other words, foreign investors might borrow at a lower cost either from their home country's financial institutions or other international capital markets, and make investments abroad to get opportunity of the market size, growth potential, skilled and low cost labour, agglomeration effect, etc. of the host country. Therefore, the study does not predict a particular relationship between real lending interest rates and inward FDI.

v. *Financial Risk and Country Creditworthiness*

Many studies have used country credit ratings provided by various institutions, such as the *Political Risk Services Group's (PRS) International Country Risk Guide (ICRG)*, *Economist Intelligence Unit (EIU)*, *Euromoney*, *Institutional Investor*, etc., as an indicator of overall economic stability that includes both political and macroeconomic stability. However, there arises the question of subjectivity in these ratings since it is found that the ranking of countries based on these ratings differ across estimates provided by different agencies. To avoid the problem of subjectivity, this study prefers to use separately the most frequently used variables in assessing a country's ongoing and prospective financial position.

- *Financial Risk*

A country's financial risk refers to the ability of an economy to generate enough foreign exchange to meet payments of interest and principal on its foreign debt (Clark and Marois, 1996, Bouchet, Clark and Gros Lambert, 2003). The variables most frequently used by international financial institutions and financial analysts in assessing cross-border financial risk include those variables that give information on a country's foreign debt and interest payments (ICRG, EIU, Euromoney, Institutional Investor, Nagy, 1979, Cosset and Roy, 1991, Eaton, Gersovitz and Stiglitz, 1992, Lee, 1993, De Bondt and Winder, 1996, Lehman, 1999, Ul Haque, Mark and Mathieson, 1997 and 1998).

To capture financial risk and country creditworthiness, the empirical study employs some of the most common financial ratios. These ratios are:

- *Total External Debt / Exports of Goods and Services (EDT/XGS) (%)*
- *Total External Debt / GNI (EDT/GNI) (%)*
- *Total Debt Service / Exports of Goods and Services (TDS/XGS) (%)*

The ratios *EDT/XGS* and *EDT/GNI* can be interpreted as a measure of an economy's *financial leverage*. Financial leverage measures the extent to which the assets are financed with debt. The higher a country's external debt obligations relative to its export revenues (*EDT/XGS*) or output levels (*EDT/GNI*), the higher is its financial risk and default on payment. Foreign investors consider high external debt ratios of a host country as unfavourable. Alternatively, one might argue that, a high external debt might motivate a host country to sell-off State properties to reduce the burden of the government and attract foreign capital to pay-off its external debt, thus attracting "*privatization-related FDP*". Therefore, the study does not predict a sign for (*EDT/XGS*) or (*EDT/GNI*) on inward FDI.

The ratio *TDS/XGS* resembles a *cash flow coverage* ratio. It relates export earnings to total current financial obligations including payments of interest and principal. A low ratio indicates a better financial position. However, the same argument as above applies for *TDS/XGS*. High current financial obligations of a host country, including payments of interest and principal, might motivate a country to sell-off State properties and attract "*privatisation-related FDP*". Thus, the study does not predict a sign for the impact of (*TDS/XGS*) on FDI.

- *International Liquidity Position (or Liquidity Risk)*

International liquidity position or liquidity risk refers to a country's ability to meet its maturing short-term obligations. The ratios which indicate the liquidity risk of a country are:

- *Reserves / Imports of Goods and Services (RES/MGS) (months)*
- *Reserves / Total External Debt (RES/EDT) (%)*

The *RES/MGS* ratio measures a country's ability to maintain import levels with current cash in hand. The higher the reserves of a host country in months of imports (i.e. the higher the import coverage period), the higher is its international liquidity position, thus the higher is its international creditworthiness (Bouchet, Clark, and Gros Lambert, 2003). The *RES/EDT* measures a country's ability to maintain its external debt obligations with current cash in hand. A higher ratio indicates higher liquidity position, thus higher creditworthiness. Reserves may be interpreted also as proxy for *exchange rate stability*, at least in the short run (Matyas 1997, Matyas *et al.* 1997, and Egger and Pfaffermayer, 2004b). Foreign investors consider high reserve ratios as favourable. Thus, the study expects both *RES/MGS* and *RES/EDT* to have positive impacts on inward FDI.

Different specifications are used to examine separately the impact of each indicator on inward FDI in CEC4. All financial risk and creditworthiness indicators are employed in natural logarithms in all the regressions, as indicated in the tables. Data are from the World Bank *Global Development Finance*.

vi. *International Competitiveness*

A broad interpretation of international competitiveness would involve comparison of the success of different countries in raising productivity, and fostering innovation (Porter, 1990). Cost factors may significantly influence the choice of an investment location for the “*resource-seeking*” and “*efficiency-seeking*” FDI. To capture cost and availability of skilled labour the study uses relative unit labour costs in manufacturing *with respect* to OECD countries ($RULC_{OECD}$), and the percentage of labour force that has attained secondary education (EDU2) to indicate the quality of labour force.

- *Relative Unit Labour Cost with respect to OECD Countries: RULC*

RULC is an index published in *OECD FACTBOOK 2006* as an indicator of *international competitiveness*. It measures changes in a country's price competitiveness in international markets based on changes in that country's exchange rate and price level using unit labour costs in manufacturing relative to those of its

competitors. According to OECD *FACTBOOK 2006*, *RULC* can also be called index of real effective exchange rate. Unlike nominal effective exchange rates, it takes into account not only changes in market exchange rates but also variations in relative price levels, using unit labour costs in manufacturing, and therefore can be used as an indicator of competitiveness.

The change in a country's index of relative unit labour costs in manufacturing between two years is obtained by comparing the change in the country's unit labour cost (converted into US dollars at market exchange rates) to a weighted average of changes in its competitors' unit labour costs (also expressed in US dollars), using the weighting matrix for the current year. The index shows changes in the international competitiveness of each country over time. It is in base year 2000. A rise in the index indicates deterioration in the country's competitiveness. Therefore, the study expects *RULC* to have a negative impact on inward FDI.

- *Quality of Labour Force: EDU2*

Foreign investors are concerned not only with the cost of labour, but also with its "quality". Quality of labour force can be reflected by the level of education of the labour force. A more educated labour force can learn and adopt new technology faster, and the cost of training local workers would be less for investing firms. Many empirical studies tested the impact of labour quality using the general secondary education enrolment rate (Campos and Kinoshita, 2003). There is a strong empirical evidence of the positive relationship between FDI and the "quality" of labour force. This study employs the proportion of the labour force that has attained secondary education, as a percentage of the total labour force (*EDU2*). The share of the labour force that has attained qualifications at the secondary level is a key indicator of how well countries are placed to profit from technological progress. The higher the proportion of labour force having attained secondary education, the higher the potential for an investment decision and achievement of expected outcome. Thus, the expected sign on FDI is positive. Data are from the World Bank *World Development Indicators*.

vii. *Regional Investment Agreement (OECD)*

A dummy is included to capture the impact of concluding a regional investment agreement, the *OECD Code of liberalization of Capital Movements*. $OECD_{jt}$ is a binary variable that takes the value of “1” if the host country (j) has joined the OECD in year (t) and after, “0” otherwise. The study expects the conclusion of a regional investment agreement and membership of a regional economic organization (OECD) to have a positive impact on inward FDI in CEC4.

viii. *International Monetary Agreement (IMF)*

A dummy is included to capture the impact of concluding an international monetary agreement, *The Articles of Agreement of the IMF: Article VIII*. IMF_{jt} is a binary variable that takes the value of “1” if the host country (j) has accepted IMF’s *Article VIII* in year (t) and after, “0” otherwise. The study expects the acceptance of an international monetary agreement, IMF’s *Article VIII*, concerning current account convertibility, to have a positive impact on inward FDI in CEC4.

ix. *Multilateral Investment Agreement (WTO)*

WTO is not strictly an investment agreement, but it shares a similar language and so is included in the measurement of FDI activity. WTO membership is important for a number of reasons: first, because membership promotes the establishment of the legal framework and market based institutions in support of international trade that were absent under central planning; second, because WTO membership provides better guarantees for “market access” through the provision of unconditional MFN status; and third, because the WTO has established a binding dispute settlement mechanism, which, at least so far, has proved effective in adjusting trade disputes (Michalopoulos, 1999a). For the CEC4, Hungary and Poland became contracting parties in the 1970s and 1980s. They renegotiated their GATT protocols and became founding members of the WTO in 1995. Similarly, Czechoslovakia, an original contracting party of the GATT, ostensibly continued its adherence to the agreement throughout its central planning period, with the Czech and Slovakia Republics becoming subsequently members of the WTO in 1995 (Michalopoulos, 1999a). Thus, WTO, as an

international trade agreement, made the CEC4 more attractive destinations for investment as an export platform. Again, not controlling for the broader economic change would bias upwards the importance of a BIT that is really due to changes in trade policy. WTO_{jt} is a binary variable that takes the value of “1” if the host country (j) has joined the WTO in year (t) and after, “0” otherwise. The study expects the membership of CEC4 to the WTO to have a positive impact on inward FDI in CEC4.

x. Other Variables

- *Openness: Trade (export plus import)/GDP*

The term “openness” of the economy refers to the share of trade (import plus export) in GDP. International trade in goods and services is a principal channel of economic integration. A convenient way to measure the importance of international trade is to calculate the share of trade in GDP. Many studies tested the impact of openness of trade and regional trade agreements on FDI inflows and found them to be important determinants (Gastanaga, Nugent and Pashmova, 1998, Yeyati, Stein and Daude, 2003, Hallward-Driemeier, 2003). The expected effect may differ by the type of investment regarding local market or export orientation. Thus, the study does not predict a sign for the effect of *Openness* on FDI. Trade indicator is entered in the regressions in natural logarithmic form. Data are from World Bank *WDI*.

- *Trend*

Global FDI grew dramatically during the period under study (the 1990s). *Trend* is included in the regressions to capture this global trend in FDI inflows, business cycle and technological change. The study expects a positive relationship between *Trend* and FDI activity in CEC4. In order to capture the same year effect, the trend starts with 1992 for all countries regardless of each country’s first year of observation. It is equal to 1 for 1992, 2 for 1993, 3 for 1994, 4 for 1995, etc...

Table 6-1 summarizes the definitions of the explanatory variables and reports their expected signs. Appendix B describes the variables and provides information on data sources. Appendix C reports summary statistics for the variables, and Appendix D presents a pair-wise correlation matrix for the variables.

6.2.3 Data

Data are originally collected by the researcher. They are compiled from the World Bank *World Development Indicators and Global Development Finance*, the IMF *International Financial Statistics*, OECD *International Direct Investment Statistics Yearbook 1992-2003*, and OECD *FACTBOOK 2006*, and UNCTAD *International Investment Instruments online and FDI/TNC databases*.

One of the major obstacles in the analysis of the impact of IIAs, particularly BITs, on FDI is data constraints. As noted earlier, this begins with measuring the treaty activity. However, there are also significant measurement issues with respect to the data on bilateral FDI activity as well. This study uses OECD data on bilateral FDI stocks and flows, as reported by OECD member countries. Such data were not even compiled into a publicly-available form until 1993 with the first annual OECD *International Direct Investment Statistics Yearbook*. Since data are collected from national sources in each country, there is substantial variation in coverage by country source and by year, and there is variation in measurement of FDI activity itself. The data sets use un-balanced panel data from 1992 through 2003.

6.2.4 Estimation Method

The study uses *panel data methodology* in the estimation process. A panel data regression differs from a regular time-series or cross-section regression in that it has a double subscript on its variables. In general, it appears as follows:

$$y_{it} = \alpha + X'_{it} \beta + u_{it} \quad i = 1, \dots, N; \quad t = 1, \dots, T \quad (5)$$

$$u_{it} = \mu_i + \varepsilon_{it} \quad (6)$$

Where y represents the dependent variable, X' represents a set of explanatory variables, α is a scalar, β is a $K \times 1$ vector, and X_{it} is the it th observations on K explanatory variables. u_{it} is the error component model for the disturbances, where μ_i denotes the *unobservable* specific effects and ε_{it} denotes the remainder disturbance. The subscript i

denotes the cross-section dimension, and t denotes the time-series dimension (Baltagi, 1998, 2001, Wooldridge 2002, and 2003).

The data set of this study gives rise to a *specific panel model* with two cross-section dimensions (source countries $i, i = 1, \dots, N_i$, and host countries $j, j = 1, \dots, N_j$) and one time dimension $t, t = 1, \dots, T$. Thus, the panel data regression that will be specified for the empirical analysis of this study appears as follows:

$$y_{ijt} = \alpha + X'_{ijt}\beta + u_{ijt} \quad (7)$$

$$u_{ijt} = \mu_{ij} + \varepsilon_{ijt} \quad (8)$$

Where the dependent variable y_{ijt} represents bilateral FDI activity from source country i into host country j at time t , β is $K \times 1$, and X'_{ijt} denotes a vector of exogenous variables which vary in the cross-section (either with the host country j , or with both source country i and host country j) and in the time dimension t . The explanatory variable vector X'_{ijt} represents the selection of variables described in the economic model for FDI activity in CEC4 specified in the previous chapter.

The typical error component model is given in (8). Here, μ_{ij} is a term unique to the country-pairs, for which $\mu_{ij} \sim (0, \sigma_\mu^2)$, known as the time-invariant *unobservable* country-pair specific effects. The fact that μ_{ij} has no t subscript tells that it does not change over time. The remaining error ε_{ijt} is the *idiosyncratic error* or time-varying error. It varies with countries and time and can be thought of as the usual disturbance in the regression, follows a normal distribution with zero mean and constant variance, $\varepsilon_{ijt} \sim (0, \sigma_\varepsilon^2)$, and is assumed to be uncorrelated over all i, j and t . That is, $E[\varepsilon_{ijt} \mu_{ij}] = 0$ and $E[\varepsilon_{ijt} X_{ijt}] = 0$ (Wooldridge, 2003).

Country-pair specific effects (μ_{ij}) are considered in the econometric model to take into account all *unobservable* country-pair specific effects that are time-invariant and may affect FDI activity between two countries. They are taken into consideration because one might suspect that there are factors making a country attractive to foreign investors that are not captured by the mentioned explanatory variables (X'_{ijt}) and are

time-invariant such as history, culture, language, frontier, climate, geographical distance to the centres of the Western developed countries, and other effects.

The country-pair specific effects (μ_{ij}) may or may not be correlated with the explanatory variable vector (X'_{ijt}). The existence of a correlation between the country-pair specific effect and the regressors may be detected by applying the Hausman test (1978), whose null hypothesis is the non-correlation between (μ_{ij}) and (X'_{ijt}). In the case of there being a correlation, estimation must be done with a fixed-effects estimator (LSDV)⁴⁵. Otherwise, the random effect estimator would be the most appropriate. In other words, (μ_{ij}) can be treated as being fixed or random, depending on the data sample.

The specified model is estimated by both fixed-effects and random-effects estimation methods. For all of the specifications, a Hausman test did not reject the null hypothesis of no correlation between the country-pair specific effects (μ_{ij}) and the explanatory variables (X'_{ijt}). Therefore, a random-effects estimation method is adopted and the Generalised Least Squares (GLS) methodology is employed to obtain consistent and efficient estimates. The results are displayed in the tables of the following section.

The regressions were experimented also by using year-specific effects. A full set of year-specific dummies (λ_t) were used to take into account the effect of excluded variables whose common impact on all panel members have varied over time (i.e, may capture some time-variant effects that affect all country-pairs in the same way). When either of the fixed or random effects estimation method is augmented with the year-specific dummies, their coefficients turned to be insignificant. They do not show a significant departure from the overall intercept. Therefore, one can exclude the use of year-specific effects (λ_t) in the econometric model. The results are displayed in appendix E.

⁴⁵ Least Squares with Dummy Variables

Table 6-1: Variables and Theoretical Predictions

Determinant	Variable Name	Proxy Used	Abbreviation	Expected Sign
Economic Performance	Market Size	GDP (constant 2000 US\$)	GDP	(+)
	Growth Prospects	GDP Growth (annual %)	Growth	(+)
Macroeconomic Stability	Inflation Rate	Inflation, consumer prices (annual %)	INFL	(-)
	Exchange Rate	Index of Real Effective Exchange Rate	REXR	(+) / (-)
Financial Institutions' Level of Development and Efficiency	Financial Inst. Size and level of Development	Liquid liabilities, M3 (% of GDP)	M3/GDP	(+)
	Financial Inst. Depth	Domestic Credit Provided by the Banking Sector (% of GDP)	BANKCR	(+)
	Financial Inst. Efficiency	Interest Rate Spread (lending rate minus deposit rate % points)	INTSPREAD	(+)
	Cost of Capital	Real lending Interest Rates (%)	REALRATE	(+) / (-)
Financial Risk and Creditworthiness	External Debt Position	Total External Debt / Exports of Goods and Services (%)	EDT/XGS	(+) / (-)
		Total External Debt / GNI (%)	EDT/GNI	(+) / (-)
		Total Debt Services / Exports of Goods and Services (%)	TDS/XGS	(+) / (-)
	International Liquidity Position	Reserves / Imports of Goods and Services (in months of imports)	RES/MGS	(+)
		Reserves / Total External Debt (%)	RES/EDT	(+)
International Competitiveness	Relative Unit Labour Costs in Manufacturing with respect to OECD Countries	RULC w.r.t. OECD countries (Index)	RULC	(-)
	Quality of Labour Force	Labour force with secondary education (% of total)	EDU2	(+)
Trade Openness	Share of Trade in GDP	Trade (Exports plus Imports) (% of GDP)	Openness	(+) / (-)
Global FDI Trend	Trend	Trend	TREND	(+)
International Investment Agreements	Bilateral Investment Treaties	BIT with OECD Countries (Dummy)	BIT	(+)
	Regional Investment Agreement	OECD Code of Liberalization (Dummy)	OECD	(+)
	International Monetary Agreement	IMF Article VIII (Dummy)	IMF	(+)
	International Investment Agreement	WTO Membership (Dummy)	WTO	(+)

6.2.5 Estimation Results

Table 6-2: Baseline Model: FDI and BITs

Random-Effects GLS Estimation Results											
Baseline Model: FDI and BITs											
Dependent Variable: Natural log of Bilateral FDI Inward Stock in constant 2000 US\$.											
	1	2	3	4	5	6	7	8	9	10	11
BIT	0.55 [2.32]**	0.46 [1.95]*	0.47 [2.00]**	0.50 [2.12]**	0.54 [2.29]**	0.45 [1.91]*	0.46 [1.95]*	0.48 [2.01]**	0.54 [2.30]**	0.53 [2.25]**	0.55 [2.33]**
BIT-effect in % (Wooldridge, 2000)	73.33	58.41	60.00	64.87	71.60	56.83	58.41	61.61	71.60	69.89	73.33
ln GDP	1.38 [4.22]***	1.07 [3.57]***	1.33 [4.03]***	0.98 [3.23]***	1.23 [3.79]***	1.01 [3.35]***	1.29 [3.91]***	1.09 [3.60]***	0.99 [3.25]***	1.06 [3.56]***	0.93 [2.70]***
Growth	0.03 [1.30]	0.02 [0.94]	0.05 [1.82]*	0.01 [0.48]	0.03 [0.88]	0.00 [0.15]	0.04 [1.40]	-0.02 [0.90]	0.01 [0.42]	0.03 [1.14]	0.01 [0.26]
ln INFL	-0.13 [2.15]**	-0.19 [3.74]***	-0.13 [2.20]**	-0.19 [3.92]***	-0.17 [3.26]***	-0.16 [3.08]***	-0.10 [1.63]	-0.19 [3.89]***	-0.18 [3.47]***	-0.18 [3.55]***	-0.18 [3.20]***
REXR	0.00 [0.69]	0.01 [1.95]*	0.01 [1.46]	0.01 [1.05]	0.01 [1.74]*	0.01 [2.06]**	0.01 [1.56]	0.00 [0.61]	0.01 [1.68]*	0.01 [1.18]	0.01 [1.38]
RULC	0.01 [4.20]***	0.01 [3.69]***	0.01 [3.35]***	0.01 [4.44]***	0.01 [3.69]***	0.01 [3.42]***	0.01 [3.03]***	0.02 [4.80]***	0.01 [2.92]***	0.02 [4.99]***	0.01 [2.31]**
EDU2	0.00 [0.08]	0.01 [0.78]	0.00 [0.36]	0.00 [0.33]	0.00 [0.35]	0.00 [0.24]	0.00 [0.16]	0.00 [0.13]	0.00 [0.65]	0.00 [0.31]	0.00 [0.68]
ln M3/GDP	1.59 [2.19]**		1.28 [1.75]*				1.40 [1.93]*				
INTSPREAD		0.06 [3.12]***	0.05 [2.80]***								
REALRATE				0.02 [1.93]*							
ln BANKCR					0.62 [1.35]						
ln RES/MGS						0.57 [3.27]***	0.54 [3.06]***				
ln RES/EDT								0.38 [2.33]**			
ln EDT/XGS									0.31 [1.21]		
ln TDS/XGS										0.29 [2.08]**	
ln Openness											-0.34 [0.85]
Observations	680	680	680	680	680	680	680	680	680	680	680
No. of Country pair	87	87	87	87	87	87	87	87	87	87	87
R-sq.(overall)	0.06	0.07	0.06	0.07	0.08	0.07	0.06	0.07	0.08	0.08	0.07
sigma_u:	1.94	2.01	1.95	2.01	2.01	2.02	1.95	2.02	2.01	1.99	2.01
sigma_e:	0.91	0.90	0.90	0.91	0.91	0.90	0.90	0.91	0.91	0.91	0.91
rho:p	0.82	0.83	0.82	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83
Hausman Test	8.36	9.19	7.24	8.24	42.72	10.29	8.51	9.21	0.16	0.46	9.42
Prob > chi2	0.40	0.33	0.61	0.41	0.00	0.25	0.48	0.33	1.00	1.00	0.31

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

$\rho = (\sigma_u)^2 / (\sigma_u)^2 + (\sigma_e)^2$. All models include an intercept. Estimated using STATA Software.

Table 6-3: Baseline Model: FDI and BITs

Random-Effects GLS Estimation Results

Baseline Model: FDI and BITs

Dependent Variable: Natural Log of Bilateral **FDI Inflows** in constant 2000 US\$.

	1	2	3	4	5	6	7	8	9	10
BIT	0.41 [0.83]	0.35 [0.72]	0.32 [0.65]	0.37 [0.76]	0.36 [0.74]	0.34 [0.70]	0.38 [0.78]	0.37 [0.75]	0.39 [0.80]	0.35 [0.72]
ln GDP	1.43 [3.46]***	1.04 [2.52]**	1.23 [3.34]***	1.21 [3.19]***	1.25 [3.03]***	1.26 [3.34]***	1.36 [3.27]***	1.38 [3.76]***	1.35 [3.73]***	1.88 [3.39]***
Growth	0.03 [0.55]	0.00 [0.01]	0.00 [0.05]	0.04 [0.69]	0.01 [0.21]	-0.01 [0.09]	0.03 [0.52]	0.02 [0.24]	0.02 [0.37]	0.01 [0.24]
ln INFL	-0.06 [0.41]	-0.04 [0.26]	-0.14 [0.98]	-0.07 [0.48]	-0.06 [0.44]	-0.09 [0.60]	-0.05 [0.33]	-0.07 [0.50]	-0.06 [0.42]	-0.09 [0.62]
REXR	0.00 [0.21]	0.00 [0.08]	-0.01 [0.53]	0.00 [0.22]	0.00 [0.07]	-0.01 [0.26]	0.00 [0.08]	-0.01 [0.23]	0.00 [0.03]	-0.02 [0.77]
RULC	0.02 [1.49]	0.01 [0.74]	0.03 [1.80]*	0.02 [1.31]	0.02 [1.31]	0.02 [1.42]	0.02 [1.42]	0.02 [1.49]	0.02 [1.37]	0.03 [1.70]*
EDU2	0.03 [0.58]	0.03 [0.61]	0.02 [0.39]	0.02 [0.48]	0.02 [0.37]	0.01 [0.19]	0.03 [0.73]	0.03 [0.61]	0.03 [0.79]	0.04 [0.89]
ln M3/GDP	0.45 [0.35]									
ln BANKCR		-1.10 [1.47]								
INTSPREAD			0.07 [1.68]*							
REALRATE				0.03 [1.17]						
ln RES/MGS					0.21 [0.50]					
ln RES/EDT						0.25 [0.85]				
ln EDT/GNI							0.02 [0.05]			
ln EDT/XGS								-0.21 [0.43]		
ln TDS/XGS									-0.09 [0.33]	
ln Openness										1.02 [1.24]
Observations	490	490	490	490	490	490	490	490	490	490
No. of country pair	78	78	78	78	78	78	78	78	78	78
R-sq Overall	0.10	0.08	0.09	0.08	0.09	0.09	0.09	0.10	0.09	0.10
sigma_u	1.95	1.97	2.00	2.03	2.01	2.02	2.02	1.99	1.99	1.96
sigma_e	1.57	1.57	1.57	1.57	1.57	1.58	1.58	1.58	1.57	1.57
rho	0.60	0.61	0.62	0.62	0.62	0.62	0.62	0.61	0.62	0.61
Hausman Test	10.51	1.90	9.76	10.57	10.46	9.06	9.81	10.17	14.89	13.51
Prob>chi2 =	0.23	0.98	0.20	0.23	0.16	0.34	0.28	0.18	0.06	0.06

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

Estimated Using STATA Software.

Table 6-4: FDI, BITs and a Regional Investment Agreement (OECD)

Random-Effects GLS Estimation Results

FDI, BIT and OECD

Dependent Variable: Natural Log of Bilateral **FDI Inward Stock** in constant 2000 US\$.

	1	2	3	4	5	6	7	8
BIT	0.55 [2.34]**	0.46 [1.96]**	0.50 [2.13]**	0.45 [1.93]*	0.48 [2.02]**	0.54 [2.30]**	0.55 [2.33]**	0.54 [2.30]**
OECD	-0.10 [0.59]	-0.12 [0.72]	-0.13 [0.79]	-0.07 [0.43]	-0.13 [0.77]	0.02 [0.14]	0.04 [0.21]	-0.04 [0.23]
ln GDP	1.42 [4.25]***	1.10 [3.64]***	0.99 [3.28]***	1.02 [3.39]***	1.11 [3.69]***	0.99 [3.22]***	0.91 [2.57]**	1.04 [3.47]***
Growth	0.04 [1.37]	0.02 [0.98]	0.01 [0.58]	0.00 [0.15]	-0.02 [0.97]	0.01 [0.43]	0.01 [0.30]	-0.02 [0.88]
ln INFL	-0.12 [1.93]*	-0.18 [3.58]***	-0.19 [3.73]***	-0.15 [2.96]***	-0.19 [3.71]***	-0.18 [3.45]***	-0.18 [3.19]***	-0.14 [2.20]**
REXR	0.01 [0.89]	0.01 [2.03]**	0.01 [1.31]	0.01 [1.99]**	0.01 [0.90]	0.01 [1.53]	0.01 [1.35]	-0.02 [1.01]
RULC	0.01 [3.14]***	0.01 [2.67]***	0.01 [3.16]***	0.01 [2.67]***	0.01 [3.60]***	0.01 [2.77]***	0.01 [2.31]**	0.02 [3.87]***
EDU2	0.00 [0.37]	0.01 [1.04]	0.01 [0.69]	0.00 [0.43]	0.00 [0.49]	0.00 [0.47]	0.00 [0.47]	0.00 [0.28]
ln M3/GDP	1.70 [2.27]**							
INTSPREAD		0.06 [3.20]***						
REALRATE			0.03 [2.08]**					
ln RES/MGS				0.58 [3.28]***				
ln RES/EDT					0.42 [2.44]**			
ln EDT/XGS						0.32 [1.22]		
ln Openness							-0.37 [0.87]	
TREND								0.11 [1.65]*
Observations	680	680	680	680	680	680	680	680
No. of country pairs	87	87	87	87	87	87	87	87
R-sq:(overall)	0.06	0.07	0.07	0.07	0.06	0.08	0.07	0.08
sigma_u	1.94	1.99	1.99	1.99	1.99	1.99	1.99	1.99
sigma_e	0.91	0.90	0.91	0.90	0.91	0.91	0.91	0.91
rho	0.82	0.83	0.83	0.83	0.83	0.83	0.83	0.83
Hausman Test	7.62	4.52	8.59	5.83	6.93	3.45	6.37	6.78
Prob > chi2	0.57	0.87	0.48	0.76	0.64	0.94	0.70	0.66

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

rho: $\rho = (\sigma_u)^2 / (\sigma_u)^2 + (\sigma_e)^2$ (fraction of variance due to u_i). Estimated using STATA Software.

Table 6-5: FDI, BITs and an International Monetary Agreement (IMF)

Random-Effects GLS Estimation Results

FDI, BIT and IMF

Dependent Variable: Bilateral **FDI Inward Stock** in constant 2000 US\$.

	1	2	3	4	5	6	7	8	9
BIT	0.54 [2.27]**	0.47 [2.01]**	0.51 [2.16]**	0.46 [1.94]*	0.48 [2.04]**	0.53 [2.23]**	0.52 [2.20]**	0.55 [2.30]**	0.54 [2.26]**
IMF	0.11 [0.56]	-0.32 [1.47]	-0.12 [0.56]	-0.06 [0.30]	-0.18 [0.87]	0.19 [0.90]	0.11 [0.57]	0.08 [0.44]	0.07 [0.38]
ln GDP	1.39 [4.22]***	1.09 [3.69]***	0.97 [3.29]***	1.01 [3.39]***	1.10 [3.68]***	0.95 [3.14]***	1.06 [3.55]***	0.90 [2.63]***	1.03 [3.47]***
Growth	0.03 [1.20]	0.04 [1.54]	0.02 [0.68]	0.01 [0.24]	-0.01 [0.69]	0.01 [0.36]	0.03 [1.03]	0.00 [0.18]	-0.02 [0.94]
ln INFL	-0.13 [2.21]**	-0.16 [2.94]***	-0.18 [3.50]***	-0.15 [2.82]***	-0.18 [3.36]***	-0.19 [3.55]***	-0.19 [3.57]***	-0.18 [3.21]***	-0.14 [2.30]**
REXR	0.00 [0.21]	0.02 [2.43]**	0.01 [1.18]	0.01 [1.82]*	0.01 [0.99]	0.01 [1.31]	0.00 [0.61]	0.01 [1.22]	-0.02 [1.11]
RULC	0.02 [3.68]***	0.01 [1.48]	0.01 [2.86]***	0.01 [2.45]**	0.01 [2.99]***	0.01 [3.04]***	0.02 [4.22]***	0.01 [2.32]**	0.02 [3.79]***
EDU2	0.00 [0.08]	0.01 [0.79]	0.00 [0.27]	0.00 [0.22]	0.00 [0.02]	0.00 [0.68]	0.00 [0.31]	0.00 [0.69]	0.00 [0.19]
ln M3/GDP	1.65 [2.26]**								
INTSPREAD		0.08 [3.43]***							
REALRATE			0.02 [1.98]**						
ln RES/MGS				0.58 [3.25]***					
ln RES/EDT					0.45 [2.45]**				
ln EDT/XGS						0.44 [1.50]			
ln TDS/XGS							0.30 [2.14]**		
ln Openness								-0.38 [0.92]	
TREND									0.11 [1.66]*
Observations	680	680	680	680	680	680	680	680	680
No. country pairs	87	87	87	87	87	87	87	87	87
R-sq: (overall)	0.06	0.07	0.07	0.07	0.07	0.08	0.08	0.07	0.08
sigma_u	1.95	1.95	1.94	1.98	1.98	1.96	1.98	1.98	1.98
sigma_e	0.91	0.90	0.91	0.90	0.91	0.91	0.91	0.91	0.91
rho	0.82	0.82	0.82	0.83	0.83	0.82	0.83	0.82	0.83
Hausman Test	9.14	17.70	7.80	14.92	10.99	3.02	0.71	11.65	3.19
Prob> chi 2	0.42	0.04	0.45	0.09	0.28	0.96	1.00	0.23	0.96

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

$$\rho = (\sigma_{\mu})^2 / (\sigma_{\mu})^2 + (\sigma_{\epsilon})^2$$

Estimated using STATA Software.

Table 6-6: FDI, BITs and Multilateral Investment Agreements (WTO)

Random-Effects GLS Estimation Results									
FDI, BITs and WTO									
Dependent Variable: Natural Log of Bilateral FDI Inward Stock in constant 2000 US\$.									
	1	2	3	4	5	6	7	8	9
BIT	0.51 [2.15]**	0.45 [1.92]*	0.49 [2.07]**	0.45 [1.91]*	0.48 [2.02]**	0.50 [2.12]**	0.48 [2.02]**	0.51 [2.16]**	0.50 [2.12]**
WTO	0.35 [2.07]**	0.17 [0.95]	0.27 [1.42]	0.10 [0.49]	0.18 [0.81]	0.40 [2.34]**	0.45 [2.65]**	0.41 [2.37]**	0.35 [2.11]**
In GDP	1.37 [4.15]**	1.06 [3.59]**	1.00 [3.34]**	1.01 [3.39]**	1.07 [3.60]**	0.96 [3.17]**	1.05 [3.53]**	0.82 [2.39]**	1.03 [3.43]**
Growth	0.03 [1.30]	0.02 [0.79]	0.01 [0.24]	0.00 [0.12]	-0.01 [0.65]	0.01 [0.63]	0.04 [1.53]	0.01 [0.58]	-0.02 [0.83]
In INFL	-0.15 [2.51]**	-0.20 [3.85]**	-0.21 [4.14]**	-0.17 [3.03]**	-0.21 [3.93]**	-0.20 [3.80]**	-0.20 [3.97]**	-0.19 [3.42]**	-0.16 [2.63]**
REXR	0.00 [0.52]	0.01 [0.93]	0.00 [0.07]	0.01 [1.20]	0.00 [0.09]	0.01 [0.64]	0.00 [0.47]	0.01 [0.88]	-0.02 [1.51]
RULC	0.02 [4.58]**	0.02 [3.30]**	0.02 [4.17]**	0.01 [2.64]**	0.02 [3.86]**	0.02 [3.68]**	0.02 [5.53]**	0.02 [2.95]**	0.03 [4.58]**
EDU2	0.00 [0.06]	0.00 [0.72]	0.00 [0.37]	0.00 [0.25]	0.00 [0.23]	0.00 [0.61]	0.00 [0.18]	0.00 [0.69]	0.00 [0.16]
In M3/GDP	1.56 [2.16]**								
INTSPREAD		0.05 [2.46]**							
REALRATE			0.01 [1.09]						
In RES/MGS				0.52 [2.50]**					
In RES/EDT					0.26 [1.21]				
In EDT/XGS						0.41 [1.56]			
In TDS/XGS							0.37 [2.61]**		
In Openness								-0.55 [1.35]	
TREND									0.10 [1.61]
Observations	680	680	680	680	680	680	680	680	680
No. of country pairs	87	87	87	87	87	87	87	87	87
R-sq.overall	0.06	0.07	0.07	0.07	0.07	0.08	0.08	0.08	0.08
sigma_u	1.95	1.97	1.97	1.98	1.98	1.97	1.97	1.98	1.98
sigma_e	0.90	0.91	0.91	0.90	0.91	0.91	0.90	0.91	0.90
rho	0.82	0.83	0.82	0.83	0.83	0.82	0.83	0.83	0.83
Hausman Test	8.74	7.45	11.13	5.86	5.98	3.43	1.28	9.00	8.11
Prob >chi 2	0.46	0.59	0.27	0.75	0.74	0.94	1.00	0.44	0.52

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

$$\rho = \frac{\sigma_u^2}{(\sigma_u^2) + (\sigma_e)^2}$$

Estimated using STATA Software.

Table 6-7: Robustness: FDI, Economic Fundamentals and IIAs

Random-Effects GLS Estimation Results

Robustness: FDI, Economic Fundamentals and IIA

(Without Financial & Creditworthiness Indicators)

Dependent Variable: Natural log of Bilateral **FDI Inward Stock** in constant 2000 US\$.

	1	2	3	4	5
BIT	0.54 [2.30]**	0.55 [2.31]**	0.54 [2.29]**	0.51 [2.14]**	0.50 [2.13]**
OECD		-0.01 [0.05]			-0.19 [0.95]
IMF			0.05 [0.26]		0.01 [0.04]
WTO				0.36 [2.12]**	0.44 [2.34]**
ln GDP	1.07 [3.55]***	1.07 [3.56]***	1.06 [3.58]***	1.05 [3.56]***	1.09 [3.64]***
Growth	0.00 [0.24]	0.00 [0.24]	-0.01 [0.30]	0.00 [0.20]	0.00 [0.21]
ln INFL	-0.20 [3.99]***	-0.20 [3.93]***	-0.20 [3.88]***	-0.22 [4.34]***	-0.22 [4.18]***
REXR	0.01 [1.18]	0.01 [1.05]	0.01 [0.81]	0.00 [0.16]	0.00 [0.11]
RULC	0.02 [4.78]***	0.02 [4.03]***	0.02 [3.89]***	0.02 [5.06]***	0.02 [4.42]***
EDU2	0.00 [0.57]	0.00 [0.51]	0.00 [0.56]	0.00 [0.52]	0.01 [0.98]
Observations	680	680	680	680	680
Number of Country Pairs	87	87	87	87	87
R-sq: overall	0.07	0.07	0.07	0.07	0.07
sigma_u	2.00	1.98	1.97	1.97	1.97
sigma_e	0.91	0.91	0.91	0.91	0.91
rho	0.83	0.82	0.82	0.82	0.82
Hausman Test	8.03	3.45	11.52	9.12	3.43
Prob> chi2	0.33	0.90	0.17	0.33	0.97

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

rho: $\rho = (\sigma_u)^2 / (\sigma_u)^2 + (\sigma_e)^2$ (fraction of variance due to u_i). Estimated using STATA Software.

All Models Include an Intercept

Table 6-8: Robustness: FDI & IIAs

Random-Effects GLS Estimation Results

Robustness: FDI and IIAs

Dependent Variable: Natural Log of Bilateral **FDI Inward Stock** in constant 2000 US\$.

	1	2	3	4	5	6	7	8	9	10
BIT	0.50 [2.13]**	0.49 [2.09]**	0.46 [1.97]**	0.49 [2.07]**	0.46 [1.92]*	0.48 [2.03]**	0.46 [1.97]**	0.49 [2.06]**	0.51 [2.14]**	0.49 [2.09]**
OECD	-0.19 [0.95]	-0.40 [1.87]*	-0.08 [0.38]	-0.21 [1.04]	-0.11 [0.56]	-0.15 [0.73]	-0.29 [1.45]	-0.23 [1.15]	-0.14 [0.71]	-0.25 [1.24]
IMF	0.01 [0.04]	0.21 [0.89]	-0.31 [1.23]	-0.07 [0.29]	-0.03 [0.13]	-0.10 [0.43]	0.11 [0.50]	0.19 [0.75]	0.02 [0.08]	0.07 [0.32]
WTO	0.44 [2.34]**	0.46 [2.47]**	0.25 [1.26]	0.35 [1.76]*	0.16 [0.75]	0.25 [1.05]	0.56 [2.94]***	0.45 [2.42]**	0.46 [2.45]**	0.44 [2.38]**
In GDP	1.09 [3.64]***	1.54 [4.51]***	1.09 [3.72]***	1.02 [3.44]***	1.03 [3.44]***	1.11 [3.68]***	1.09 [3.65]***	0.97 [3.18]***	0.88 [2.49]**	1.06 [3.53]***
Growth	0.00 [0.21]	0.04 [1.47]	0.03 [1.33]	0.01 [0.43]	0.00 [0.14]	-0.01 [0.54]	0.04 [1.49]	0.01 [0.47]	0.01 [0.42]	-0.02 [0.94]
In INFL	-0.22 [4.18]***	-0.13 [2.19]**	-0.17 [3.13]***	-0.20 [3.78]***	-0.17 [2.92]***	-0.19 [3.52]***	-0.20 [3.89]***	-0.20 [3.85]***	-0.19 [3.40]***	-0.16 [2.51]**
REXR	0.00 [0.11]	0.00 [0.44]	0.02 [1.66]*	0.00 [0.54]	0.01 [1.27]	0.00 [0.52]	0.00 [0.27]	0.01 [0.70]	0.01 [0.85]	-0.02 [1.50]
RULC	0.02 [4.42]***	0.02 [4.04]***	0.01 [1.91]*	0.02 [3.18]***	0.01 [2.37]**	0.02 [2.93]***	0.02 [4.97]***	0.02 [3.57]***	0.02 [2.85]***	0.03 [4.31]***
EDU2	0.01 [0.98]	0.01 [1.15]	0.01 [0.80]	0.01 [0.87]	0.00 [0.54]	0.00 [0.56]	0.01 [1.03]	0.01 [1.20]	0.01 [0.97]	0.01 [0.86]
In M3/GDP		2.09 [2.65]***								
INTSPREAD			0.07 [2.78]***							
REALRATE				0.02 [1.37]						
In RES/MGS					0.50 [2.37]**					
In RES/EDT						0.30 [1.31]				
In TDS/XGS							0.40 [2.80]***			
In EDT/XGS								0.48 [1.64]		
In Openness									-0.48 [1.14]	
TREND										0.12 [1.76]*
Observations	680	680	680	680	680	680	680	680	680	680
No. of country pairs	87	87	87	87	87	87	87	87	87	87
R-sq (overall)	0.07	0.05	0.07	0.07	0.07	0.07	0.08	0.08	0.07	0.08
sigma_u:	1.97	1.94	1.93	1.94	1.99	1.98	1.99	1.98	1.99	1.99
sigma_e:	0.91	0.90	0.90	0.91	0.91	0.91	0.90	0.91	0.91	0.90
rho:ρ	0.82	0.82	0.82	0.82	0.83	0.83	0.83	0.83	0.83	0.83
Hausman Test	3.43	12.15	6.12	9.05	3.61	5.08	0.39	3.69	6.11	10.95
Prob > chi 2	0.97	0.35	0.87	0.62	0.98	0.93	1.00	0.98	0.87	0.45

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

$\rho = (\sigma_u)^2 / (\sigma_u)^2 + (\sigma_e)^2$

Estimated using STATA Software.

Table 6-9: Robustness: FDI & IIAs without BIT

Random-Effects GLS Estimation Results

Robustness: FDI and IIAs Without BITs

Dependent Variable: Natural Log of Bilateral **FDI Inward Stock** in constant 2000 US\$.

	1	2	3	4	5	6	7	8	9
OECD	-0.42 [1.98]**	-0.26 [1.29]	-0.22 [1.12]	-0.09 [0.42]	-0.12 [0.60]	-0.16 [0.78]	-0.41 [1.96]*	-0.16 [0.79]	-0.26 [1.31]
IMF	0.25 [1.05]	0.15 [0.63]	-0.04 [0.18]	-0.30 [1.17]	0.00 [0.01]	-0.09 [0.36]	0.58 [2.05]**	0.05 [0.22]	0.10 [0.46]
WTO	0.49 [2.63]***	0.43 [2.29]**	0.37 [1.86]*	0.26 [1.34]	0.17 [0.77]	0.25 [1.06]	0.58 [3.09]***	0.49 [2.60]***	0.47 [2.52]**
In GDP	1.60 [4.65]***	1.32 [3.97]***	1.07 [3.54]***	1.15 [3.84]***	1.08 [3.54]***	1.16 [3.81]***	1.45 [4.53]***	0.94 [2.66]***	1.11 [3.64]***
Growth	0.04 [1.58]	0.03 [0.84]	0.01 [0.55]	0.04 [1.46]	0.01 [0.24]	-0.01 [0.51]	0.02 [0.86]	0.01 [0.47]	-0.02 [0.89]
In INFL	-0.13 [2.17]**	-0.20 [3.59]***	-0.20 [3.79]***	-0.17 [3.13]***	-0.16 [2.88]***	-0.19 [3.50]***	-0.18 [3.27]***	-0.20 [3.44]***	-0.16 [2.51]**
REXR	0.00 [0.43]	0.01 [0.72]	0.00 [0.60]	0.02 [1.75]*	0.01 [1.37]	0.00 [0.59]	-0.01 [0.64]	0.01 [0.85]	-0.02 [1.51]
RULC	0.02 [4.12]***	0.02 [3.84]***	0.02 [3.21]***	0.01 [1.90]*	0.01 [2.35]**	0.02 [2.91]***	0.03 [5.46]***	0.02 [2.95]***	0.03 [4.40]***
EDU2	0.01 [1.32]	0.01 [1.15]	0.01 [1.01]	0.01 [0.93]	0.01 [0.64]	0.01 [0.65]	0.02 [2.08]**	0.01 [1.12]	0.01 [1.00]
In M3/GDP	2.16 [2.73]***								
In BANKCR		0.65 [1.30]							
REALRATE			0.02 [1.47]						
INTSPREAD				0.07 [2.92]***					
In RES/MGS					0.53 [2.55]**				
In RES/EDT						0.34 [1.47]			
In EDT/GNI							1.55 [3.07]***		
In Openness								-0.47 [1.10]	
TREND									0.12 [1.80]*
Observations	680	680	680	680	680	680	680	680	680
No. of Country Pairs	87	87	87	87	87	87	87	87	87
R-sq:overall	0.05	0.07	0.06	0.07	0.06	0.06	0.07	0.06	0.07
sigma_u	1.99	2.02	2.00	1.98	2.04	2.03	2.03	2.04	2.04
sigma_e	0.90	0.91	0.91	0.90	0.91	0.91	0.91	0.91	0.90
rho	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.83	0.84
Hausman Test	9.57	8.30	3.85	3.96	1.73	3.57	0.83	2.99	9.28
Prob > chi 2	0.48	0.60	0.95	0.95	1.00	0.96	1.00	0.98	0.51

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%
All Models Include An Intercept.

Table 6-10: Interaction: BIT with Financial Depth & Efficiency

Random-Effects GLS Estimation Results

Interaction: BIT with Financial Depth & EfficiencyDependent Variable: Natural log of Bilateral **FDI Inward stock** in constant 2000 US\$.

	1	2	3	4
BIT	0.55 [2.32]**	1.17 [0.38]	0.46 [1.95]*	0.70 [2.21]**
ln GDP	1.38 [4.22]***	1.39 [4.22]***	1.07 [3.57]***	1.07 [3.54]***
Growth	0.03 [1.30]	0.03 [1.31]	0.02 [0.94]	0.02 [0.95]
ln INFL	-0.13 [2.15]**	-0.13 [2.15]**	-0.19 [3.74]***	-0.18 [3.72]***
REXR	0.00 [0.69]	0.00 [0.68]	0.01 [1.95]*	0.01 [1.92]*
RULC	0.01 [4.20]***	0.01 [4.20]***	0.01 [3.69]***	0.01 [3.67]***
EDU2	0.00 [0.08]	0.00 [0.09]	0.01 [0.78]	0.01 [0.82]
ln M3/GDP	1.59 [2.19]**	1.73 [1.73]*		
BIT*ln M3/GDP		-0.16 [0.20]		
INTSPREAD			0.06 [3.12]***	0.10 [2.61]***
BIT*INTSPREAD				-0.04 [1.14]
Observations	680	680	680	680
No. of country pairs	87	87	87	87
R-sq. (overall)	0.06	0.06	0.07	0.07
sigma_u	1.94	1.94	2.01	2.02
sigma_e	0.91	0.90	0.90	0.90
rho	0.82	0.82	0.83	0.83
Hausman Test	8.36	8.87	9.19	7.93
Prob > chi 2	0.40	0.45	0.33	0.54

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

 $\rho = (\sigma_{\mu})^2 / (\sigma_{\mu})^2 + (\sigma_{\epsilon})^2$

Estimated Using STATA Software.

All Models Include An Intercept.

6.2.6 Discussion of Results

To estimate the impact of IIAs on inward FDI activity in CEC4, both fixed-effects and random-effects estimation methods have been used. However, the analysis is based on random-effects GLS estimation results because for all specifications the Hausman Statistic shows that the regressors are not correlated with the country-pair specific effects (μ_{ij}).

6.2.6.1 Baseline Model: FDI and BITs

To investigate the impact of BITs on inward FDI in CEC4, a Baseline Model is estimated with the *(BIT)*, the focus variable, in addition to economic, financial, creditworthiness, and international competitiveness variables. Table 6-2 reports random-effects GLS estimation results of FDI inward stock as dependent variable. Different specifications are estimated to examine separately the impact of each indicator. Each regression uses a different indicator for financial institutions, financial risk, creditworthiness, and openness. Column (1) uses *M3/GDP*, the liquid liabilities of the financial system, as an indicator of the size and level of development of financial institutions, column (2) uses *INTSPREAD*, interest rate spread, for the efficiency of financial institutions, column (3) uses both *M3/GDP* and *INTSPREAD* for both financial size and efficiency, column (4) uses *REALRATE* for the cost of capital, column (5) uses *BANKCR* for the development of the banking sector, column (6) uses *RES/MGS* for international liquidity and creditworthiness, column (7) uses both *M3/GDP* and *RES/MGS* for both size of financial institutions and creditworthiness, column (8) uses *RES/EDT* another indicator for international liquidity, column (9) uses *EDT/XGS* for external debt position, column (10) uses *TDS/XGS* to indicate current financial obligations, and column (11) uses *Openness* as an indicator for trade openness.

Most of the variables, reported under the different specifications of Table 6-2, have the expected signs and are consistent with the literature. They test in accordance with theoretical predictions.

Regarding the impact of *BIT*, the focus variable, several findings are worth emphasizing. First, in all the specifications in Table 6-2, the coefficient of *BIT* is significantly different from zero and it ranges from 0.45 (column 6) to 0.55 (columns 1 and 11). *BIT* shows a statistically significant positive coefficient at 5% level in most specifications. Hence, the estimated impact of *BIT* is relatively unaffected by the choice of specification, and that *BIT* is not correlated with other variables. Second, only in specifications (2), (6) and (7), when *INTSPREAD* and *RES/MGS* are introduced, *BIT* becomes marginally significant (10 % level). Since FDI stocks are measured in logs, the study must transform the *BIT* effect to percentage figures. Following Wooldridge (2000, p.219)⁴⁶, the overall effect of implementing a treaty is calculated as $100 * [\exp(\gamma_1) - 1]$ ⁴⁷. According to Table 6-2, this estimated effect of *BIT* on bilateral real inward FDI stock ranges from about 56 % (column 6) to about 73% (columns 1 and 11). Such results clearly demonstrate the significant favourable role BITs play in attracting FDI to CEC4. The ratification of BITs between OECD countries and CEC4 (in late 1980s they were considered as Transition economies) provided guarantees to foreign OECD investors. International legal protection through the provisions concerning investor-State dispute settlement, protection against nationalization and expropriation, transfer of funds, non-discriminatory treatment of foreign firms (NT) and (MFN), removal of restrictions on their operations, and protection of property rights appear to be a significant determinant of FDI to CEC4 from OECD countries.

All the specifications in Table 6-2 clearly demonstrate the importance of market size (*GDP*) for attracting FDI. The coefficient of *GDP* is highly significant and positive in all specifications (1%). This underscores the importance of market size as a

⁴⁶ Generally, if γ_1 is the coefficient on a dummy variable, say x_1 , when $\log(y)$ is the dependent variable, the exact percentage difference in the predicted y when $x_1 = 1$ versus when $x_1 = 0$ is $100 * [\exp(\gamma_1) - 1]$. The estimated γ_1 can be positive or negative, and it is important to preserve its sign in computing $100 * [\exp(\gamma_1) - 1]$.

⁴⁷ Egger and Pfaffermayr (2004a) follow Kennedy (1981) and compute the percentage impact of BIT ratification as $100 * [\exp(\gamma_1 - 0.5 \text{ Var}(\gamma_1)) - 1]$.

determinant for FDI. In other words, considerations for market-size have indeed dominated investment decisions of OECD investors. This reflects the fact that OECD investors are “*market-seeking*” investors, because they are attracted by the market size of the CEC4. While (*Growth*) shows insignificant coefficient in most specifications. This confirms that it is the existing size of the market and not the growth prospects that determines the actual inward FDI.

Macroeconomic instability indicated by the inflation rate (*INFL*) shows a statistically significant and inverse coefficient in all specifications. This suggests that instability in prices creates uncertainty in the economy and deters inward FDI. On the other hand, the index of real effective exchange rate (*REXR*) shows an insignificant coefficient in most specifications. This suggests that exchange rate levels have not affected inward FDI activity and that the effect of (*REXR*) on inward FDI is ambiguous. In columns (2), (5) and (9) it shows marginally significant positive coefficient. The inclusion of each interest rate spread (*INTSPREAD*), domestic credit provided by the banking sector (*BANKCR*), and the external debt relative to export levels (*EDT/XGS*) have raised the significance of *REXR*. Such results show that a country’s currency level is correlated with financial institutions’ depth and efficiency, and external debt management ability. In column (6) when (*RES/MGS*) is introduced *REXR* turns to be significant at 5%. Moreover, the finding of column (6) confirms that reserves do act as proxy for exchange rate stability, at least in the short run, and cause currency appreciation, thus, attracting “*market-seeking*” FDI. According to the exchange rate theory, the effect of level of the exchange rate depends on the destination of the goods produced. If foreign investors aim at serving the local market, then an appreciation of host country currency in real terms attracts FDI inflows.

International competitiveness, indicated by RULC, has a highly significant positive effect that holds throughout all of the specifications. This finding is contrary to the hypothesis formulated that an increase in the RULC indicates deterioration in international competitiveness, and hence a negative sign was expected. But this result is neither strange nor shocking. The positive coefficient of RULC can be explained by the fact that although the relative unit labor cost of the CEC4 increased, but compared

to their OECD competitors, the CEC4's unit labour cost in manufacturing was still considered to be relatively lower to the extent that attracted inward FDI significantly. Moreover, this confirms that OECD investors are “*efficiency-seeking*” investors. They weight heavily cost factors, which in its turn affect the profitability of their investments. Thus, international competitiveness of a host country, indicated by the relative unit labour cost in manufacturing, is an important determinant of FDI.

The quality of labour force reflected by the proportion of labour force having attained secondary education (*EDU2*) is found to be insignificant, though it has the expected positive sign. An insignificant coefficient on education is consistent with the finding of Campos and Kinoshita (2003). This result might be due to the lack of cross-country variance, as the CEC4 show rather high levels of human capital.

The indicators of financial institutions' level of development and efficiency, liquid liabilities of the financial sector (*M3/GDP*), interest rate spread (*INTSPREAD*), and real interest rates (*REALRATE*), have statistically significant positive relationships with FDI. Columns (1), (2), (3) and (4), show that these variables are significant at 5% and 1% levels. Especially, columns (2) and (3) indicate that the “efficiency” of financial institutions, reflected by the interest rate spread (*INTSPREAD*), has a crucial role in determining inward FDI (significant at 1%). Foreign investors are very sensitive to the “efficiency and quality” of financial institutions. High real lending interest rates (*REALRATE*) in a host country seems to attract inward FDI. The high cost of capital in CEC4 has attracted foreign capital brought in by foreign investors. However, domestic credit provided by the banking sector in percent of GDP (*BANKCR*), which indicates the level of development of the banking sector in CEC4, shows an insignificant coefficient. This reflects the fact that banks in CEC4 have not provided enough domestic credit to the extent of attracting inward FDI significantly.

The international liquidity position indicators, *RES/MGS* and *RES/EDT* (columns 6, 7 and 8), show highly significant positive coefficients (1% and 5% levels respectively). This shows that the international liquidity position of a host country and the ability to meet short-term payments, adds to its creditworthiness, and affects

foreign investor's decisions favourably. High reserve levels, is a sort of guarantee to foreign investors that the host country will not face balance of payments problems in the near future. Thus, investors feel more secured concerning the transfer of funds (repatriation of profits, and dividends), and transactions.

The external debt position relative to export revenues (EDT/XGS) shows an insignificant coefficient. The ratio of total debt services to export revenues (TDS/XGS) reveals a significant positive coefficient (column 10). The significant positive effect of an external debt ratio on FDI might be explained by the fact that the current external debt obligations (payments of interest and principal) have motivated the CEC4 governments to sell off State-properties, thus attracting "*privatisation-related*" FDI. Trade openness shows an insignificant coefficient, indicating that the impact of trade openness on inward FDI is ambiguous.

To check the *robustness* of the estimation results, the study repeats the same set of regressions but uses recoded values for the dependent variable bilateral FDI inward stock. For all negative and blank values of the dependent variable, the study recoded their logarithm as zeros ($= \log(1)$). Then, the number of observations in the panel data increases from 680 to 704 observations (5 negative and 19 blank values of FDI inward stock are recoded as 1, so that $\log(1) = 0$, thus having 24 more observations). This change alters the point estimates and the t -statistics of BIT substantially. BIT shows a highly significant positive coefficient (at 1% level) throughout all specifications. Moreover, both the coefficients and t -statistics are higher with estimations having more number of observations. The coefficients of economic performance, macroeconomic stability, and international competitiveness variables maintain their level of significance and sign. The financial and creditworthiness indicators lose their significance. Only reserve ratios show marginally significant effect on inward FDI. The results of the regressions are displayed in Appendix E.

Baseline Model with FDI Inflows

Table 6-3 examines the Baseline model by testing the response of FDI inflows to BITs. The same set of regressions is repeated but having FDI inflows as the dependant

variable. The results reveal that all variables are of the expected sign but none are significant except market size (GDP). *BIT*, the focus variable, does not show a significant coefficient. This result may be due to the smaller number of observations (490 observations).

In a further analysis for FDI inflows, the study repeats the same set of regressions by recoding negative and blank values of FDI inflows with a positive one US\$. This increases the number of observations (63 negative and 25 blank values are recoded as US\$ 1, to increase the number of observations by 88, and have 570 observations). With the recoded values of FDI inflows, *BIT* demonstrates a highly significant positive coefficient (1% level) throughout all specifications. All other variables show insignificant coefficients even the market size (GDP) becomes insignificant throughout all specifications. The results of this set of regressions show that *BIT* increases the likelihood to have FDI positive. The results are displayed in Appendix E.

6.2.6.2 FDI, BITs and Regional Investment Agreements

The study extends the empirical analysis and examines the impact of a regional investment agreement on inward FDI in CEC4. The new variable introduced to the Baseline Model is *OECD* for the *OECD Code of Liberalization of Capital Movements*. A new set of regressions are run under both fixed-effects and random-effects estimations. A Hausman test (1978) prefers the random-effects estimation method for all specifications. Hence, the analysis is based on the random-effects GLS estimation results (Table 6-4). As in the Baseline Model, different specifications are estimated to examine separately the impact of each indicator for financial institutions, financial risk, creditworthiness, openness, and trend. Table 6-4 reports that the variables tested in the different regressions do not change their magnitude, significance and sign, and they test in accordance with theoretical expectations. The results are consistent with the baseline model results.

The coefficients of greatest interest concern the effects of *BIT*, and *OECD*; what do they reveal? *BIT*, the focus variable, appears to be significant and positive. It continues to show a statistically significant positive coefficient in all specifications

(5% level). The introduction of a regional investment agreement (*OECD*), does not affect the significance of (*BIT*). Such a result confirms that BITs, by providing international legal protection, play an important role and have significant favourable impact on FDI in CEC4.

The negative surprise is that a regional investment agreement, *OECD Code of Liberalization of Capital Movements*, is not correlated with deeper FDI activity in CEC4. The coefficient of *OECD* is insignificant throughout all specifications. *Why this is the case?* In part, the insignificance of the result could be due to the following factors. First, the four Central European countries, the Czech and Slovak Republics, Hungary and Poland, concluded BITs with old OECD members in the early 1990s and then joined the OECD afterwards (see Appendix F). Thus, the impact of *OECD* has already been captured in *BIT*. That is, the issues and obligations of the OECD Code regarding liberalization of capital movements, removal of restrictions, and repatriation of capital and profits, are already covered in BITs. Specifically, BITs are *enforceable*, whereas the *OECD Code is not enforceable*. BITs provide provisions that are much very important to foreign investors. For example, BITs provide international legal protection to foreign investors through two key provisions concerning State-State and investor-State dispute settlement procedures. The usual approach to investor-State disputes in BITs is to specify that the parties to the dispute must seek an amicable negotiated settlement. Only where such an approach fails to resolve the dispute can they resort to arbitration. If amicable negotiations fail to resolve a dispute, international arbitration is usually the next step. Rather than bringing the case in local courts (the quality and speed of which the foreign investors may not like) or seeking diplomatic protection, BITs specify dispute resolution mechanisms. Agreements differ on the extent of investor choice over the applicable means of dispute settlement. The majority of BITs refer to ICSID (International Centre for Settlement of Investment Disputes) arbitration, an affiliate agency of the World Bank, or to a choice between ICSID and other international arbitration systems, most commonly the UNCITRAL Arbitration Rules (United Nations Commission on International Trade Law) (UNCTAD 1998a, b, 2003). In these arbitration proceedings, three arbiters are selected – generally with each party selecting one and the forum selecting the third. These

proceedings are not bound by precedents, are not necessarily obliged to be open to the public, or to publish final decisions. The decisions have only limited avenues for appeal and cannot be amended by the domestic legal system or the supreme-court (Hallward-Driemeier, 2003). The OECD Code does not provide an article for the settlement of dispute between a foreign investor and the host country. Also, the OECD Code does not provide provisions for the compensation of damages or losses, and protection against nationalisation, and expropriation. Therefore, the CEC4 by concluding BITs with individual OECD countries in the late 1980s and early 1990s, and before their membership of OECD, already have offered international legal protection and guarantees to OECD investors. Thus, the provisions of *OECD* have already been captured in *BIT*.

Another factor which might explain the insignificance of the *OECD* is that BITs provide non-discriminatory treatment to foreign investors through special provisions concerning standards of treatment. Two key provisions are the ones concerning national treatment (NT) and most-favoured-nation treatment (MFN). These issues are of extreme importance to foreign investors. The national treatment issue features in OECD National Treatment Instrument (legally non-binding). The National Treatment Decision contained in the OECD Declaration on International Investment and Multinational Enterprises of 1976 makes clear in paragraph II (4) that “this Declaration does not deal with the right of Member countries to regulate the entry of foreign investment or the conditions of establishment of foreign enterprises”. It should be noted that the OECD National Treatment instrument contains no legal obligation, but is subject to a legally binding system of notification and examination of member countries’ exceptions to national treatment. Under the OECD regime, matters of entry and establishment are the concern of the OECD Code of Liberalization of Capital Movements in which the right of establishment was introduced in 1984 (UNCTAD, 2004b).

Concerning the admission of investment as an aspect of the liberalization of capital movements, the OECD Code obligates OECD member countries to liberalize progressively between one another restrictions on movements of capital, including

direct investment. The Code allows for country-specific reservations and contains temporary derogations, including in the event of adverse balance-of-payments developments, and exceptions for measures taken on grounds of public order and security. That is, the OECD Code contains reservations that individual member countries have lodged in accordance with article 2 (b) to the Code. Some sectors are prohibited for investment by non residents. Thus, for the reasons explained above, the OECD Code, as a regional investment agreement, does not demonstrate a significant impact on FDI in CEC4.

The set of economic and international competitiveness variables do not change significance and sign. Host country market size (*GDP*), (*RULC*), *Growth*, *EDU2*, inflation (*INFL*), real effective exchange rate (*REXR*), financial institutions' level of development (*M3/GDP*), efficiency (*INTSPREAD*), creditworthiness (*RES/MGS*), (*RES/EDT*), (*EDT/XGS*), and *Openness* maintain their significance and sign.

6.2.6.3 FDI, BITs and International Monetary Agreement

In a further effort to check the robustness of the model, the study examines the impact of an international monetary agreement – *Articles of Agreement of the International Monetary Fund IMF: Article VIII*, concerning current account convertibility, on inward FDI in CEC4. Table 6-5 presents random-effects GLS estimation results, which is preferred by the Hausman test. Similar to the previous regressions, different specifications are used to examine separately the impact of each indicator on inward FDI in CEC4. The coefficients of interest concern *BIT* and *IMF*.

BIT, the focus variable, maintains its statistical significance and sign throughout all specifications. The results clearly demonstrate that BITs perform an important role in attracting inward FDI. On the other hand, *IMF* shows an insignificant coefficient throughout all specifications. *How to explain this result? The Articles of Agreement of the International Monetary Fund (the Fund)* constitute an international treaty and the Fund's charter. While the obligations established under the Fund's Articles serve to liberalize investment flows in a number of important respects, it is not an international investment agreement. Article VIII (2) (a) of the Articles of Agreement of the IMF

provide that IMF members may not “impose restrictions on the making of payments and transfers for current international transactions” except where such restrictions are approved by the IMF. This provision protects the ability of an investor to repatriate income arising from investment but does not cover payments and transfers arising from the liquidation of investment and from the making of new investment. Also, the term “International transactions” refers to transactions between residents and non-residents. Thus transactions between a foreign affiliate and other companies in a host country are not considered international in this sense. In addition, the obligation in Article VIII (2) (a) extends only to the making of outward payments and transfers. Thus in the case of investment-related payments and transfers, the provision protects the ability of a non-resident to transfer proceeds from an investment but does not apply to inward payments and transfers related to the making of an investment (chapter three, section 3.4.8 explicitly elaborates this issue). This finding suggests that current account liberalization does not have a significant impact on inward FDI in CEC4. International agreements that provide provisions concerning international legal protection (such as BITs) appear to have significant favourable impact of foreign investors’ decisions. All the other variables maintain their level of significance and sign.

6.2.6.4 FDI, BITs and Multilateral Investment Agreements

In an effort to estimate the impact of multilateral investment agreements on inward FDI to CEC4, a new set of regressions are run using WTO membership to capture the effect of multilateral investment agreement. Table 6-6 reports random-effects GLS estimation results which are preferred by a Hausman statistic. In this new set of regressions the coefficients of interest are *BIT* and *WTO*.

BIT maintains its significance and sign in all specifications. The *WTO* variable shows statistically significant positive coefficient in many specifications. When financial institutions’ efficiency (*INTSPREAD*), real interest rates (*REALRATE*), and reserves in months of imports (*RES/MGS*) are introduced to the regressions, *WTO* loses its significance (Columns 2, 3, 4 and 5). This might be due to the significant effect of financial institutions’ efficiency and country creditworthiness on FDI to the extent that their presence causes a drop in the significance of WTO membership.

Otherwise, the results show that membership of an international trade organization (WTO) has made CEC4 attractive destinations for investment as an export platform. WTO membership is correlated with deeper and significant inward FDI to CEC4. Moreover, the significance of the *WTO* can be explained by the GATS provisions and articles providing national treatment (NT) and most-favoured-nation treatment (MFN), and “market access”. In addition, mention should be made also of the WTO dispute settlement rules (DSU), which can be invoked in disputes that arise between States with regard to investment-related matters covered by the WTO agreements, notably the GATS, the TRIMs and the TRIPS Agreements (UNCTAD, 2004c). All other variables maintain their level of significance and sign.

6.2.6.5 Robustness Checks

To check the robustness of the estimation results, the empirical analysis uses different specifications and runs different sets of regressions for the IIA variables. Table 6-7 reports results of specifications using IIAs without financial and creditworthiness variables. One can see that the estimated coefficients of BIT, the focus variable, show results similar to the baseline model. They are statistically significant positive throughout all specifications. Moreover, they are quite stable from one specification to another. This clearly demonstrates that the financial and creditworthiness variable are not correlated with the BIT variable, since their exclusion has not affected the significance, sign and magnitude of the BIT coefficients.

Table 6-8 reports results of specifications introducing all IIAs simultaneously to the economic, financial, creditworthiness, and openness variables. The coefficient of greatest interest is that of (*BIT*), which demonstrates statistically significant positive impact on inward FDI throughout all specifications (at 5% level). Moreover, the estimated coefficients stay almost unchanged. All the other variables maintain their significance, sign and magnitude. The (*OECD*), (*IMF*), and (*WTO*) variables do not change significance and sign. They reveal the same level of significance and sign whether introduced individually or simultaneously to the regressions. Both OECD and IMF variables reveal insignificant coefficients throughout all specifications, whereas

WTO demonstrates significant positive coefficients in most specifications. Clearly, the results show that *BIT* is not correlated with other variables.

Table 6-9 repeats the same set of regressions but excludes the *BIT* variable. The estimated coefficients of all variables remain unchanged. They continue to maintain the same level of significance, sign and magnitude. The robustness of the estimations is checked also by “recoding” the negative and blank values of the dependent variable. For negative and blank values of the dependent variable *FDI* (inward stock or *FDI* inflows), we have recoded their logarithm as zeros [= $\log(1)$]. Then the number of observations in the panel data is increased. In this case, *BIT*, the *focus variable*, demonstrates highly significant positive coefficients throughout all specifications (at 1% level). The robustness of the findings is checked also by introducing year-fixed-effects to the specifications. The coefficients of the year-fixed effects do not show any significance. *BIT*, the focus variable, still reveals significant and positive coefficients. The results are displayed in Appendix E.

6.2.6.6 Interaction Term Analysis: *BIT* with Financial Depth and Efficiency

Table 6-10 reports results by introducing an interaction term to the regressions – the interaction of (*BIT*) with financial institutions’ level of development (*M3/GDP*), and efficiency (*INTSPREAD*). The regressions are estimated under both fixed-effects and random-effects methods. A Hausman test is more efficient under random-effects, thus the analysis is based on random-effects GLS estimation results.

Column (2) presents the result of a regression including the interaction of *BIT* with financial depth ($BIT \cdot \ln M3/GDP$). When an interaction term is introduced, the *BIT* variable loses its significance still maintaining positive coefficient. The financial variable (*M3/GDP*) is marginally significant and positive. The interaction term $BIT \cdot \ln M3/GDP$ is insignificant. How to interpret this result? With an interaction term included, one cannot interpret the coefficients on the individual components in the conventional way. Instead, the coefficient on *M3/GDP* in a model with insignificant interaction term $BIT \cdot \ln M3/GDP$ is the effect of *M3/GDP* on *FDI* when the *BIT* variable is zero. It follows from the estimations that the level of development of the

financial sector, as measured by M3/GDP, has significant positive impact on FDI in the absence of BITs. The interaction term is insignificant and negative; however, the individual effect of BITs is insignificant and positive. The significant and positive effect of BIT on FDI becomes smaller and insignificant in the presence of well-developed financial institutions, but never to the extent that the effect would become negative. Furthermore, this demonstrates that the level of development of financial institutions has stronger effect on FDI than BITs. This suggests that BITs and financial institutions complement each other, and that a BIT is not a substitute for institutions, specially, financial institutions.

Column (4) examines the impact of BIT interaction with the “efficiency” or “quality” of financial institutions (INTSPREAD). With the introduction of an interaction term the individual effects of BIT and INTSPREAD are still significant and positive. However, the interaction term BIT* INTSPREAD is insignificant. Such a result demonstrates that BITs and “efficiency” or “quality” of financial institutions individually exert a significant positive impact on FDI. They are complementary in creating a favourable investment environment. This is very strong empirical evidence that in the presence of “efficient” financial system BITs do not have significant positive impact on FDI. Each exerts an individual significant positive effect on inward FDI. Therefore, the answer to the question, raised by the study, are BITs more effective in well developed and efficient financial system, is no. Each has a separate and distinct role in creating favourable “investment environment” in attracting FDI. The economic and international competitiveness variables maintain their level of significance and sign. Market size (*GDP*) and relative unit labour cost (*RULC*) appear to be significant determinants of FDI. Inflation (*INFL*) is a significant deterrent to FDI. Growth prospects (*Growth*), real effective exchange rate (*REXR*), and the education level of labour force (*EDU2*), show to be insignificant. The financial variables (*M3/GDP*) (*INTSPREAD*) have very significant positive coefficients, suggesting that inward FDI is positively correlated with host country financial institutions’ the level of development and efficiency.

Table 6-11: Summary of Empirical Results

Determinant	Variable Name	Proxy Used	Coefficient Sign	Significance Level
International Investment Agreements	Bilateral Investment Treaties	BIT with OECD Countries (Dummy)	(+)	5%
	Regional Investment Agreement	OECD Code of Liberalization (Dummy)	(-)	not significant
	International Monetary Agreement	IMF Article VIII Acceptance (Dummy)	(+) / (-)	not significant
	International Investment Agreement	WTO Membership (Dummy)	(+)	5 % (in most specifications)
Economic Performance	Market Size	GDP (constant 2000 US\$)	(+)	1%
	Growth Prospects	GDP Growth (annual %)	(+)	not significant
Macroeconomic Stability	Inflation Rate	Inflation, consumer prices (annual %)	(-)	1 % (in most specifications), 5 % (in some)
	Exchange Rate	Index of Real Effective Exchange Rate	(+)	not significant
Financial Institutions' Level of Development and Efficiency	Financial Inst. Size and Development	Liquid liabilities, M3 (% of GDP)	(+)	5%
	Financial Inst. Depth	Domestic credit provided by the Banking Sector (% of GDP)	(+)	not significant
	Financial Inst. Efficiency	Interest rate spread (% points)	(+)	1%
	Cost of Capital	Real lending interest rates (%)	(+)	10 % or 5 %
Financial Risk and Creditworthiness	External Debt Position	EDT/XGS (%)	(+)	not significant
		EDT/GNI (%)	(+)	1%
		TDS/XGS (%)	(+)	5%
	International Liquidity Position	RES/MGS (in months of imports)	(+)	1 % (in most specifications), 5 % (in some)
		RES/EDT (%)	(+)	5%
International Competitiveness	Relative Unit Labour Costs in Manufacturing with respect to OECD Countries	RULC w.r.t. OECD countries (Index)	(+)	1%
	Quality of Labour Force	Labour force with secondary education (% of total)	(+)	not significant
Trade Openness	Share of Trade in GDP	Trade (Exports plus Imports) (% of GDP)	(-)	not significant
Global FDI Trend	Trend	Trend	(+)	10%

6.3 Conclusion

This chapter examined empirically the impact of IIAs on bilateral FDI inward activity in CEC4. Since the late 1980s the CEC4 concluded extensively BITs with OECD countries. In 1995-96 these countries joined the OECD and the WTO, thus became members of international economic organizations, and accepted regional and multilateral agreement obligations. Also, in 1995, they accepted IMF Article VIII, concerning current account convertibility. Eventually they became EU member countries in May 2004.

The focus of the empirical analysis was on examining the impact of BIT ratification between 22 OECD countries and CEC4 on inward FDI in CEC4. The purpose was to examine whether or not BIT ratification has increased FDI activity into CEC4. The study used data on bilateral FDI activity from the OECD International Direct Investment Statistics. The dataset covered bilateral FDI inward stock and inflows from 22 OECD source countries to CEC4 host countries during the period 1992-2003. This is the period for which data are available. Since the OECD area is the source of over ninety percent of FDI stock in the CEC4, the empirical analysis covered the majority of FDI in CEC4 that are covered by BITs. Data were originally collected by the researcher. They were compiled mainly from the World Bank, the OECD, and UNCTAD.

The empirical analysis used *panel data methodology* in the estimation process because it has many advantages. The econometric specification utilized the factors and variables of the “integrated” theory that was constructed in chapter five. Country-pair specific effects were used in the specifications to detect all time-invariant *unobservable* factors that might affect FDI activity between source-host countries. The regressions were estimated under both fixed effects and random effects methods. To detect the correlation between country-pair specific effects and the explanatory variables, a Hausman test (1978) was applied for the efficiency of the estimation method. For all specifications, a Hausman test did not reject the null hypothesis of no correlation

between the country-pair specific effects and the explanatory variables. Thus the results of random effects GLS estimation were adopted and analyzed.

The results of the regressions under all specifications clearly demonstrated that BITs have significant positive impact on inward FDI in CEC4. *OECD Code of Liberalization of Capital Movements*, as regional investment agreement, and the acceptance of *IMF Article VIII*, concerning current account convertibility, did not show any significant impact on inward FDI. On the other hand, membership of WTO, an international trade agreement, showed a significant and favourable impact on inward FDI in CEC4. Concerning the economic fundamentals, considerations for market size, financial institutions level of development and efficiency, country creditworthiness, especially the level of reserves, international competitiveness indicated by low relative unit labour costs in manufacturing revealed to have significant positive impact on inward FDI in CEC4. On the other hand, macroeconomic instability indicated by high inflation revealed to be a strong deterrent to inward foreign investment.

In an additional effort, the empirical analysis examined the interaction of BIT with the financial system's level of development and efficiency. It investigated whether or not BITs are more effective in well developed and efficient financial system. The empirical results revealed that BIT, financial depth and efficiency, individually exert significant positive effects on inward FDI. The insignificance of the coefficient of the interaction term demonstrated that BITs do not play an additional role on FDI in the presence of well developed and efficient financial system. Each has separate, distinct and significant favourable impact on inward FDI in CEC4. The presence of BITs, well developed and efficient financial institutions create a favourable "investment environment" and attract foreign investments.

7 Policy Implications

7.1 Introduction

This dissertation aimed at the examination of the impact of IIAs on attracting FDI. Namely, the study concerned itself with whether BITs attract FDI. In particular, it assessed the extent to which the ratification of a BIT between a source-host country pair increases bilateral inward FDI in CEC4. The dissertation dwelt on the experiences of the four Central European countries, the Czech and Slovak Republics, Hungary and Poland during the 1990s.

The study found out that the ratification of BITs between OECD countries and CEC4 exert a significant positive effect on bilateral inward FDI in CEC4 during the period under study. Both the acceptance of the *OECD Code of Liberalization of Capital Movements*, as a regional investment agreement, and the *IMF Article VIII*, concerning current account convertibility, do not have any significant effect on inward FDI in CEC4. It was interesting to see that WTO membership has a significant positive effect on inward FDI in CEC4. Among the economic fundamentals market size revealed to be a strong determinant to inward FDI, whereas, economic growth did not show any significance. Well developed and efficient financial institutions, high levels of international liquidity position, and high external debt obligations, were found also to have significant positive impact on inward FDI. Macroeconomic instability reflected by high inflation rates revealed to be a strong deterrent to inward FDI. Concerning the effects of the level of real effective exchange rates and trade openness, both were found to be ambiguous. In addition, the study found out that inward FDI in CEC4 was marginally affected by the global trend in FDI inflows during the 1990s.

In view of these findings, the aim of this chapter is to determine their policy implications on the countries that implemented them, and whether they have relevance to countries in other parts of the world. In the forthcoming analysis, the researcher will assess the policy implications for each finding and will deal with them one at a time.

7.2 Findings and Policy Implications

This section presents the findings of the study, assesses the policy implications for each finding and deals with them one at a time.

7.2.1 Role of BITs

First Finding: BITs exert a significant positive impact on bilateral inward FDI in CEC4.

This result verifies the significant importance of IIAs at the bilateral level (BITs), in attracting FDI into the four Central European countries. This is the focus variable, hence, it represents a key finding. It shows that apart from the economic fundamentals of the economy, which may attract FDI inflows, FDI international policies and investment agreements also play an important role. Countries can attract FDI in many ways. The most important point is the “investment environment” and “attitude toward foreign investors”. In fact, policy makers in CEC4, in the wake of their transition phase, focused on attracting FDI by concluding BITs. The conclusion of BITs reflects the fact that these countries have moved towards “market-friendly” policies. Their objective was to provide international legal protection, reduce obstacles, create “investor-friendly” settings and promote FDI. These international agreements aim to encourage investment by guaranteeing legal protections for the property rights of foreign investors. Investors feel more secure because their rights, protected by international law, can be enforced through international jurisprudence. The CEC4 had very weak institutions, compared to that of the developed OECD countries, and the “political risk” from the point of view of foreign investors was considered to be very high. Thus, the CEC4 in order to attract FDI from their developed European

neighbours and other OECD countries had no choice but to offer policy guarantees at the international level.

It is noteworthy to mention that the concerns of the CEC4 competitiveness for FDI has led, also, both to the adoption of national laws establishing specific regimes for FDI and to their extensive liberalization, in terms of entry and other conditions. The CEC4 introduced national laws, regulations and “codes” specifically for FDI - Hungary in 1988, Poland and Slovakia in 1991, and the Czech Republic in 1992 (UNCTAD, 2004b). Beside national policy regulations for FDI, they offered incentives to MNCs designed to attract FDI from competing countries and to offset potential risk factors that might deter investment. While the laws specifically addressing FDI are of great importance for foreign investors and appear to influence their decisions, a country’s entire legal system is directly relevant, as well. A country’s commercial law, its property law, the laws concerning companies or labour, even civil procedure or criminal law, and of course the laws concerning the judicial system or the civil service, are also important. These laws create the legal environment for the operation of firms and establish directly applicable sets of rules and reflect prevalent policy trends.

A point of particular significance is that the CEC4, in their early transition stage, late 1980s and early 1990s, were considered to be somehow “risky” for foreign investors, in terms of “quality of institutions”, contract enforcement, property rights, rule of law, transfer of funds, taking of property, and settlement of disputes. Foreign investors had serious concerns about such issues. It is true that international investors always face risks because changes in market prices and opportunities cannot be perfectly predicted *ex ante*. However, in CEC4 – in their early transition stage - the risk goes beyond ordinary market risk. Investors may have little trust in the reliability and fairness of property rights and government enforcement. Investors might complain that the rules are unclear and variable over time. In the extreme case, the distrust can be so large that little or no investment takes place. Thus, for CEC4 governments, the principal way to attract FDI was to improve the overall political / economic environment to reduce risk. One way to reduce risk for foreign investors is to have clearly defined and enforced property rights. Well-enforced property rights not only

lead to greater amounts of current domestic investment but also create a stable market environment that can promote FDI. Confidence in the enforcement of property rights reduces the incentive to insure against political risk and reduces the cost of doing business. Foreign investors prefer to do business in environments with well-enforced property rights. The CEC4 in late 1980s did not have the legal systems and institutional structures in place to adequately enforce laws of property rights.

Given the weakness of domestic political / legal environment in the CEC4 in their early transition stage, foreign investors seek alternatives tailored to their needs. This can be done on a case-by-case basis, but transaction costs can be reduced if the host country commits itself to a basic framework. Along with other international institutions, this is what BITs do. They provide *enforceable rules* to protect foreign investment and reduce the risk faced by investors. BITs protect and promote foreign investment through a series of policy provisions, including guarantees of a high standard of treatment (NT and MFN), legal protection of investment under international law, and access to international dispute resolution. Thus, in the late 1980s, the CEC4 resorted to international agreements, and concluded bilateral treaties with individual OECD countries in order to provide international guarantees to OECD investors. The significant positive impact of BITs on bilateral inward FDI from OECD to CEC4 clearly demonstrates that BITs have been successfully utilized in the 1990s through the process of transition of Central European countries towards a market-type economy. Their most significant function appears to be that of providing signals of an attitude favouring FDI. Moreover, this confirms the fact that at the beginning of the transition stage, BITs were necessary and very important for the CEC4.

A theme that is quite relevant to transition and specially countries with weak domestic institutions is, therefore, giving in or yielding to the obligations of BITs does have the desired payoff of higher FDI inflows. Countries with weak domestic institutions possibly stand most to gain from BITs. This study verified that the very proliferation of BITs during the 1990s has made them standard features of the investment climate for any country interested in attracting FDI. BITs are efficient instruments since they allow countries the freedom of choosing the partners to enter an

agreement and tailor the agreement to their specific situations. They offer countries flexibility to conclude them with countries that are key investors, avoiding countries that are less interesting or that may insist on unwanted provisions. In addition, they can be negotiated quickly. Their principal focus has been from the very start on investment protection, in the wider context of policies that favour and promote FDI: the protection of investments against nationalization or expropriation and assurances on the free transfer of funds and provision for dispute-settlement mechanisms between investors and host States. BITs also cover a number of other areas, in particular, non-discrimination in the treatment, and in some cases, the entry of foreign-controlled enterprises, subrogation in the case of insurance payment by the source country's investment guarantee agency, and other topics.

The majority of existing BITs have very similar provisions. The major differences lie in the protection or non-protection of certain types of investment and whether or not the treaties' apply as soon as a contract has been signed or whether funds must actually have been invested. The basic provisions of BITs are the following: (a) *Scope and Definition*: the definition of investment is fundamental to BITs, since it describes precisely which assets or investment flows are covered by the operational provisions. In most BITs, the definition of investment is broad and open ended so that it can accommodate new forms of foreign investment. It includes tangible and intangible assets and generally applies to existing as well as new investments. Additionally, all BITs define intellectual property rights as one type of investment; (b) *Admission and Establishment*: the rights of natural or legal persons of one State to enter and conduct business in the territory of another State principally derive from international treaties. Most BITs encourage the entry and establishment of foreign investment, although it is typically subject to national laws and regulations. Most BITs contain clauses that exclude investments in particular areas such as national security; (c) *National Treatment*: national treatment designates that host countries must treat foreign investors at least as well as domestic investors once an investment is made. Most BITs now grant NT, the principle also being often subject to qualifications (to take into account the different characteristics between national and foreign firms) and exceptions (relating mainly to specific industries or economic activities, or to policy

measures such as incentives and taxation); (d) *Most-Favoured-Nation Treatment*: All BITs include MFN clauses for non-discriminatory treatment. Thus a guarantee of MFN treatment is virtually universal, but subject to some standardized exceptions; (e) *Fair and Equitable Treatment*: Most BITs contain some obligation to accord foreign investors a (usually undefined) minimum standard of treatment, often characterized as minimum international standards of treatment, or fair and equitable treatment. This obligation is usually understood to relate to procedural fairness, and may also refer to standards dictated by customary international law; (f) *Taking of Property (Expropriation and Nationalization)*: Most BITs prohibit expropriation of an investment, unless it is for a public purpose, is non-discriminatory, is in accordance with the due domestic legal process, and is adequately compensated in a timely manner; (g) *Transfer of Funds*: Many BITs establish the right of the investor to transfer all earnings to the investing country; (h) *Dispute Settlement (State-State and Investor State)*: Dispute resolution is a standard part of all BITs. The provisions generally provide for resolution of both country-country and investor-host country disputes by an international body such as the World Bank Group's ICSID or other arbitration systems, such as those operated by the ICC. The possibility of enforcing arbitral awards directly without going through diplomatic channels benefits investors who win judgments against states. Arbitration has been one of the hallmarks of the investment protection regimes established by BITs; (i) *Transparency*: Many BITs include a provision requiring the host country the publication of domestic laws and regulations.

All BITs are not the same, as they are the products of intense negotiations between two governments. Some treaties are as short as two pages while others extend to twenty. The provisions vary from agreement to agreement, but most share characteristics that they can be described in a general sense. All place obligations on host countries as to the treatment they should accord foreign investors establishing and / or operating investments in their countries. The standards of international investment law that have developed are remarkably consistent across the agreements. Overall, the provisions of BITs are meant to secure the legal environment for foreign investors, establish mechanisms for dispute resolution, and facilitate the entry and exit of funds.

BITs are currently the dominant means through which international investment is regulated under international law. The treaties are a response to the weaknesses and ambiguities of customary international law as applied to investments by international firms in countries having more risky and institutionally weak environments.

In order to assess the impact of BITs on countries with weak institutions, it is necessary to look at the costs and benefits of concluding BITs, and the risk-BITs relationship, particularly the importance of property rights reform in weak countries.

A. Costs and Benefits

Countries with domestically weak institutions can employ BITs as a means to attract inward investment. The protections to foreign investment are presumed to attract investment flows that will lead to economic development. Transition or countries with weak domestic institutions hope that the treaties are a signal to foreign investors either of a strong protective “investment environment” or a commitment that foreign investments will be protected through international enforcement of the treaty. Beyond attracting investment, transition or weak countries hope that BITs will have peripheral benefits. For example, binding foreign investment disputes to international arbitration may serve not only as a signal that the current government is friendly towards FDI, but it may lock future governments into the same policy stance. Further, BITs may provide symbolic benefits to the current government. For example, signing a BIT may signal a willingness to sign international treaties in other areas. For countries in transition or with weak institutions, BITs may provide a shortcut to policy credibility in the international arena.

The benefits must be balanced against the costs. Although transition or countries with weak institutions may enter into the treaties in the hopes of obtaining peripheral benefits, some countries may be forced to sign the treaties to compete with similar countries. For example, if two countries offer relatively similar investment environments and one signs a BIT with a major foreign investor, the other country may agree to sign a similar treaty – regardless of the potentially negative impacts of that treaty – simply to remain on par with the competing country.

BITs may lead to a division of profits that favours developed countries. They increase the bargaining power of MNC relative to a non-BIT regime and may disfavour domestic investors. MNCs argue that BITs only level the playing field for them relative to domestic investors, but it is at least possible that the scales may end up tilted toward foreign investors. For example, foreign investors have recourse to international arbitration tribunals to settle any claims resulting from what they believe to be unfair treatment of their property. Domestic investors are left to the local property rights enforcement systems. If domestic investors try to define themselves as foreign to get access to their preferred forum, that may be evidence that the local courts are seen as less effective than international arbitration. Furthermore, transition or countries with weak institutions fear a loss of control over their internal economic activity through restrictions on their employment and development policies as well as through challenges to national industries. This loss of sovereignty may be too high a burden for some transition or countries with weak institutions and lead them to refuse to sign BITs.

Nearly all BITs contain clauses that firms can use to petition governments for damages stemming from government actions such as tax law changes and environmental or health regulations that can be enacted after investment takes place. Investors may lose their cases especially when the host government law or regulation has a public policy justification and is applied uniformly. Nevertheless, this remains an area of concern to countries contemplating signing new BITs and to emerging transition countries with many outstanding BITs that are seeking to reform their tax treaty and regulatory systems.

Repatriation of profits is another area that may have negative consequences for emerging transition or countries with weak institutions. The majority of treaties grant the investor the ability to repatriate profits “without undue delay” although there is an exception for times of economic emergency. If the treaties are interpreted to give a narrow reading to the term “economic emergency,” the ability to repatriate profits could intensify liquidity problems faced by host countries. In other words, the host country could face foreign exchange problem.

B. Risks and BITs

Given the mixed impact of BITs, one might ask the question of which countries should sign BITs and why? One would expect that countries will vary on their enthusiasm and their insistence on the inclusion of exceptions. For example, resource rich countries have an advantage in bargaining with foreign investors. Therefore, one would expect resource rich states to try to avoid signing such treaties or to sign treaties with favourable clauses; in contrast, countries with few distinctive benefits to offer investors are more likely need to sign BITs. Countries competing for the same types of investment need to mimic the policies of competing countries, or they risk placing themselves at a disadvantage. Thus, one would expect that if one country signs a BIT as a signal to foreign investors that their investments will be protected, this will encourage similar countries to act likewise.

Weak countries may sign BITs to constrain stronger states, but in the process they must accept a deal that is favourable to the stronger state. Only risk-takers will invest in highly risky countries, such as Congo. These investors are likely to care mainly about natural resources; they are not much concerned with the overall domestic investment environment. Even if these countries signed BITs, it is unlikely that investors would rely on the treaties to assure investment protections. In contrast, the previously centrally planned Central European countries, Czechoslovakia, Hungary, and Poland, have broken the risk barrier through policy changes and are considered to be low investment risks. Firms have confidence that these countries will enforce the property rights of all investors. Their stable investment environment enables them to negotiate over the terms or even to refuse to sign treaties without risking a loss of foreign investment. For example, Hungary has not entered into a BIT with the United States based on its model treaty.⁴⁸

⁴⁸ Based on an interview with a Czech officer at the Czech Permanent delegation at the OECD in Paris.

The CEC4 in their early transition phase, in the late 1980s, were considered middle cases of risk countries. These cases lie at mid-point of property rights evolution and could either stagnate or move forward. On one hand, without BITs, competition for foreign investors could encourage property rights reform – perhaps aided by domestic investors who realize the potential benefits of establishing a rule of law. On the other hand, domestic elites and corrupt bureaucrats might attempt to maintain the status quo. A governmental decision to reform property rights is unlikely if the rents derived from the non-enforcement of property rights are high, if incumbents do not expect to gain many from reform (perhaps because they risk losing political power) and, most importantly, if the power of the opposing interest group is high. A world with BITs might reduce the interest of foreign investors in property rights reform and enforcement in transition or countries with weak institutions. Domestic reform may be less likely and the country may even regress toward policies that harm domestic investors. Attempts at reform may fail, or no attempts at reform may be made at all. In such cases, the BIT, although benefiting foreign investors, could have a negative effect on the trustworthiness of the business environment for domestic investors. Of course, even with a BIT foreign investors can benefit from some improvements in the domestic property rights regime and may even use the provisions of international treaties as a template for domestic legislation.

BITs, therefore, form an important policy instrument for attracting FDI inflows. The present study is clearly a pacesetter in that it is the first to provide robust empirical evidence on the impact of BITs on FDI in Central European (transition stage) countries, and that BITs fulfil their stated objective. Countries with weak domestic institutions possibly stand most to gain from BITs. This reflects the fact that countries do believe that BITs, by providing international legal protection, play an important role in the promotion and encouragement of FDI.

7.2.2 Role of a Regional Investment Agreement (OECD Code)

Second Finding: The *OECD Code of Liberalization of Capital Movements*, as a regional investment agreement, does not have a significant impact on inward FDI in CEC4.

The insignificant impact of OECD membership and the acceptance of *OECD Code of Liberalization of Capital Movements* as a regional investment agreement on bilateral FDI from OECD countries to CEC4 is due to the fact that the four Central European countries, the Czech and Slovak Republics, Hungary and Poland, concluded individual BITs with original OECD member countries in the late 1980s and the early 1990s and then joined the OECD afterwards (The Czech Republic in 1995, Hungary and Poland in 1996 and The Slovak Republic in 2000). The provisions included in the *OECD Code* are already captured in BITs. In addition, BITs stipulate provisions that are much more of a serious concern to foreign investors, such as the international legal protection through the investor-State dispute-settlement provision, compensation for damages and losses, property rights, protection against taking of property such as nationalization or expropriation, non-discriminatory treatment (NT and MFN), free transfer of funds, repatriation of capital, profits and income. Moreover, BITs are *enforceable*, whereas the *OECD Code* is *not enforceable*.

As signatory to the *OECD Code of Liberalization of Capital Movements* (the Code) and the National Treatment Instrument (NTI), the CEC4 have undertaken a number of obligations in the FDI field. The Code and the NTI are the two main instruments for co-operation among OECD member countries in the field of FDI (OECD 2000). The Code, which has the legal status of OECD Council Decisions and is binding on all Member countries, cover the main aspects of the right of establishment for non-resident enterprises and requires OECD members to progressively liberalise their investment regimes on a non-discriminatory basis and treat resident and non-resident investors alike. The NTI is a “policy commitment” by Member countries to accord to established foreign controlled enterprises treatment no less favourable than that accorded to domestic enterprises in like situations. While the

NTI is a non-binding agreement among OECD Member countries, all measures constituting exceptions to this principle and any other measures which have a bearing on it must be reported to the OECD. Member countries need not, however, liberalise all their restrictions upon adherence to the two instruments. Rather, the goal of full liberalisation is to be achieved progressively over time. Accordingly, members unable to fully liberalise are permitted to maintain “reservations” to the code of Capital Movements and “exceptions” to the NTI for outstanding foreign investment restrictions. These limitations to the liberalization obligations may be lodged at the time a member adheres to the Codes, whenever specific obligations begin to apply to a member, or whenever new obligations are added to these two instruments (OECD, 2000).

The investment obligations of the Code and the NTI are, in fact, complementary, both dealing with the laws, policies and practices of Member countries in the field of direct investment. However, the Code addresses the subject from the point of view of non-resident investors in an OECD host country, while the NTI is concerned with the rights of established foreign-controlled enterprises. Limitations on non-resident (as opposed to resident) investors affecting the enterprises’ operations and other requirements set at the time of entry or establishment are covered by the Code. The investment operations of foreign-controlled enterprises after entry, including new investment, are covered by the National Treatment Instrument.

Therefore, the finding suggests that just being an OECD member country, as a regional economic organization, does not attract significant amounts of FDI from OECD investors. OECD investors have many other considerations. Concerning their choice for CEC4, besides the economic and the international competitiveness factors, the most important thing was the political stability, international legal protection, contract enforcement, property rights, free transfer of funds, and all these have been covered in BITs. The OECD Code does not have additional provisions that more important to foreign investors.

7.2.3 Role of an International Monetary Agreement

Third Finding: The acceptance of *IMF Article VIII*, concerning current account convertibility, does not have a significant impact on inward FDI in CEC4.

The insignificance of the impact of acceptance of *IMF Article VIII*, concerning current account convertibility, is due to the fact that it is already captured in BITs. In fact all BITs provide provisions concerning transfer of funds. BITs require that host countries guarantee the free transfer of payments related to investments as an important aspect of investment protection. This requirement only applies to transfers related to inward investment made by investors of one party in the territory of another party. The main categories of payments in respect of which this right of free transfer applies are the principal and additional amounts to maintain or increase the investment, profits, interest, capital gains, royalty payments, management, technical assistance or other fees and returns in kind; proceeds of the total or partial liquidation of investments, repayment of loans. The provision include also payments made by a host country as compensation for an expropriation of investment or for losses suffered by foreign investors as a result of an armed conflict or civil disturbance and of payments that arise from dispute settlement proceedings. Provisions on transfer of funds in BITs often require host countries to ensure that transfers can be made without delay, in freely usable or freely convertible currencies, at the normal exchange rate applicable at the time of transfer.

Since the most important reason for undertaking foreign investment is profit-making, what matters most for foreign investors is the guarantee and assurance concerning the transfer of funds, repatriation of capital, profits, and dividends. Thus, one of the most critical points that effects foreign investors' location decision is the guarantee for repatriation of capital. The *Articles of Agreement of the International Monetary Fund (the Fund)* constitute an international treaty and the Fund's charter. While the obligations established under the Fund's Articles serve to liberalize investment flows in a number of important respects, it is not an international

investment agreement. Article VIII (2) (a) of the Agreement of the IMF stipulates that its members may not “impose restrictions on the making of payments and transfers for current international transactions” except where such restrictions are approved by the IMF. This provision protects the ability of an investor to repatriate income accruing from investment, but does not cover payments and transfers arising from the liquidation of investment and from the making of new investment. Also, the term “international transactions” refers to transactions between residents and non-residents. Thus transactions between a foreign affiliate and other companies in a host country are not considered international in this sense. In addition, the obligation in Article VIII (2) (a) extends only to the making of outward payments and transfers. Thus in the case of investment-related payments and transfers, the provision protects the ability of a non-resident to transfer proceeds from an investment but does not apply to inward payments and transfers related to the making of an investment (UNCTAD, 2004b, and c). This finding suggests that current account liberalization does not have that significant impact on foreign investors’ decisions. BITs have more comprehensive provisions concerning transfer of funds, and provisions concerning international legal protection, which seem to be more important for foreign investors.

7.2.4 Role of Multilateral Investment Agreements

Fourth Finding: WTO membership has a significant positive impact on inward FDI in CEC4.

The study found that CEC4 membership of WTO has significant favourable impact on foreign investors’ decisions and has attracted FDI as an export platform. In the decade since the first major trade reforms were introduced, CEC4 have made giant strides in moving away from the autarkic trade regimes and distorted trade patterns that characterized central planning. The CEC4 can be considered to be genuinely and fully integrated in the world trading system. The main challenge for these countries involved strengthening the capacity of broad, market based institutions and those which are more specifically trade-related, such as the financial sector, customs and

trade facilitation, which made them better able to enjoy the benefits and meet the responsibilities of participation in multilateral trading system.

A country's trade policy is a key link in the transmission of price signals from the world market to domestic resource allocation and to the economy's effective integration in the world trading system. Thus, it is not surprising that these Central European countries wishing to escape the inefficiencies of central planning and increase consumer choice, made trade policy reform an early important component of broader price and market oriented reforms. Integration in the world trading system fundamentally depends on whether policies and institutions are established in a country and its trading partners which are conducive to the mutually beneficial exchange of goods and services based on specialization and comparative advantage. Effective integration of the economies in transition thus involves not only their own trade policies and institutions, but also those of their trading partners which affect market access and the terms of trade. Integration involves abiding by the rules of conduct that govern the multilateral trading system (Michalopoulos, 1999a). These rules have been established and are implemented in the context of the agreements administered by the WTO. These agreements include trade in goods (GATT), trade in services (GATS), as well as other aspects of international exchange of goods and services, such as trade related intellectual property rights (TRIPS), sanitary and phytosanitary standards (SPS), government procurement etc. The policies and institutions governing these matters under central planning were either radically different or completely lacking. Thus, membership in the WTO is an essential element, perhaps even a necessary condition for full integration in the world trading system.

WTO membership is important for a number of reasons: first, because membership promotes the establishment of the legal framework and market based institutions in support of international trade that were absent under central planning; second, because WTO membership provides better guarantees for market access through the provision of unconditional MFN status; and through the avoidance of arbitrary measures that limit market access to non-members; and third, because the WTO has established a

binding dispute settlement mechanism, which, at least so far, has proved effective in resolving trade disputes (Michalopoulos, 1999a, and b).

The significant favourable impact of WTO membership on inward FDI suggests that countries with weak institutions need to continue to make efforts to strengthen their institutional capabilities in such areas as financial sector development, customs administration and trade facilitation, which would make them better able to enjoy the benefits of WTO membership. Weakness in operations of fundamental market institutions inhibit effective integration in the trading system, thus, market and trade reforms are necessary conditions to attract FDI and get full benefits of its spill-over effect on the economy.

7.2.5 Role of Macroeconomic Stability

Fifth Finding: High inflation rates have a significant negative impact on inward FDI in CEC4.

The study found that macroeconomic instability reflected by high inflation rate is a strong deterrent to FDI. Such a finding suggests that in order to attract foreign investment price stability is so important and so desirable. Many analysts believe that the central bank should focus primarily on achieving price stability. A stable level of prices appears to be the condition most conducive to maximum sustained output and employment and to moderate long-term interest rates; in such circumstances, the prices of goods, materials, and services are undistorted by inflation and thus can serve as clearer signals and guides for the efficient allocation of resources. Also, a background of stable prices is thought to encourage saving and, indirectly, capital formation because it prevents the erosion of asset values by unanticipated inflation (Board of the Governors of the Federal Reserve System, 1994).

Moreover, a key principle for monetary policy is that price stability is a means to an end – to promote sustainable economic growth. According to William Mc Donough, former president of Federal Reserve Bank of New York, price stability is both important and desirable because a rising price level – inflation – even at moderate rates imposes substantial economic costs on society. All countries incur these costs. They entail, for example, (i) increased uncertainty about the outcome of business decisions and profitability; (ii) negative effects on the cost of capital resulting from the interaction of inflation with the tax system; (iii) reduced effectiveness of the price and market systems; and (iv) distortions that create perverse incentives to engage in non-productive activities (Mc Donough, 1997, p. 2).

Thus, a key issue facing central banks is what strategy to pursue in the conduct of monetary policy. One choice of monetary strategy that has become increasingly popular in recent years is inflation targeting, which involves the public announcement of medium to long-term numerical targets for inflation with a commitment by the monetary authorities to achieve these targets (Mishkin and Posen, 1997). Once a commitment has been made to price stability as the goal of monetary policy – and that commitment has been entrusted to an independent central bank – there are several possible approaches to implementing that goal. While the choice will depend on a country's history, economic conditions, and traditions, all successful approaches share two important features: first, they focus on a long-term time horizon and, second, they provide a transparent standard for the assessment of policy. For many of these approaches, what guides monetary policy is an announced target; such a target is one proven means of credibly conveying to the public the commitment to price stability and thereby locking in inflation expectations (Mc Donough, 1997).

7.2.6 Role of Financial Institutions' Depth and Efficiency

Sixth Finding: Well developed and efficient financial institutions have significant positive impact on inward FDI in CEC4.

In order to examine the role of “institutions” in attracting FDI, the study focused on “financial institutions” and found that well developed and efficient financial institutions have a significant positive impact on FDI. Moreover, the lack of development of local financial institutions can adversely limit an economy’s ability to take advantage of potential FDI benefits. This finding demonstrates that the full benefits of long-term stable financial flows may not be realized in the absence of well-functioning financial institutions. The significant positive impact of the “*quality of financial institutions*”, reflected by the interest rate spread, on FDI means that financial reforms in CEC4 are advanced enough to have banking sector or financial institutions comparable to the advanced economies and to that of the EU, and complies with the *acquis communautaire*. Moreover, such a result clearly demonstrates that financial reforms pay off and that financial sector development and efficiency is a crucial factor for the attraction of long-term stable capital.

Concerning the relationship between BITs and financial institutions *vis-à-vis* FDI, there is no evidence that BITs perform differently in the presence of well developed and efficient financial institutions. The estimations of the two interaction terms - BIT with financial depth and BIT with efficiency – were found to be insignificant. This is a strong evidence that each has a separate and crucial role in creating favourable “investment environment”. Ratified BITs and developed and efficient financial institutions have distinct and separate impacts on FDI. In the presence of well developed and efficient financial institutions BITs do not exert a different impact on FDI. Furthermore, the level of development and efficiency of financial institutions were found to have more important role in FDI attraction than the presence of BITs.

Financial institutions are crucial players in the integration of transactions over time; in particular, the channelling of savings and investment, the organisation of payments and the enforcement of financial discipline. Although most FDI by its nature relies on capital from abroad, it is important to recognise that foreign investors’ decisions crucially depend on the extent of the level of development and efficiency of domestic financial institutions. Progress in establishing financial infrastructure and capital markets is very important for foreign investors because it facilitates access to

local capital markets. Well developed and efficient financial institutions encourage foreign investors to set up operations, as they can have access to complementary local finance more easily, and face lower transaction costs for local financial services. Moreover, their customers too, are more likely to have access to credit, which might accelerate the demand for their products that are often bought on credit.

The great importance of the financial system in our daily lives can be illustrated by reviewing its different functions. The financial system in a modern economy has seven basic functions: (1) *Savings function*, providing a potentially profitable, low-risk outlet for the public's savings; (2) *Wealth function*, providing a means to store purchasing power until needed for future spending on goods and services; (3) *Liquidity function*, providing a means of raising funds by converting securities and other financial assets into cash balances; (4) *Credit function*, providing a supply of credit to support both consumption and investment spending in the economy; (5) *Payments function*, providing a mechanism for making payments to purchase goods and services; (6) *Risk function*, providing a means to protect businesses, consumers, and governments against risks to people, property, and income; and (7) *Policy function*; providing a channel for government policy to achieve society's goal of high employment, low inflation, and sustainable economic growth.

Clearly today's financial system is of great importance to every one. Foreign investors, local businessmen, consumers, government policymakers, and private citizens – all depend on the speed, efficiency, and quality of services that the system of money and capital markets provide. The financial system of money and capital markets is *not* independent of the economy and society that surrounds it. Economic booms and recessions, government budget deficits and taxes, technological innovations, political upheavals, wars, and social change – all impact the decisions made in the financial marketplace and often have devastating financial consequences. The enormous political, economic and social changes seen recently – the collapse of the Warsaw Pact and the ending of the cold war, the opening of Central and Eastern Europe and the republics once a part of the Soviet Union to investment and financial

aid from the West, the growth of private market systems in economies formerly dominated by government control, the growing financial and political integration of Europe, the movement toward free trade zones – these economic, political and social changes set in motion powerful forces reshaping financial systems around the globe.

7.2.7 Role of International Liquidity Position

Seventh Finding: High international liquidity position reflected by high level of reserves – *indicating Country Creditworthiness* - has a significant positive impact on inward FDI in CEC4.

One of the major findings of the study was that high level of reserves of a country, both in months of imports and total external debt, has a very significant positive impact on inward FDI. The ratio of reserves in months of imports indicates a country's ability to maintain import levels with current cash in hand. When this ratio - reserves in months of imports is high - means that the host country has a longer import coverage period, is in a better liquidity position - at least short-term liquidity - thus the country will not face balance-of-payments problems in the near future. This issue is very important for foreign investors, in the sense that it directly concerns their transfer of funds, repatriation of capital, profits, dividends, transfers related to liquidation of assets, etc. When a host country faces balance-of-payments problem, it might put restrictions on the transfer of funds. This might create serious problems to foreign investors and causes difficulties in their transactions. Therefore, the international liquidity position of a host country is so crucial for foreign investors. For this reason high reserve levels are so desirable, since it indicates the international liquidity position of a country or the liquidity risk, this in its turn affects a country's creditworthiness.

7.2.8 Role of International Competitiveness

Eight Finding: (a) Low relative unit labour costs with respect to OECD countries have a significant positive impact on inward FDI in CEC4.

(b) The secondary level of education of the labour force does not have a significant impact on inward FDI in CEC4.

The study found out that relative unit labour costs in manufacturing of CEC4 with respect to OECD countries have a highly significant effect on FDI attraction. On the other hand, the percentage of labour force having attained secondary education does not show any significance. Such a result clearly demonstrates the importance of a country's international competitiveness in attracting FDI. Actually, the index used for the relative unit labour cost of CEC4 captures the real effective exchange rate, and the education level of labour force. This is a strong evidence that “*efficiency-seeking FDI*” and “*resource-seeking FDI*” are significantly correlated with the international competitiveness factor. Foreign investors weight heavily this factor against other factors ahead of making their decision for a location of their foreign investment. On the other hand, for the purposes of attracting FDI, investment in secondary education appears to be sufficient. Therefore, governments may choose to invest further in education beyond that level for other national purposes.

7.3 Conclusion

This chapter assessed the policy implications of the findings of study. The implications of this study are important for the following reasons: (a) it assesses the policies that pertain to the attraction of long-term capital to enhance growth, (b) although CEC4 may have some access to international capital market (Eurobonds, bank loans, and multilateral loans), FDI is more important since it involves the

transfers of technologies, entrepreneurial skills, product, and capital, and (c) it examines the dynamics of country risk since political risk and economic risk are important determinants of FDI. One crucial implication of this study to countries with weak domestic institutions, and others seeking reciprocal protection and promotion is that although the obligations of BITs incur some costs, they create favourable environment. But BITs are insufficient by themselves. They need to be supported by the economic fundamentals particularly macroeconomic stability and international competitiveness which are necessary conditions to attract FDI. International obligations would help reduce investor risk perceptions and narrow the gap between the actual risk of policy instability that may be suggested by a host country's domestic legislation, and the risk as perceived by foreign investors. If bilateral disciplines further reduced obstacles to FDI beyond what other IIAs do, this (plus the right economic determinants) would presumably lead to higher investment flows. Even then, however, bilateral agreed investment treaties would not by themselves guarantee higher FDI inflows. Nor would it be possible to predict the geographical distribution of FDI flows, because this would be determined first and foremost by the economic fundamentals of individual locations.

General Conclusion

The Uniqueness of This Study

This study is original in that it makes an important contribution to the determinants of FDI. It is unique in that it taps previously unexplored horizons related to the impact of IIAs, at the bilateral, regional, and multilateral levels on FDI. Other studies, such as Hallward-Driemeier (2003), Banga (2003), Egger and Pfaffermayr (2004a), Salacuse and Sullivan (2004), Tobin and Rose-Ackerman (2005), Neumayer and Spess (2005), Desbord and Vicard (2006) have examined only the impact of BITs on FDI. Some of these authors found that BITs exert a significant positive effect on inward FDI (Banga, 2003, Egger and Pfaffermayr, 2004a, Neumayer and Spess, 2005, Salacuse and Sullivan, 2005, Desbord and Vicard, 2006). Others found very weak relationship between BITs and FDI (Hallward-Driemeier, 2003, and Tobin and Rose-Ackerman, 2005). Clearly, there is a disagreement and contradiction in the mentioned studies. Part of the variation is explained by differing empirical approaches and methodologies. Some studies look at country dyads while others look at cumulative number of BITs and total FDI. Additionally, there are differences in the dependent variables as the various studies look at total FDI inflows, bilateral FDI inflows, FDI inflows as a share of global FDI and FDI inflows as a share of global FDI going to developing countries. Also, the differences in the results are due to the different samples of countries and different time periods. All these studies have examined the impact of BITs on FDI in developing countries. Only the study of Egger and Pfaffermayr (2004a) takes into consideration both OECD and non-OECD countries. Given the conflicting results and

different model specifications it is hard to determine who is correct. The simplest conclusion is that this research is completely different and unique. This study is the first to provide rigorous quantitative evidence on the impact of IIAs at the bilateral, regional, and multilateral levels on FDI. That is, this study is the first to estimate the impact of OECD, IMF, and WTO membership on FDI, in addition to the impact of BITs on FDI. To the researcher's knowledge, Rose (2005) was the first to estimate the effect of WTO, IMF and OECD membership on international trade. Using standard "gravity" model of bilateral merchandise trade and a large panel data set covering over fifty years and 175 countries, his results indicated that OECD membership (but neither WTO nor IMF membership) has had a consistently large positive effect on trade. This study found that among the international institutions, WTO membership (but neither OECD nor IMF) exerts a significant positive impact on FDI. Another difference is that Rose (2005) did not estimate the impact of BITs. Therefore, this study is completely different than other studies (on FDI or on trade) in the sense that it conducted a very original and a comprehensive research, by examining the impact of BITs on FDI, in addition to membership of international economic institutions, such as OECD, IMF and WTO.

Furthermore, the empirical analysis of the study utilized variables and indicators not used previously in available empirical literature on FDI. For example, the level of development of financial institutions using liquid liabilities of the financial sector ($M3/GDP$), domestic credit provided by the banking sector ($BANKCR$), quality and efficiency of financial institutions using interest rate spread ($INTSPREAD$), local cost of capital using real lending interest rates ($REALRATE$), the international liquidity position of a country and country creditworthiness using the ratios of reserves to import levels (RES/MGS) and external debt (RES/EDT), the financial health of an economy using external debt obligations relative to output (EDT/GNI), to export revenues (EDT/XGS), or external debt services to export revenues (TDS/XGS). The impact of such indicators on FDI has not been examined before in available empirical literature. Therefore, this study is an addition to the existing empirical literature, is unique and original.

The Objective of the Research

Beginning in the late 1980s and the early 1990s countries of Central Europe – The Czech and Slovak Republics, Hungary, and Poland have engaged in a historical effort to transform their centrally planned economies into market economies that would eventually allow them to participate in the global economy. This change was prompted by the poor performance of the centralized economic system which precipitated the breaking up of the USSR at the end of 1991 and the subsequent collapse of communist regimes in Central Europe. These regimes were replaced by democratic governments that committed themselves to build market economies and have, since then, implemented several reform measures. The reform package included: (a) privatisation of state enterprises, (b) establishment of competitive markets through price, wage, and exchange rate liberalization, (c) the removal of international trade restrictions, (d) macroeconomic stabilization policies, and (e) the creation of a legal framework (particularly regarding to property rights and commercial laws), and institutions vital to the functioning of a market economy. The commitments of the CEC4 to build market based economies and to participate in the global economy is evidenced also by their membership in international organizations such as the World Bank, OECD, IMF, and WTO.

The 1990s brought about important changes in the economic systems of the CEC4. This period was characterized by the establishment of liberal market environment and financial liberalisation accompanied by an increasing inflow of FDI. Based on the amount of FDI during the 1990s, these countries are considered to be a success story in attracting foreign investors within the Central European region. Without doubt, foreign capital contributed to the economic modernisation and in this respect the development path of the CEC4 approached those of other, Western European countries. These countries eventually became European Union members since May 2004. The 1990s was also characterized by a sharp increase in the share of FDI in the world's total capital flows. Following the debt crisis in the 1980s, and the financial crises during the 1990s, emerging economies have changed their attitude towards FDI. The reasons for this change are attributed to the characteristics of direct investment flows. It is believed that FDI can contribute to the development efforts of a country, is non-debt creating, is

less volatile than other types of capital flows, and is less prone to financial crises. One reason for this difference is that, FDI results in the ownership and operation of productive facilities, a flow is not easily reversible, and is more long-term. Thus, by comparison with portfolio and other types of investment flows, FDI is likely to be a relatively stable source of funds. The investors' horizons are longer to begin with, and they are more deeply involved with the host economies after the investments have been made. For these reasons, the behaviour of FDI has differed from that of other forms of financial flows during the financial crises of the 1990s, and was highly recommended by policymakers for the stability of the new international financial architecture.

A third important characteristic related to the 1990s is the dramatic increase in the number of IIAs signed between countries. With the ascendancy of FDI as one of the main factors driving international economic relations in the era of globalization, international investment rulemaking has come to the forefront of economic diplomacy. It may be well that the first half of the 21st century will be characterized by the establishment of an international investment law system. Efforts to attract FDI and benefit from it increasingly take place in an environment characterized by a proliferation of investment rules at the bilateral, sub-regional, regional and multilateral levels. The resulting investment rules laid out in 2,495 BITs concluded till 2005 (www.unctad.org/iia), compared to 385 by the end of 1989. The number of countries involved in BITs, now encompasses 176 countries. In this respect, the desire of the CEC4 to facilitate and attract FDI is reflected by the dramatic increase in the number of BITs concluded by these countries. Since the late 1980s, the CEC4 have concluded extensively BITs with OECD countries with the overarching objective of improving the "investment climate" and attracting foreign investment. These treaties have been ratified in the early 1990s, and the majority of FDI in CEC4 have originated from the OECD area.

This dissertation aimed at pointing out the role of IIAs in attracting FDI into the CEC4 and focused on the role of BITs. The main objective of the study was to answer the question pertaining to whether IIAs actually attract FDI into CEC4, whether BITs

attract FDI into CEC4. Such an issue has not yet been addressed by the pertinent literature. One of the key reasons CEC4 countries signed BITs is the expectation that they will attract foreign investment, and that investment in turn will foster economic development. This study provided original empirical evidence that BITs have fulfilled their stated objective for the Central European countries. The CEC4 with poor domestic institutions in the early 1990s have gained from BITs and have attracted impressive amounts of FDI.

International Investment Agreements (IIAs), especially at the bilateral level, have contributed in tilting the composition of international financial flows toward *less volatile, less crises-prone, non-debt creating and longer-term stable* components, such as FDI. Therefore, IIAs having positive impact on stable long-term financial flows are important for the global financial stability and the strengthening of new international financial architecture.

Summary

This study consisted of seven chapters. The general introduction stated the purpose, objective, need and contribution of the study; it reviewed the literature on FDI determinants in CEC4, and other studies analyzing the impact of BITs on FDI. It also stated the research hypotheses, described the econometric methodology of the empirical analysis, the variables and the data sources. Chapter one presented the concept and definition of FDI according to the international standards set by the OECD and IMF. It analyzed the role of FDI in international capital flows, and focused on its main characteristics. It elaborated the relationship between globalization and FDI, and presented the global trend of FDI inflows from 1985 to 2005.

Chapter two described the structure and trend of capital inflows into the CEC4 for the period 1990-2005. Given the importance and size of FDI relative to other types of capital inflows, attention shifted towards the evolution of FDI during the period under study. The amount of FDI absorbed by the CEC4 has been significant in terms of both GDP and investments. However, the distribution of FDI in the four countries is not

similar. This difference between the four countries is due to the fact that governments in CEC4 adopted different policies to attract foreign investors into their economies. It is interesting to remark that foreign investment in CEC4 originates mainly from the European Union. Investments come largely from neighbouring countries, such as Germany and the Netherlands.

Chapter three presented the international legal framework on international investment. It elaborated the sources of the international investment law; the reasons countries sign IIAs, and the views of industrialized and emerging countries with respect to the nature and content of international investment law. It described the growth of IIAs, and focused on the growth of the number of BITs during the 1990s. It elaborated the major issues covered in BITs. As to regional investment agreements, the chapter mentioned the *OECD Code of liberalization of Capital Movements*. In connection to OECD Code of Liberalization, Article (4), the study highlighted on the *IMF Articles of Agreement, Article VIII*, concerning current account convertibility. Within the framework of multilateral investment agreements, it discussed the WTO investment related provisions. It looked also at the characteristics of IIAs at different levels. Finally, it presented a list of BITs concluded by the CEC4 as of June 2006.

Chapter four reviewed the international literature on FDI. Foreign direct investment has a huge international theoretical literature. There are many theories on the determinants and others on the effects of FDI on the host economies. The study discussed the theories concerning the determinants of FDI. The author divided this chapter into four major parts: theories assuming perfect markets, theories assuming imperfect markets, other theories, and theories based on other factors. It further elaborated the different theories under each of the four major headings.

Chapter five attempted to construct the theoretical model for the analysis of FDI determinants in CEC4. This presented a major theoretical contribution to the literature. On the basis of the theoretical survey carried out in chapter four, two theories – the “eclectic” and “country risk” - were integrated to explain FDI in CEC4. The “eclectic” theory has been organised into a framework based on three factors: ownership,

location, and internalisation advantages. The “country risk” theory was based on “macroeconomic risk” and “political risk” factors. The study applied the “integrated” theory to explain FDI in CEC4 and focused on the location-specific advantages. The economic model was specified using the factors of the “integrated” theory that can be utilized also as “pull-factors” within the “pull and push” approach.

Chapter six made a major contribution to the empirical literature by empirically verifying the significant favourable impact of IIAs on FDI in CEC4. To estimate the impact of BITs on FDI, the empirical analysis used bilateral FDI inward stock and inflows from 22 OECD countries to CEC4 for the period 1992-2003. The analysis adopted the “integrated” theory, constructed in chapter five, and used *panel data methodology* in the estimation process. The econometric specification utilized country-pair specific effects to capture all unobservable time invariant determinants that might affect bilateral FDI activity between source-host country, and which are not explained by the explanatory variables. The model was estimated using both fixed-effects and random-effects estimation methods. A Hausman (1978) test was applied to capture the correlation between the unobservable country-pair specific effects and the explanatory variables. The regressions were estimated under different specifications, using economic, financial, creditworthiness, and international competitiveness variables that are considered as “pull” factors’, and specific to both “country risk” and “eclectic” theories. The study employed data from the World Bank, OECD, and UNCTAD. The results of random effects GLS estimation method were discussed.

Main Findings

The study analyzed twelve years of bilateral FDI inward stock and inflows from 22 OECD countries to CEC4 during the period 1992-2003, and found strong empirical evidence that IIAs at the bilateral level - BITs - have a significant positive effect on FDI. The CEC4 had weak domestic institutions in the late 1980s and early 1990s. They signed BITs with developed countries, and received impressive amounts of FDI. The effect is robust to various sample sizes, and model specifications. The estimated effect of BITs on bilateral real inward FDI stock ranges from 56% to 73%. Such a result clearly demonstrated the significant favourable role BITs have played in attracting FDI

to CEC4. However, IIAs at the regional level (*OECD Code of Liberalization of Capital Movement*), and an international monetary agreement (*IMF Article VIII*) concerning current account convertibility, do not have significant effect on FDI. WTO membership, an international trade agreement, has encouraged and attracted FDI significantly in CEC4.

The effect of the economic fundamentals are robust and of the expected sign. One of hypotheses was that the larger the host country size (market-size) the more is the market-seeking FDI. The local market is very important for investors. However, FDI in CEC4 is devoted to supply both the domestic and export markets. There are two explanations for this. One is that the local market- however small it is - was still a new market. The other is to think that apart from being a local market, CEC4 is also a regional one, somehow, is a door to the Central European market. On the other hand, growth prospects of the host economy (Growth) seem not to have a significant impact on FDI inflows. Empirical evidence has also shown that macroeconomic instability reflected by inflation discourages FDI. A host country's exchange rate level and trade openness could be ambiguous if source countries are looking to export or serve the local market (to jump tariffs). The positive coefficient on real effective exchange rate supports the hypothesis that host country currency appreciation will attract *market-seeking* FDI. Alternatively, a negative coefficient of real effective exchange rate supports the hypothesis that host country currency depreciation will attract *export-oriented* FDI. Concerning the impact of trade policy on FDI, a positive finding on trade openness suggests that FDI will be attracted to open economies. A negative sign on trade openness supports the hypothesis that FDI will be attracted to jump tariffs. The international competitiveness of the host CEC4 country, reflected by relative unit labour cost in manufacturing, has played a major role in attracting FDI. Having the relative unit labour costs in manufacturing of CEC4 with respect to OECD countries played a significant and favourable role in FDI attraction means that OECD investors were both "*efficiency-seeking*" and "*resource-seeking*" investors.

The empirical findings show also that local institutions can limit the potential benefits BITs can provide to the host country. The study focused particularly on the

role of local financial institutions and the link between BITs and financial institutions' level of development and efficiency. The study found that well developed and efficient financial institutions have a significant and favourable impact on FDI attraction. The lack of development of local financial institutions can adversely limit an economy's ability to take advantage of such potential FDI benefits. The thesis has demonstrated that the full benefits of long-term stable financial flows may not be realized in the absence of well-functioning financial institutions. Concerning the relationship between BITs and financial institutions *vis-à-vis* FDI, the parameter estimates of the interaction terms between BIT and financial depth and efficiency were insignificant. This suggests that BITs do not have additional favourable effect on FDI in an environment with well developed and efficient financial institutions. BITs and financial depth and efficiency have individual impact on FDI. The role of financial institutions – in terms of both depth and efficiency – seems to be more crucial and important for FDI attraction than the existence of BITs.

Limitations of the Study

One of the limitations facing this research is data constraints. Studies analyzing the impact of BITs on FDI in developed or developing countries have the advantage of using a long time period, for example, since the early 1980s. Unfortunately, that is impossible in the case of the CEC4. These countries were centrally planned and data are only available from the early 1990s. This study uses OECD data on bilateral FDI stocks and flows, as reported by OECD member countries. Such data were not even compiled into a publicly-available form until 1993 with the first annual OECD *International Direct Investment Statistics Yearbook*. Since data are collected from national sources in each country, there is substantial variation in coverage by country source and by year, and there is variation in measurement of FDI activity itself. The data set use un-balanced panel data from 1992 through 2003. For example, to estimate the impact of IIAs on FDI, having as dependent variable bilateral FDI inward stock, data for the Czech Republic are available for the period 1997–2003. For Poland they are 1994-2003, and for the Slovak Republic they are available for 2000-2002. Only in the case of Hungary data are available for the period 1992-2003. The study faces greater difficulty in case of bilateral FDI inflows. For this reason, the main results of

the study are based on estimations using bilateral FDI inward stock, as dependent variable, since regressions have larger number of observations.

Another limitation is the measuring of BIT activity. There are substantial measurement issues that determine how to define this variable. One can observe when countries make bilateral investment treaties with each other, but these treaties certainly differ from each other along many dimensions which are very difficult to quantify. In addition, the same treaty on paper can have different consequences for different pairs of countries depending on the unilaterally-adopted practices of countries before entering the treaty. Because of these difficulties, this study measures investment treaty activity as a *binary variable* taking the value of “1” if two countries have a bilateral investment treaty in place in year (t) and after, “0” otherwise. Hence, a dummy is included in panel regression that takes the value of “1” once a BIT has been ratified⁴⁹ between a pair of source-host countries. The significance of the coefficient on this variable is then a test of the importance of the treaty.⁵⁰ As a result, it will be able to estimate the impact of BITs.

Another limitation is the potential endogeneity problem. The study is not able to test empirically the direction of causality between BITs and FDI. Other studies examining the impact of BIT on FDI (Hallward-Driemeier, 2003, Egger and Pfaffermayr, 2004a, and Neumayer and Spess, 2005) have tested this endogeneity issue, because they have longer period of data. Their period of study extends from the early 1980s till 2000, and their sample of countries is larger. They have examined the impact of BITs on FDI in developing countries. In the case of this study, data

⁴⁹ UNCTAD publishes both the date of signing of BITs and the date it was ratified. The distinction is important as the treaty only goes into effect once it is ratified – and there are several cases where ‘signed’ treaties have never been ratified. The thesis uses the date of ratification of the BIT in all the empirical work.

⁵⁰ This thesis does treat all BITs equally, when in fact there are some differences between them. The general point that BITs strengthen property rights holds across all of them. It is possible that there would be more of an effect if one looked only at those treaties with the strongest investor protections. Given this would require reading and devising an index measure of several hundred BITs, it is beyond the scope of this study. However, if BITs are acting as a substitute for property rights, one would expect that the stronger clauses would be included in treaties with countries that have lower domestic property rights. That there is no evidence that these countries receive additional FDI after signing a BIT would indicate that the effort to classify individual BIT terms is unlikely to be fruitful.

constraints on bilateral FDI inflows and inward stock from the 22 OECD source countries to CEC4 host countries do not allow the study to use some econometric procedures. For example, the study is not able to test the impact of BIT ratification on bilateral FDI inward stock for years before ratification and years after ratification. But in all cases, the study does not expect that there is a reverse causation, and that the CEC4 concluded BITs because of the existing FDI. That is the CEC4 did not conclude BITs with the 22 OECD to cover the existing FDI. On the contrary, according to the statistical figures, foreign investments were rare in CEC4 during the 1980s⁵¹. They received impressive amounts of FDI during the 1990s, after their ratification of BITs.

Recommendations for Further Research

This study dealt with the impact of IIAs, particularly, BITs on bilateral inward FDI in CEC4. My research found that BITs exert a significant positive impact on FDI in CEC4. The CEC4, in the late 1980s and early 1990s, with weak institutions, have gained and benefited from the conclusion of BITs with the developed OECD countries. They concluded BITs with the overarching objective of attracting foreign investment and capital in order to restructure and develop their economies.

The mushrooming growth of the number of BITs is justified by the belief and hope of policy makers that investment is a critical requirement if countries are to move, globally, towards a more sustainable future. Investments are needed to add sustainable resources, sound industrial processes, better natural resource use, as well as to achieve the economic and social factors at the heart of the development agenda. But the relationship between IIAs and sustainable development remains unclear. IIAs are seen and sold as a development tool; countries sign IIAs expecting to see significant inflows of investments due to the protections for foreign investors that the agreements provide. Regardless of such claims there is a lot more to be done in order to assess the impact of IIAs on development, and to what extent FDI contributes to development. A question

⁵¹ Appendix H describes details on FDI inflows in CEC4 during 1980 - 2005.

that is left to future research is to what extent IIAs contribute to sustainable development. This aspect requires further indepth research in order to assess the real impact of IIAs on sustainable development.

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Appendix A: List of Countries in the Regressions

Source OECD Countries		Host Central European Countries	
1)	Australia	1)	The Czech Republic
2)	Austria	2)	Hungary
3)	Belgium-Luxembourg	3)	Poland
4)	Canada	4)	The Slovak Republic
5)	Denmark		
6)	Finland		
7)	France		
8)	Germany		
9)	Greece		
10)	Ireland		
11)	Italy		
12)	Japan		
13)	Korea (Republic of)		
14)	Netherlands		
15)	Norway		
16)	Portugal		
17)	Spain		
18)	Sweden		
19)	Switzerland		
20)	Turkey		
21)	U.K.		
22)	U.S.		

Appendix B: Description and Sources of Variables

Variable Name	Description and Source															
Dependent Variables																
In FDI Inflows	<p>Natural logarithm of FDI Inflows from each OECD source country into each CEC4 host country expressed in constant 2000 US\$. Due to data limitation on bilateral inflows, the data set available for each host country is as follows:</p> <table border="1"> <thead> <tr> <th>Host CEC4</th> <th>Source OECD</th> <th>Years Covered</th> </tr> </thead> <tbody> <tr> <td><i>Czech Rep.</i></td> <td><i>13 countries</i></td> <td><i>1993 - 2003</i></td> </tr> <tr> <td><i>Hungary</i></td> <td><i>22 countries</i></td> <td><i>1999 - 2003</i></td> </tr> <tr> <td><i>Poland</i></td> <td><i>22 countries</i></td> <td><i>1993 - 2003</i></td> </tr> <tr> <td><i>Slovak Rep.</i></td> <td><i>22 countries</i></td> <td><i>2000 - 2003</i></td> </tr> </tbody> </table>	Host CEC4	Source OECD	Years Covered	<i>Czech Rep.</i>	<i>13 countries</i>	<i>1993 - 2003</i>	<i>Hungary</i>	<i>22 countries</i>	<i>1999 - 2003</i>	<i>Poland</i>	<i>22 countries</i>	<i>1993 - 2003</i>	<i>Slovak Rep.</i>	<i>22 countries</i>	<i>2000 - 2003</i>
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<i>Slovak Rep.</i>	<i>22 countries</i>	<i>2000 - 2003</i>														
In FDI Stock	<p>Natural logarithm of FDI inward stock of each 22 OECD source country in each CEC4 host country expressed in constant 2000 US\$. Due to data limitation, the period of data available for each host country is as follows:</p> <table border="1"> <thead> <tr> <th>Host CEC4</th> <th>Source OECD</th> <th>Years Covered</th> </tr> </thead> <tbody> <tr> <td><i>Czech Rep.</i></td> <td><i>22 countries</i></td> <td><i>1997 - 2003</i></td> </tr> <tr> <td><i>Hungary</i></td> <td><i>22 countries</i></td> <td><i>1992 - 2003</i></td> </tr> <tr> <td><i>Poland</i></td> <td><i>22 countries</i></td> <td><i>1994 - 2003</i></td> </tr> <tr> <td><i>Slovak Rep.</i></td> <td><i>22 countries</i></td> <td><i>2000 - 2002</i></td> </tr> </tbody> </table> <p>Original values are in national currencies. Conversion to US\$ is made using the yearly average exchange rates from ANNEX III of OECD's yearbook. They are further converted into constant 2000 US\$ using the GDP deflator from the World Bank WDI.</p> <p><i>Source: OECD International Direct Investment Statistics Yearbook 2004.</i></p>	Host CEC4	Source OECD	Years Covered	<i>Czech Rep.</i>	<i>22 countries</i>	<i>1997 - 2003</i>	<i>Hungary</i>	<i>22 countries</i>	<i>1992 - 2003</i>	<i>Poland</i>	<i>22 countries</i>	<i>1994 - 2003</i>	<i>Slovak Rep.</i>	<i>22 countries</i>	<i>2000 - 2002</i>
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<i>Slovak Rep.</i>	<i>22 countries</i>	<i>2000 - 2002</i>														
Explanatory Variables																
Bilateral Investment Treaties	<p>A dummy variable, equal to 1 in the year that a BIT was ratified between the source OECD country and the host CEC4 country in each year and thereafter, 0 otherwise.</p> <p>Source: UNCTAD database on bilateral investment treaties. Available via internet at: http://www.unctad.org/ia</p>															
In GDP	<p>Natural logarithm of host country GDP expressed in constant 2000 US\$. <i>Source: World Bank, WDI.</i></p>															
GDP Growth	<p>GDP growth (annual %). Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2000 US\$. <i>Source: World Bank, WDI.</i></p>															
In INFL	<p>Natural logarithm of Inflation, consumer prices (annual %). Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a fixed basket of goods and services that may be fixed or changed at specified intervals, such as yearly. The Laspeyre formula is generally used. <i>Source: World Bank, WDI.</i></p>															
REXR	<p>Real Effective Exchange Rates: Index Numbers (Year 2000 = 100) Period Averages. Real effective exchange rate is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. <i>Source: World Bank, WDI.</i></p>															

Appendix B: (Cont'd)

Variable Name	Description and Source
In M3/GDP	Natural logarithm of Liquid Liabilities, also known as Broad Money, or M3 (% of GDP). They are the sum of currency and deposits in the Central Bank (M0), plus transferable deposits and electronic currency (M1), plus time and savings deposits, foreign currency transferable deposits, certificates of deposit, and securities repurchase agreements (M2), plus travelers checks, foreign currency time deposits, commercial paper, and shares of mutual funds or market funds held by residents. <i>Source: World Bank, WDI.</i>
In BANKCR	Natural logarithm of domestic credit provided by the banking sector (% of GDP). Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks, as well as other banking institutions where data are available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations. <i>Source: World Bank, WDI.</i>
INTSPREAD	Interest rate spread (lending rate minus deposit rate % points). It is the interest rate charged by banks on loans to prime customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. <i>Source: World Bank, WDI.</i>
REALRATE	Real interest rate (%). It is the lending interest rate adjusted for inflation as measured by the GDP deflator. <i>Source: World Bank, WDI.</i>
In RES/MGS	Natural logarithm of total reserves (RES) in months of imports of goods and services (MGS) (months). They are calculated as: $RES * 12 / MGS$. <i>Source: World Bank, WDI.</i>
In RES/EDT	Natural logarithm of total reserves (RES) to total external debt (RES/ EDT) (%). <i>Source: World Bank, WDI.</i>
In EDT/GNI	Natural logarithm of Total External Debt to Gross National Product (EDT/ GNI) (%). <i>Source: World Bank, GDF.</i>
In EDT/XGS	Natural logarithm of Total External Debt to Exports of Goods and Services (including workers' remittances) (EDT/ XGS) (%). <i>Source: World Bank, GDF.</i>
In TDS/XGS	Natural logarithm of Total Debt Service to Exports of Goods and Services (TDS/XGS) (%). Total Debt Service is the sum of principal repayments and interest actually paid in foreign currency, goods, or services on long-term debt, interest paid on short term debt, and repayments (repurchases and charges) to the IMF. Exports of goods and services includes income and workers' remittances. <i>Source: World Bank, GDF.</i>
OECD	A dummy variable, equal to 1 in the year that a host CEC4 country has joined the OECD in each year and thereafter, 0 otherwise.
IMF	A dummy variable, equal to 1 in the year a host CEC4 country has accepted the IMF' Articles of Agreement: Article VIII in each year and thereafter, 0 otherwise.
WTO	A dummy variable, equal to 1 in the year a host CEC4 country joined the WTO in each year and thereafter, 0 otherwise.
Trend	Trend starts with 1992 for all countries. For example, 1992= 1, 1993=2, 1994=4, etc...
RULC OECD	Relative Unit Labour Cost in Manufacturing with respect to OECD Countries. <i>Source: OECD Factbook 2006.</i>
EDU2	Labour force with secondary education is the proportion of the labour force that has a secondary education, as a percentage of the total labour force. <i>Source: World Bank, WDI.</i>

Appendix C: Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ln FDI stock	680	18.93	2.35	9.81	23.27
ln GDP host	704	24.86	0.65	23.73	25.90
Growth	704	3.03	2.28	-3.06	7.00
ln INFL	704	2.02	1.19	-2.30	3.50
REXR	704	99.25	9.79	76.20	121.70
RULC	704	109.12	18.41	76.31	157.00
EDU 2	704	68.03	8.61	41.00	80.00
ln M3/GDP	704	3.90	0.23	3.47	4.28
ln BANKCR	704	3.93	0.33	3.40	4.57
INTSPREAD	704	5.19	2.31	-1.00	10.00
REALRATE	704	5.69	4.01	-3.00	17.00
ln RES/MGS	704	1.44	0.26	0.92	1.85
ln RES/EDT	704	3.68	0.37	2.65	4.45
ln EDT/GNI	704	3.87	0.27	3.31	4.30
ln EDT/XGS	704	4.61	0.38	3.98	5.51
ln TDS/XGS	704	2.95	0.53	1.81	3.90
ln Openness	704	4.50	0.43	3.82	5.04
Trend	704	7.69	3.07	1.00	12.00

Appendix D: Pair-Wise Correlation Matrix

	ln FDI Stock	ln GDP host	Growth	ln INFL	REXR	RULC	EDU2
ln FDI Stock	1.00						
ln GDP host	0.22	1.00					
Growth	0.02	0.31	1.00				
ln INFL	-0.06	-0.11	0.02	1.00			
REXR	0.05	-0.12	-0.18	-0.63	1.00		
RULC(oecd)	0.02	-0.40	-0.39	0.36	0.04	1.00	
EDU2	0.00	0.17	0.00	-0.57	0.28	-0.49	1.00
ln M3/GDP	-0.14	-0.68	-0.55	-0.44	0.43	0.09	0.36
ln BANKCR	-0.11	-0.80	-0.61	0.22	0.03	0.70	-0.27
INTSPREAD	0.05	-0.05	-0.38	0.26	-0.26	0.39	-0.28
REALRATE	0.14	0.36	-0.11	-0.09	0.06	-0.06	0.04
ln RES/MGS	0.12	0.40	0.00	-0.12	-0.19	-0.05	0.13
ln RES/EDT	-0.03	0.00	0.06	-0.59	0.40	-0.43	0.64
ln EDT/GNI	-0.09	-0.72	-0.27	0.22	0.10	0.54	-0.46
ln EDT/XGS	0.13	0.28	-0.07	0.50	-0.48	0.48	-0.56
ln TDS/XGS	0.02	-0.39	-0.40	0.22	0.14	0.58	-0.41
ln Openness	-0.18	-0.75	-0.10	-0.27	0.53	-0.03	0.21
BIT	0.14	0.13	0.03	-0.13	0.11	-0.09	0.14
OECD	0.02	0.12	0.10	-0.53	0.57	-0.46	0.62
IMF	0.00	0.19	0.34	-0.43	0.44	-0.67	0.41
WTO	0.00	0.03	0.14	-0.43	0.52	-0.54	0.37
Trend	0.03	0.06	0.19	-0.77	0.78	-0.52	0.48

	ln M3/GDP	ln BANKCR	INTSPREAD	REALRATE	ln RES/MGS	ln RES/EDT	ln EDT/GNI
ln M3/GDP	1.00						
ln BANKCR	0.54	1.00					
INTSPREAD	0.01	0.28	1.00				
REALRATE	-0.14	-0.25	0.45	1.00			
ln RES/MGS	-0.16	-0.27	0.61	0.55	1.00		
ln RES/EDT	0.47	-0.27	0.06	0.15	0.42	1.00	
ln EDT/GNI	0.26	0.78	0.03	-0.21	-0.36	-0.43	1.00
ln EDT/XGS	-0.57	0.13	0.42	0.29	0.34	-0.69	0.21
ln TDS/XGS	0.07	0.65	0.21	0.11	-0.19	-0.52	0.82
ln Openness	0.70	0.41	-0.32	-0.32	-0.50	0.39	0.45
BIT	-0.01	-0.11	-0.03	0.04	0.07	0.15	-0.12
OECD	0.22	-0.25	-0.33	0.15	-0.09	0.54	-0.17
IMF	0.04	-0.53	-0.26	0.16	-0.07	0.60	-0.41
WTO	0.19	-0.27	-0.23	0.18	0.02	0.63	-0.15
Trend	0.30	-0.37	-0.48	0.11	-0.12	0.54	-0.12

	ln EDT/XGS	ln TDS/XGS	ln Openness	BIT	OECD	IMF	WTO
ln EDT/XGS	1.00						
ln TDS/XGS	0.45	1.00					
ln Openness	-0.75	0.13	1.00				
BIT	-0.10	-0.08	0.01	1.00			
OECD	-0.59	-0.11	0.43	0.15	1.00		
IMF	-0.68	-0.39	0.36	0.13	0.75	1.00	
WTO	-0.62	-0.21	0.48	0.12	0.75	0.76	1.00
Trend	-0.62	-0.13	0.48	0.11	0.72	0.71	0.71

	Trend
Trend	1

Appendix E: Additional Estimation Results

Random-Effects GLS Estimation Results

Baseline Model: FDI and BITS

Dependent Variable: Natural Log of Bilateral **FDI Inward Stock (recoded)** in constant US\$.

[5 negative and 19 blank values are recoded as 1, so that Log (y) = 0 for all y ≤ 0]

	1	2	3	4	5	6	7	8	9	10
BIT	2.05 [3.71]***	2.04 [3.70]***	1.94 [3.49]***	2.03 [3.67]***	1.91 [3.44]***	1.88 [3.38]***	2.05 [3.71]***	2.03 [3.67]***	2.05 [3.71]***	2.03 [3.68]***
ln GDP	1.53 [2.19]**	1.21 [1.85]*	1.56 [2.74]***	1.54 [2.67]***	1.47 [2.57]**	1.64 [2.86]***	1.53 [2.51]**	1.82 [3.07]***	1.57 [2.75]***	1.82 [2.43]**
Growth	0.09 [1.33]	0.03 [0.37]	0.13 [2.35]**	0.10 [1.86]*	0.11 [2.06]**	0.07 [1.23]	0.09 [1.63]	0.05 [0.89]	0.10 [1.61]	0.08 [1.32]
ln INFL	-0.29 [1.83]*	-0.33 [2.36]**	-0.26 [1.96]**	-0.28 [2.09]**	-0.21 [1.58]	-0.26 [1.97]**	-0.29 [2.04]**	-0.33 [2.45]**	-0.27 [2.04]**	-0.31 [2.12]**
REXR	0.01 [0.62]	0.00 [0.13]	0.02 [1.02]	0.01 [0.58]	0.02 [1.12]	0.00 [0.10]	0.01 [0.57]	-0.01 [0.47]	0.01 [0.61]	0.00 [0.07]
RULC	0.02 [2.35]**	0.02 [2.64]***	0.02 [1.77]*	0.02 [2.30]**	0.01 [1.57]	0.02 [2.39]**	0.02 [2.19]**	0.03 [2.83]***	0.02 [2.38]**	0.03 [1.86]*
EDU2	-0.01 [0.42]	0.00 [0.28]	-0.01 [0.34]	-0.01 [0.49]	-0.01 [0.65]	-0.02 [0.89]	-0.01 [0.49]	-0.01 [0.61]	-0.01 [0.47]	-0.01 [0.53]
ln M3/GDP	-0.17 [0.09]									
ln BANKCR		-1.35 [1.15]								
INTSPREAD			0.08 [1.63]							
REALRATE				0.01 [0.32]						
ln RES/MGS					0.83 [1.80]*					
ln RES/EDT						0.87 [2.05]**				
ln EDT/GNI							-0.19 [0.20]			
ln EDT/XGS								-1.04 [1.57]		
ln TDS/XGS									0.06 [0.18]	
ln Openness										0.53 [0.51]
Observations	704	704	704	704	704	704	704	704	704	704
No. Country pairs	88	88	88	88	88	88	88	88	88	88
R-sq:overall	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07	0.07
sigma_u	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
sigma_e	2.49	2.49	2.49	2.49	2.49	2.48	2.49	2.49	2.50	2.49
rho	0.69	0.69	0.69	0.69	0.69	0.70	0.69	0.69	0.69	0.69
Hausman test	2.86	3.85	2.32	2.54	2.62	3.94	3.14	3.67	2.41	2.78
Prob>chi2 =	0.94	0.87	0.97	0.96	0.96	0.86	0.93	0.89	0.97	0.95

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

All Models Include An Intercept.

Estimated Using STATA Software.

Appendix E: (Cont'd)

Fixed-Effects Estimation Results

Baseline Model: FDI and BITs

Dependent Variable: Natural Log of Bilateral **FDI Inflows (recoded)** in constant 2000 US\$

[63 negative and 25 blank values are recoded as 1, so that $\text{Log}(y) = 0$ for all $y \leq 0$]

	1	2	3	4	5	6	7	8	9	10
BIT	5.07 [2.68]***	5.16 [2.74]***	5.59 [2.92]***	5.37 [2.86]***	5.84 [3.09]***	5.95 [3.12]***	5.92 [3.15]***	5.71 [3.01]***	5.68 [3.04]***	5.44 [2.90]***
ln GDP	9.73 [1.22]	3.92 [0.50]	6.36 [0.81]	3.69 [0.46]	10.02 [1.17]	10.96 [1.24]	6.75 [0.88]	6.50 [0.84]	5.76 [0.75]	2.73 [0.30]
Growth	0.22 [1.00]	0.17 [0.78]	0.27 [1.25]	0.33 [1.52]	0.35 [1.53]	0.40 [1.63]	0.44 [1.86]*	0.34 [1.34]	0.50 [2.07]**	0.28 [1.30]
ln INFL	0.57 [1.31]	0.65 [1.47]	0.53 [1.14]	0.49 [1.12]	0.56 [1.27]	0.66 [1.45]	0.88 [1.82]*	0.62 [1.30]	0.64 [1.46]	0.45 [1.00]
REXR	-0.01 [0.08]	-0.05 [0.54]	-0.05 [0.51]	-0.05 [0.60]	-0.08 [0.82]	-0.06 [0.63]	-0.04 [0.39]	-0.04 [0.43]	-0.01 [0.10]	-0.07 [0.71]
RULC	-0.03 [0.44]	-0.01 [0.23]	0.02 [0.26]	0.01 [0.23]	0.03 [0.55]	0.02 [0.36]	0.02 [0.31]	0.01 [0.22]	0.00 [0.01]	0.03 [0.45]
EDU2	-0.13 [0.40]	0.01 [0.02]	-0.08 [0.24]	-0.05 [0.16]	-0.02 [0.07]	-0.06 [0.17]	0.00 [0.01]	-0.05 [0.14]	-0.32 [0.91]	0.03 [0.09]
ln M3/GDP	-8.51 [1.65]*									
ln BANKCR		-4.91 [1.80]*								
INTSPREAD			-0.01 [0.09]							
REALRATE				0.10 [1.30]						
ln RES/MGS					-1.54 [1.03]					
ln RES/EDT						-1.27 [1.10]				
ln EDT/GNI							3.19 [1.70]*			
ln EDT/XGS								0.95 [0.52]		
ln TDS/XGS									2.27 [2.07]**	
ln Openness										3.04 [0.76]
Observations	578	578	578	578	578	578	578	578	578	578
No. of country pairs	78	78	78	78	78	78	78	78	78	78
R-sq. within	0.05	0.05	0.04	0.04	0.04	0.04	0.05	0.04	0.05	0.04
sigma_u	9.53	5.28	5.88	4.85	7.75	8.73	5.71	6.08	6.56	4.29
sigma_e	5.64	5.64	5.66	5.65	5.65	5.65	5.64	5.66	5.63	5.65
rho	0.74	0.47	0.52	0.42	0.65	0.71	0.51	0.54	0.58	0.37
Hausman Test	15.66	17.1	16.79	15.84	16.99	14.7	17.08	10.01	19.11	6.82
Prob>chi2 =	0.05	0.03	0.03	0.04	0.03	0.07	0.03	0.26	0.01	0.56

Absolute value of t statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

All Models Include An Intercept.

Estimated Using STATA Software.

Appendix E: (Cont'd)

Random-Effects GLS Estimation Results

FDI Without IIAs

Dependent Variable: Natural log of Bilateral **FDI Inward Stock** in constant 2000 US\$

	1	2	3	4	5	6	7	8	9	10
In GDP	1.45 [4.37]***	1.13 [3.70]***	1.38 [4.14]***	1.03 [3.33]***	1.30 [3.94]***	1.06 [3.46]***	1.34 [4.01]***	1.14 [3.73]***	1.06 [3.41]***	1.00 [2.90]***
Growth	0.04 [1.43]	0.02 [1.14]	0.05 [1.97]**	0.01 [0.68]	0.03 [0.98]	0.01 [0.30]	0.04 [1.52]	-0.02 [0.85]	0.01 [0.54]	0.01 [0.35]
In INFL	-0.12 [2.10]**	-0.18 [3.69]***	-0.13 [2.16]**	-0.19 [3.87]***	-0.17 [3.21]***	-0.15 [3.00]***	-0.09 [1.55]	-0.19 [3.84]***	-0.18 [3.42]***	-0.18 [3.19]***
REXR	0.01 [0.90]	0.01 [2.19]**	0.01 [1.70]*	0.01 [1.25]	0.01 [1.93]*	0.01 [2.31]**	0.01 [1.81]*	0.00 [0.73]	0.01 [1.85]*	0.01 [1.44]
RULC	0.01 [4.11]***	0.01 [3.57]***	0.01 [3.22]***	0.01 [4.34]***	0.01 [3.61]***	0.01 [3.29]***	0.01 [2.89]***	0.02 [4.73]***	0.01 [2.86]***	0.01 [2.32]**
EDU2	0.00 [0.22]	0.01 [0.91]	0.00 [0.50]	0.00 [0.43]	0.00 [0.48]	0.00 [0.33]	0.00 [0.07]	0.00 [0.20]	0.01 [0.78]	0.01 [0.80]
In M3/GDP	1.61 [2.21]**		1.27 [1.73]*				1.40 [1.94]*			
INTSPREAD		0.06 [3.36]***	0.06 [3.04]***							
REALRATE				0.02 [2.13]**						
In BANKCR					0.63 [1.36]					
In RES/MGS						0.61 [3.52]***	0.58 [3.32]***			
In RES/EDT								0.42 [2.60]***		
In EDT/XGS									0.31 [1.20]	
In Openness										-0.31 [0.77]
Observations	680	680	680	680	680	680	680	680	680	680
No. of Country pairs	87	87	87	87	87	87	87	87	87	87
R-sq.(Overall)	0.05	0.06	0.06	0.06	0.07	0.06	0.05	0.06	0.07	0.06
sigma_u	1.99	2.05	2.00	2.05	2.05	2.06	2.00	2.06	2.05	2.05
sigma_e	0.91	0.91	0.90	0.91	0.91	0.90	0.90	0.91	0.91	0.91
rho	0.83	0.84	0.83	0.83	0.83	0.84	0.83	0.84	0.83	0.83
Hausman Test	5.70	5.96	4.11	5.39	7.87	6.68	4.31	6.80	10.38	6.05
Prob > chi2	0.58	0.54	0.85	0.61	0.34	0.46	0.83	0.45	0.17	0.53

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%

All Models Include An Intercept.

Estimated Using STATA Software.

Appendix E:(Cont'd)

Random-Effects GLS Estimation Results
Baseline Model (with year-fixed effects)

Dependent Variable: Natural log of Bilateral FDI Inward Stock in constant 2000 US\$.

	1	2	3	4	5	6	7	8	9	10
BIT	0.46 [1.93]*	0.46 [1.94]*	0.45 [1.91]*	0.47 [1.98]**	0.46 [1.94]*	0.46 [1.95]*	0.47 [1.98]**	0.48 [2.01]**	0.46 [1.95]*	0.45 [1.92]*
In GDP	1.52 [4.14]***	1.39 [3.74]***	1.06 [3.61]***	1.10 [3.69]***	1.03 [3.45]***	1.13 [3.89]***	1.48 [4.52]***	0.78 [2.28]**	1.12 [3.84]***	0.61 [1.48]
Growth	-0.01 [0.21]	0.00 [0.07]	-0.02 [0.43]	-0.05 [1.49]	-0.04 [0.99]	-0.07 [2.35]**	0.03 [0.52]	0.04 [0.67]	-0.02 [0.38]	-0.03 [0.71]
In INFL	-0.14 [1.31]	-0.18 [1.76]*	-0.01 [0.08]	-0.20 [1.92]*	-0.13 [1.08]	-0.22 [2.07]**	-0.20 [2.24]**	-0.16 [1.68]*	-0.23 [2.61]***	-0.19 [2.13]**
REXR	-0.03 [1.50]	-0.03 [1.31]	-0.03 [1.09]	-0.04 [1.99]**	-0.02 [0.95]	-0.04 [1.90]*	-0.01 [0.51]	-0.01 [0.18]	-0.03 [1.30]	-0.03 [1.18]
RULC	0.03 [3.42]***	0.03 [3.11]***	0.03 [2.49]**	0.04 [3.69]***	0.03 [2.39]**	0.04 [3.71]***	0.04 [4.30]***	0.02 [1.47]	0.03 [3.68]***	0.03 [3.25]***
EDU2	0.00 [0.00]	0.00 [0.21]	0.01 [0.89]	0.00 [0.19]	0.00 [0.28]	0.00 [0.29]	0.01 [0.92]	0.00 [0.56]	0.00 [0.34]	0.01 [0.72]
In M3/GDP	1.81 [1.73]*									
In BANKCR		0.99 [1.12]								
INTSPREAD			0.09 [1.94]*							
REALRATE				0.01 [0.65]						
In RES/MGS					0.48 [1.50]					
In RES/EDT						0.13 [0.41]				
In EDT/GNI							1.80 [2.31]**			
In EDT/XGS								1.18 [2.01]**		
In TDS/XGS									0.23 [1.10]	
In Openness										-1.07 [1.76]*
Year 1992	-2.18 [1.97]**	-21.62 [1.85]*	-10.89 [1.54]	-10.23 [1.41]	-9.70 [1.36]	-2.63 [2.36]**	-29.06 [2.78]***	-1.14 [0.85]	-11.97 [1.69]**	-2.69 [2.56]**
Year 1993	-1.77 [2.00]**	-21.32 [1.80]*	-10.69 [1.51]	-9.63 [1.33]	-9.50 [1.34]	-2.11 [2.41]**	-29.08 [2.73]***	-1.51 [1.65]*	-11.63 [1.64]	-2.40 [2.80]***
Year 1994	-1.48 [1.88]*	-21.15 [1.77]*	-10.10 [1.43]	-9.37 [1.30]	-9.22 [1.30]	-1.74 [2.13]**	-29.22 [2.71]***	-1.60 [2.08]**	-11.49 [1.61]	-2.03 [2.65]***
Year 1995	-0.69 [0.97]	-20.31 [1.70]*	-9.92 [1.40]	-8.65 [1.20]	-8.80 [1.24]	-1.07 [1.59]	-28.31 [2.63]***	-0.62 [0.88]	-10.72 [1.50]	-1.14 [1.70]*
Year 1996	-0.55 [0.92]	-20.10 [1.68]*	-9.77 [1.38]	-8.47 [1.17]	-8.61 [1.21]	-0.89 [1.57]	-27.94 [2.61]***	-0.39 [0.63]	-10.51 [1.47]	-0.93 [1.65]*
Year 1997	-0.74 [1.58]	-20.26 [1.68]*	-9.69 [1.36]	-8.47 [1.17]	-8.63 [1.21]	-0.89 [1.92]*	-28.15 [2.61]***	-0.54 [1.10]	-10.61 [1.48]	-0.91 [1.98]**
Year 1998	-0.58 [1.36]	-20.07 [1.67]*	-9.55 [1.34]	-8.38 [1.16]	-8.56 [1.20]	-0.77 [1.81]*	-28.28 [2.60]***	-0.49 [1.13]	-10.51 [1.46]	-0.69 [1.65]*
Year 1999	-0.70 [1.77]*	-20.11 [1.68]*	-9.45 [1.33]	-8.50 [1.17]	-8.62 [1.21]	-0.89 [2.29]**	-28.48 [2.61]***	-0.65 [1.61]	-10.70 [1.48]	-0.76 [1.95]*
Year 2000	-0.31 [0.94]	-19.64 [1.62]	-9.03 [1.27]	-7.91 [1.09]	-8.13 [1.14]	-0.30 [0.87]	-28.09 [2.55]**	-0.17 [0.51]	-10.18 [1.40]	-0.12 [0.37]
Year 2001	-0.22 [0.84]	-19.42 [1.61]	-8.94 [1.25]	-7.77 [1.07]	-7.98 [1.11]	-0.18 [0.63]	-27.97 [2.54]**	0.03 [0.10]	-10.09 [1.39]	-0.03 [0.12]
Year 2002	-0.22 [1.12]	-19.47 [1.62]	-8.83 [1.23]	-7.80 [1.07]	-8.11 [1.13]	-0.28 [1.20]	-28.18 [2.55]**	-0.15 [0.76]	-10.19 [1.40]	-0.18 [0.89]
Year 2003	0.00 [.]	-19.36 [1.60]	-8.21 [1.14]	-7.53 [1.03]	-7.73 [1.08]	0.00 [.]	-28.10 [2.53]**	0.00 [.]	-9.99 [1.37]	0.00 [.]
Observations	680	680	680	680	680	680	680	680	680	680
No. of Country pairs	87	87	87	87	87	87	87	87	87	87
R-sq: overall	0.07	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08
sigma_u	1.87	1.87	1.87	1.87	1.87	1.87	1.87	1.87	1.87	1.87
sigma_e	0.89	0.90	0.89	0.90	0.89	0.90	0.89	0.89	0.90	0.89
rho	0.81	0.81	0.81	0.81	0.81	0.81	0.81	0.81	0.81	0.81
Hausman Test	11.28	9.84	9.59	9.92	6.79	9.80	6.63	10.50	9.21	18.11
Prob > chi2	0.88	0.83	0.89	0.82	0.98	0.94	0.97	0.91	0.90	0.52

Absolute value of z statistics in brackets. * significant at 10%; ** significant at 5%; *** significant at 1%. All Models Include An Intercept.

Appendix F: Membership of CEC4 of International Organizations

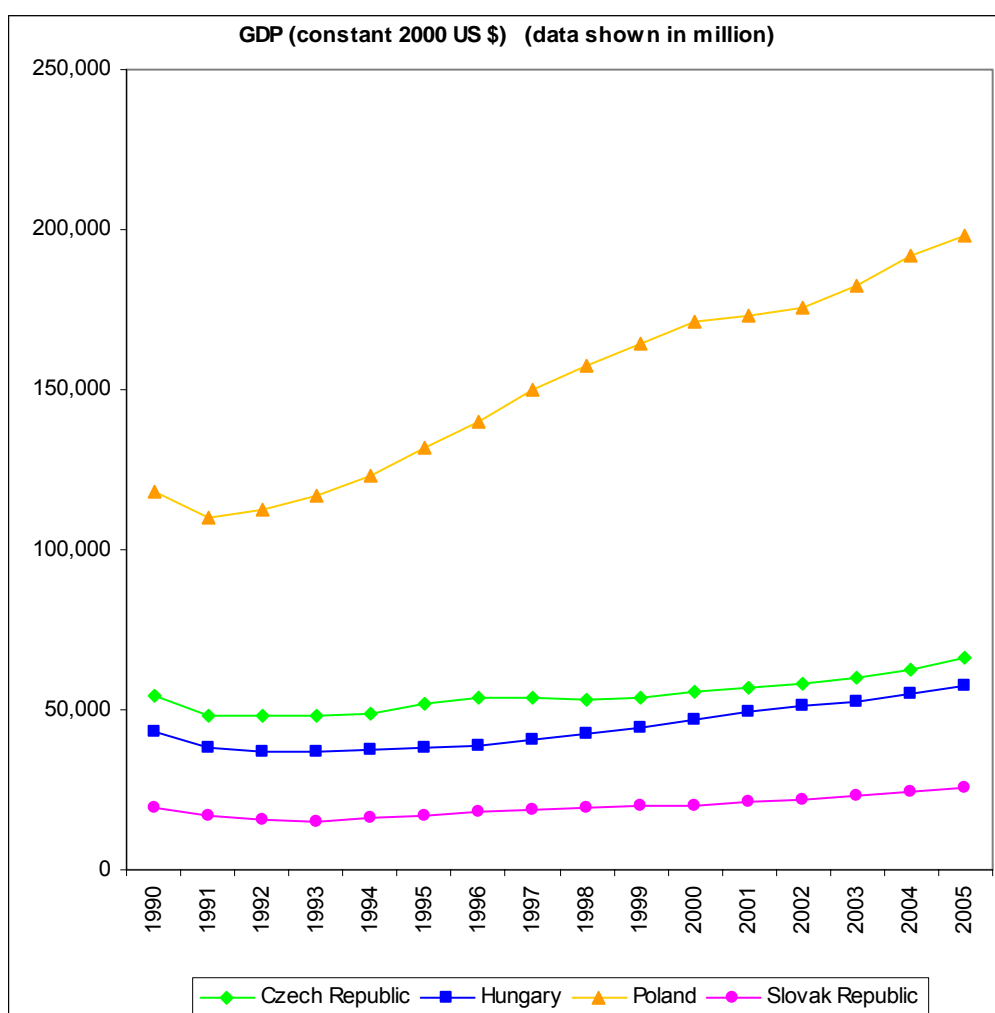
Country	World Bank	OECD	IMF	Year of Acceptance of IMF Article VIII	WTO
Czech Rep.	1993	21 Dec. 1995	01 Jan. 1993	effective 1 Oct. 1995	January 1995
Hungary	1982	7 May 1996	06 May 1982	effective 1 Jan. 1996	January 1995
Poland	Poland was one of the founding members of the World Bank, participating in Bretton Woods. After Resigning in the 1950s, it rejoined the World Bank in June 1986. The World Bank's office in Poland was opened in 1990.	22 Nov. 1996	12 June 1986	effective 1 June 1995	July 1995
Slovak Rep.	1993	Dec. 2000	01 Jan. 1993	effective 1 Oct. 1995	January 1995

Sources: World Bank, IMF, OECD and WTO.

Appendix G: Main Economic Variables of CEC4

GDP (constant 2000US\$) (million)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	54,397	48,080	47,833	47,863	48,925	51,834	53,989	53,597	52,982	53,621	55,707	57,178	58,029	59,891	62,701	66,433
Hungary	43,222	38,082	36,915	36,703	37,784	38,347	38,853	40,628	42,602	44,371	47,035	49,071	50,944	52,673	55,121	57,406
Poland	118,139	109,869	112,726	117,010	123,094	131,711	139,928	149,844	157,309	164,426	171,319	173,240	175,665	182,412	192,019	198,247
Slovak Republic	19,563	16,712	15,589	15,012	15,944	16,875	17,913	18,739	19,528	19,815	20,218	20,984	21,952	22,932	24,193	25,651

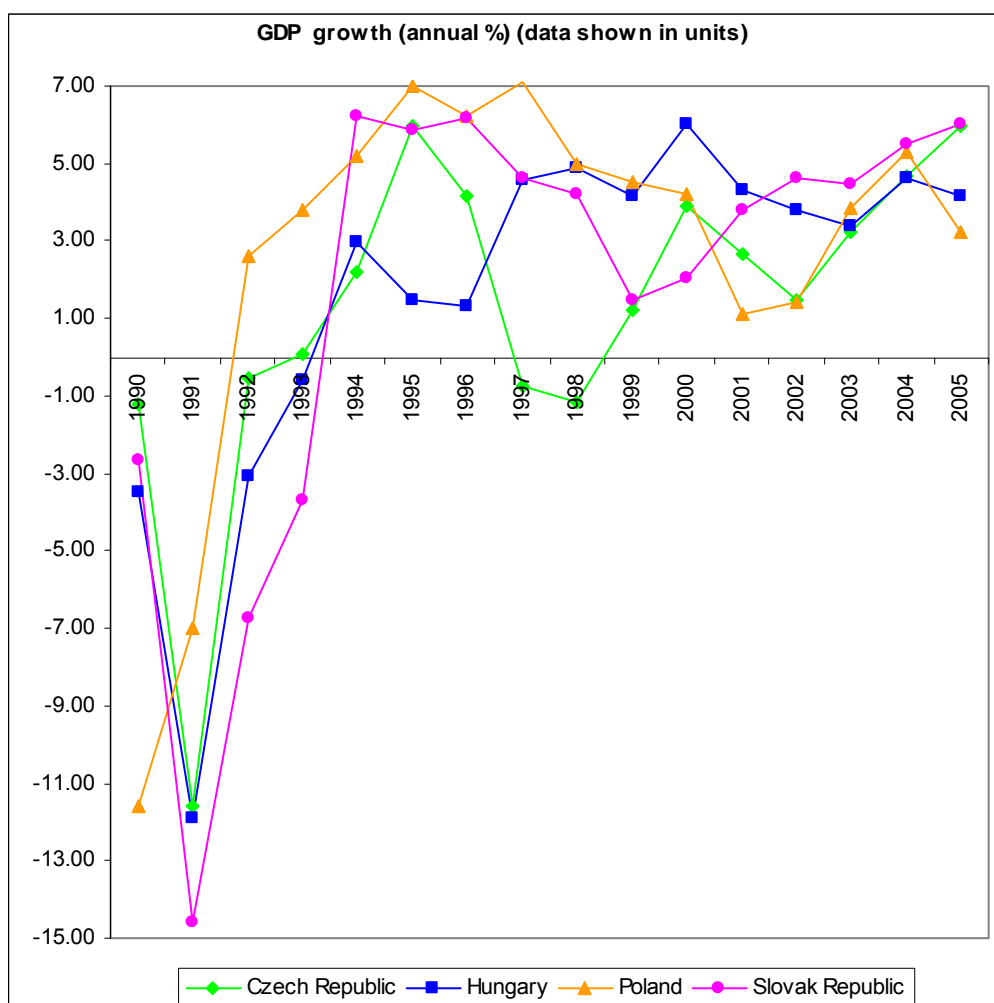
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

GDP growth (annual %)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	-1.20	-11.61	-0.52	0.06	2.22	5.95	4.16	-0.73	-1.15	1.21	3.89	2.64	1.49	3.21	4.69	5.95
Hungary	-3.50	-11.90	-3.06	-0.58	2.95	1.49	1.32	4.57	4.86	4.15	6.00	4.33	3.82	3.39	4.65	4.14
Poland	-11.60	-7.00	2.60	3.80	5.20	7.00	6.24	7.09	4.98	4.52	4.19	1.12	1.40	3.84	5.27	3.24
Slovak Republic	-2.67	-14.57	-6.72	-3.70	6.21	5.84	6.15	4.61	4.21	1.47	2.04	3.79	4.62	4.46	5.50	6.02

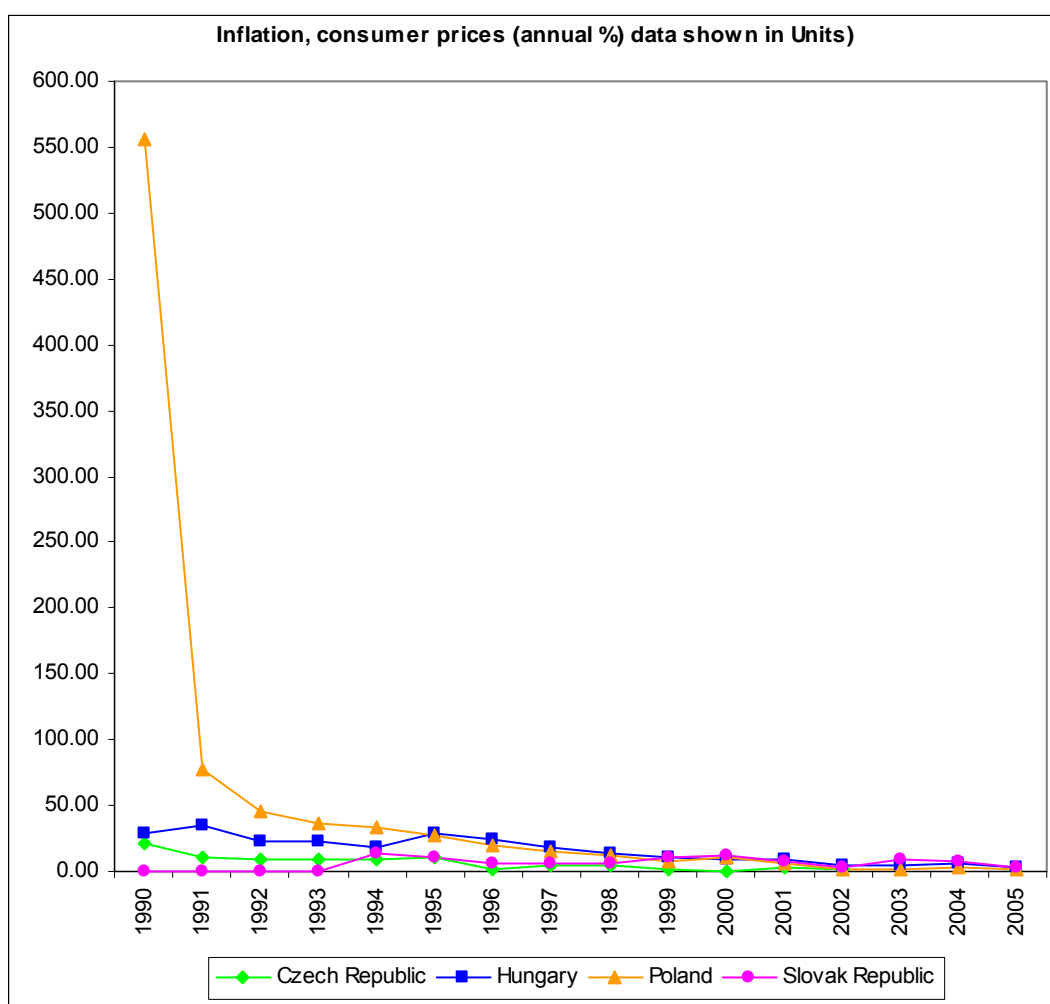
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Inflation, consumer prices (annual %)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	...	...	...	20.80	9.96	9.17	8.80	8.55	10.63	2.14	3.90	4.71	1.79	0.10	2.83	1.85
Hungary	28.97	34.23	22.95	22.45	18.87	28.30	23.60	18.28	14.23	10.00	9.80	9.22	5.27	4.64	6.78	3.55
Poland	555.38	76.71	45.33	36.87	33.25	28.07	19.82	15.08	11.73	7.28	10.06	5.49	1.90	0.79	3.58	2.11
Slovak Republic	...	...	...	...	13.41	9.89	5.81	6.11	6.70	10.57	12.04	7.33	3.32	8.55	7.55	2.71

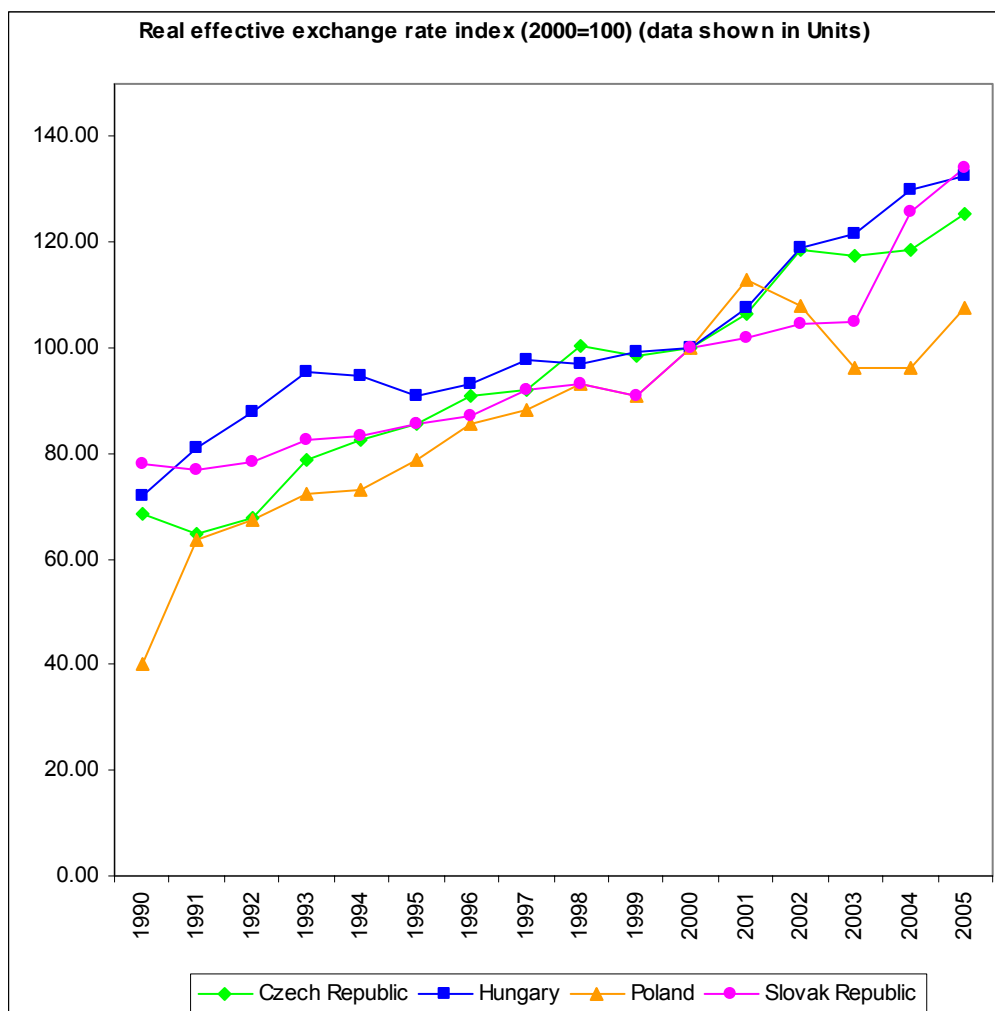
Source: Worldbank, WDI Online Database



Appendix G: (Cont'd)

Real effective exchange rate index (2000=100)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	68.67	64.70	67.70	78.70	82.66	85.45	91.05	92.07	100.30	98.50	100.00	106.39	118.71	117.26	118.49	125.22
Hungary	71.91	80.90	87.83	95.56	94.53	90.88	93.07	97.59	96.92	99.09	100.00	107.44	118.91	121.57	129.96	132.60
Poland	39.97	63.58	67.51	72.44	73.00	78.95	85.58	88.40	93.35	91.08	100.00	112.73	108.07	96.30	96.22	107.39
Slovak Republic	78.18	76.90	78.25	82.50	83.35	85.71	86.99	91.91	93.31	90.85	100.00	101.80	104.54	104.89	125.59	133.94

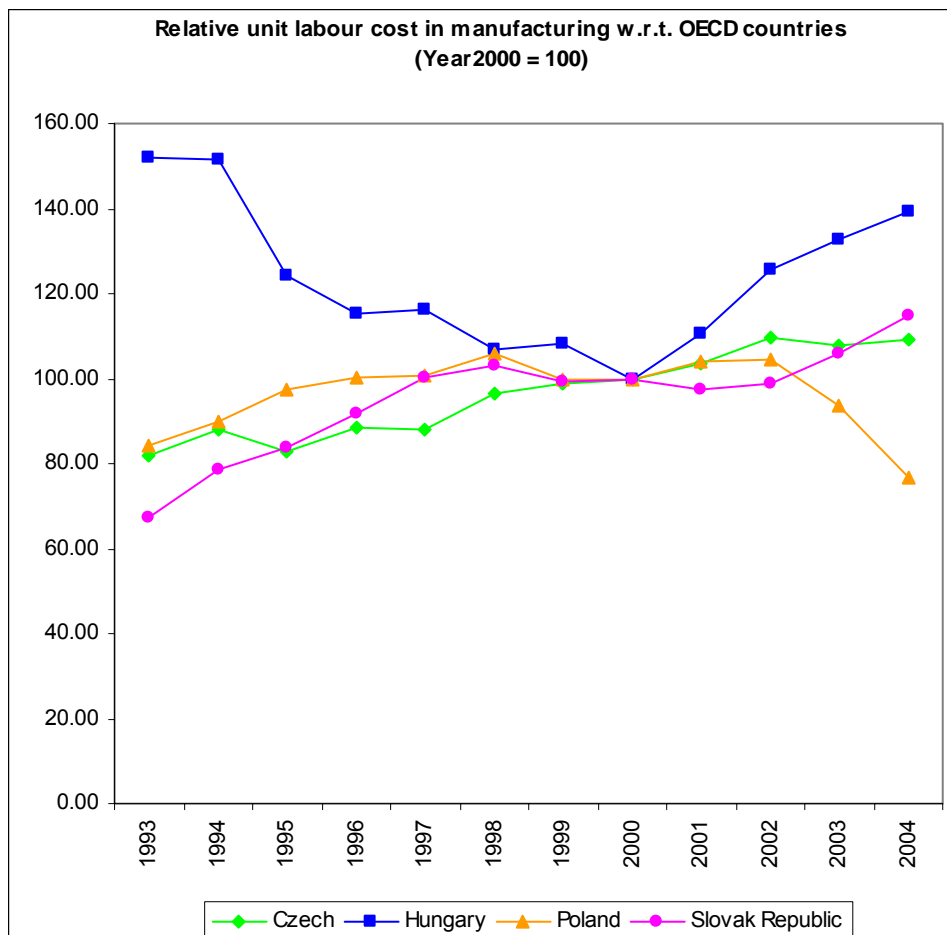
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Relative unit labour cost in manufacturing w.r.t. OECD (Year 2000=100)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Czech	81.80	87.80	82.70	88.70	88.10	96.50	99.00	100.00	103.70	109.70	107.60	109.00
Hungary	157.00	152.10	151.40	124.30	115.40	116.30	107.00	108.40	100.00	110.50	125.70	132.50	139.50
Poland	84.20	89.70	97.40	100.20	100.80	106.00	99.60	100.00	103.96	104.30	93.80	76.80
Slovak Republic	67.30	78.40	83.60	92.00	100.30	103.10	99.40	100.00	97.30	99.00	105.70	114.90
Euro area	120.90	118.20	123.90	119.80	116.50	120.40	121.10	109.20	111.90	111.40	100.00	100.80	105.80	120.70	125.40

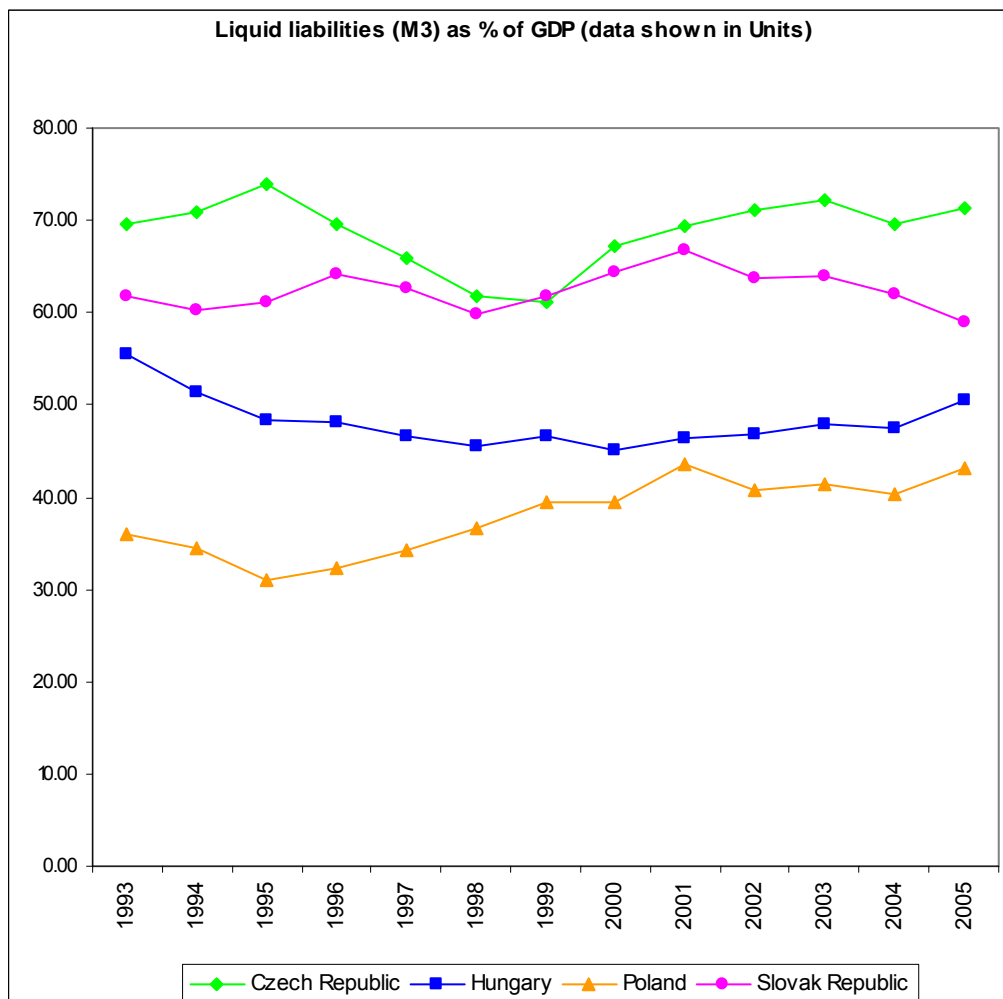
Source: OECD FACTBOOK 2006



Appendix G: (Cont'd)

Liquid liabilities (M3) as % of GDP	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	...	...	...	69.57	70.99	74.02	69.59	65.81	61.88	61.05	67.24	69.42	71.16	72.19	69.62	71.24
Hungary	43.76	47.36	56.81	55.45	51.48	48.39	48.16	46.54	45.55	46.65	45.09	46.38	46.89	47.82	47.57	50.51
Poland	34.02	32.27	35.76	35.90	34.53	30.94	32.35	34.23	36.74	39.55	39.55	43.48	40.78	41.35	40.37	43.16
Slovak Republic	...	...	...	61.74	60.18	61.24	64.24	62.55	59.87	61.87	64.39	66.70	63.79	63.98	61.91	59.03

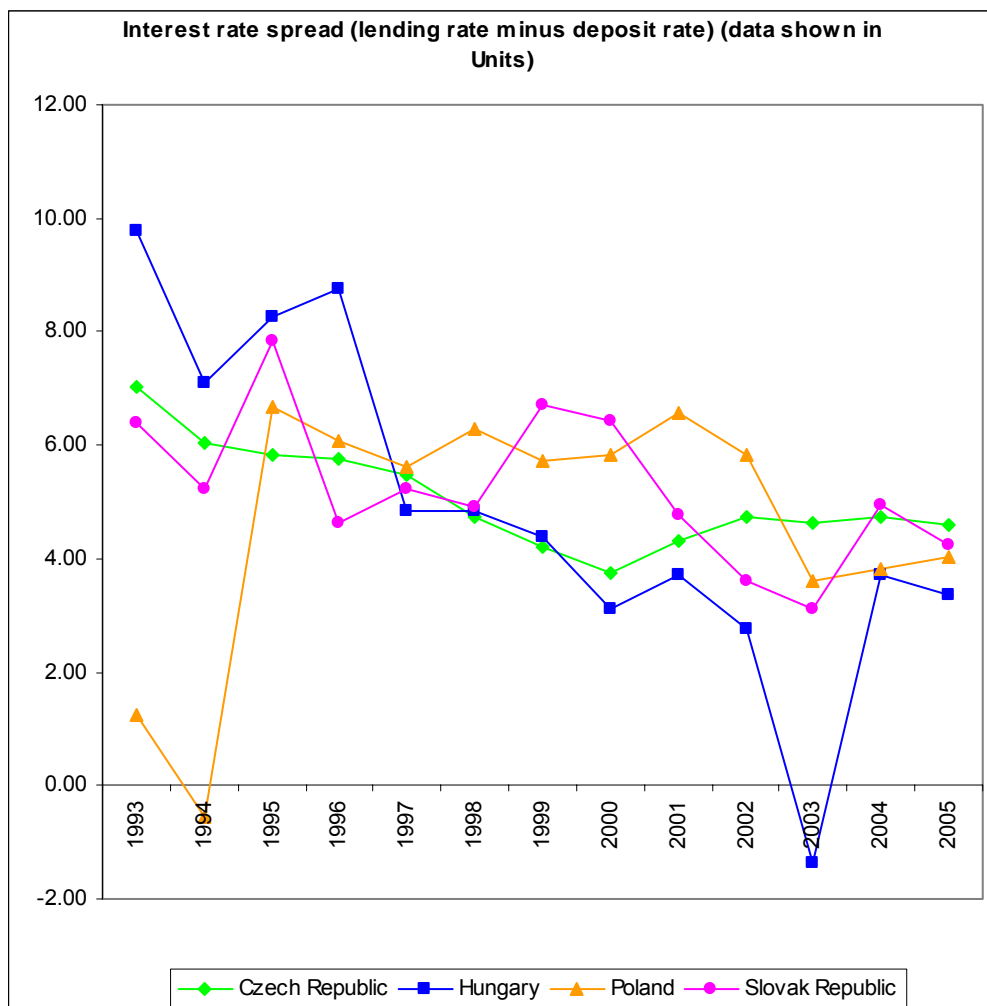
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Interest rate spread (lending rate minus deposit rate)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	...	...	...	7.04	6.05	5.84	5.75	5.49	4.73	4.20	3.74	4.32	4.73	4.62	4.74	4.60
Hungary	4.10	4.74	8.64	9.77	7.09	8.25	8.74	4.83	4.85	4.40	3.11	3.71	2.76	-1.37	3.73	3.37
Poland	462.50	1.08	1.25	1.25	-0.57	6.67	6.06	5.60	6.30	5.71	5.83	6.56	5.83	3.60	3.81	4.04
Slovak Republic	...	...	...	6.39	5.24	7.84	4.62	5.22	4.92	6.70	6.44	4.78	3.60	3.13	4.93	4.24

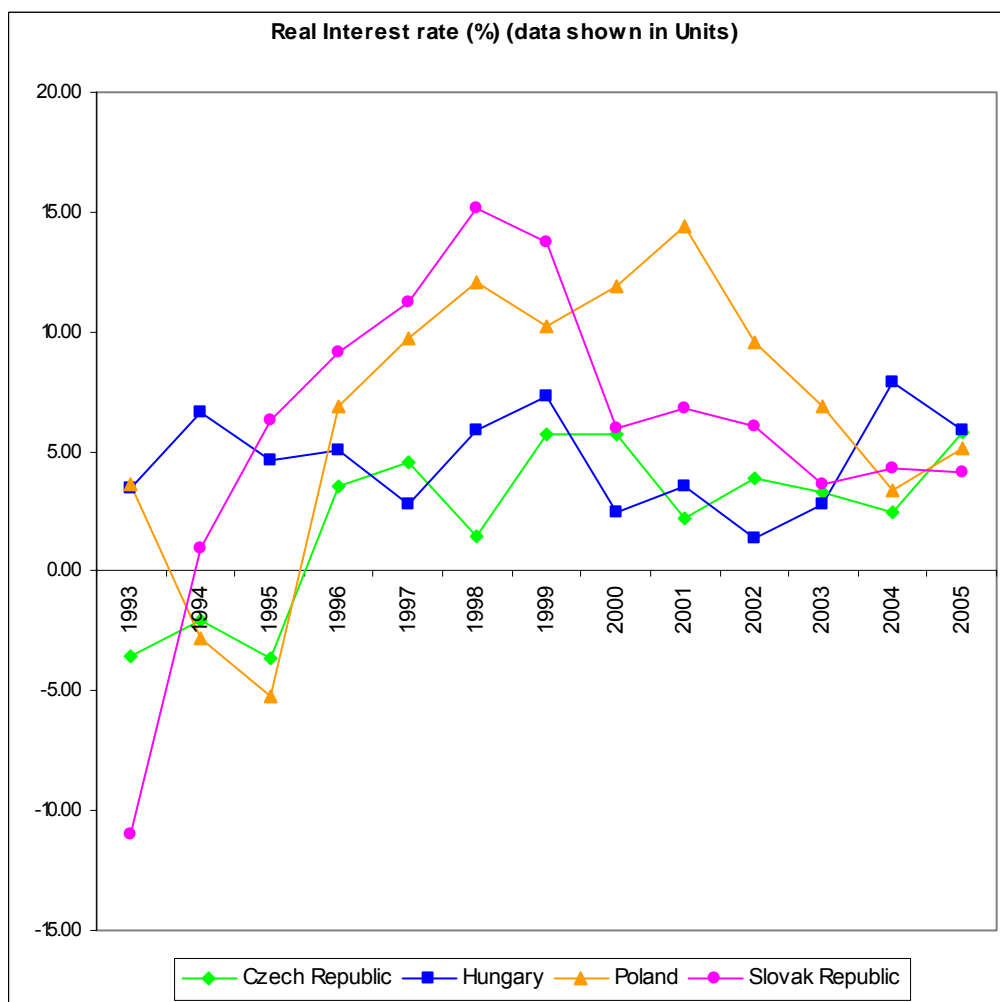
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Real interest rate (%)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	...	...	...	-3.57	-2.02	-3.63	3.53	4.54	1.43	5.75	5.70	2.17	3.85	3.31	2.50	5.83
Hungary	2.47	-0.41	9.50	3.42	6.62	4.64	5.04	2.78	5.89	7.28	2.46	3.57	1.35	2.78	7.87	5.92
Poland	...	-0.42	0.35	3.59	-2.77	-5.19	6.92	9.69	12.08	10.23	11.89	14.37	9.57	6.89	3.40	5.11
Slovak Republic	...	...	...	-11.00	0.98	6.33	9.18	11.19	15.16	13.73	5.94	6.79	6.02	3.63	4.28	4.12

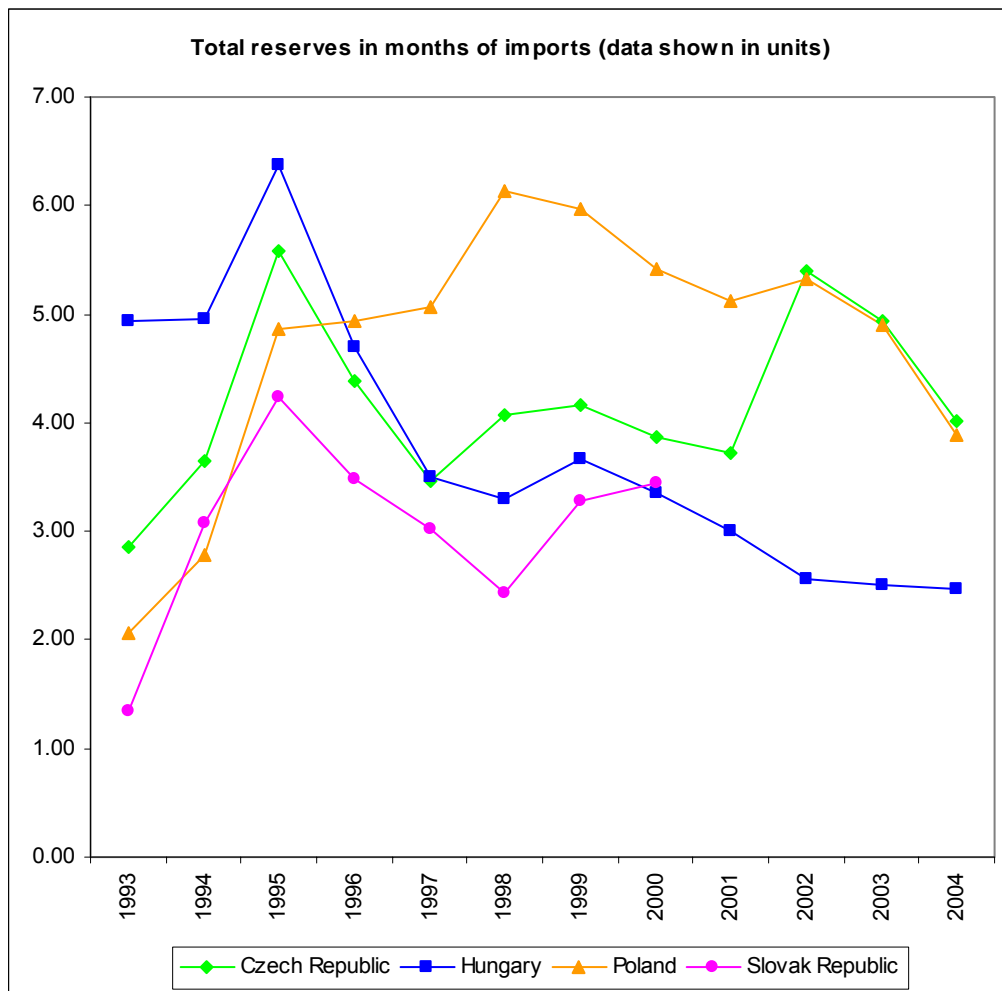
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Total reserves in months of imports (RES/MGS)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	...	...	...	2.86	3.65	5.59	4.38	3.46	4.08	4.17	3.86	3.73	5.39	4.94	4.01	...
Hungary	1.12	3.72	3.71	4.93	4.96	6.38	4.70	3.50	3.30	3.67	3.35	3.00	2.56	2.50	2.47	2.65
Poland	2.94	2.11	2.22	2.06	2.79	4.86	4.94	5.07	6.13	5.96	5.41	5.12	5.33	4.90	3.89	4.05
Slovak Republic	...	...	...	1.34	3.08	4.24	3.49	3.03	2.44	3.28	3.45	...	5.58	5.47	...	...

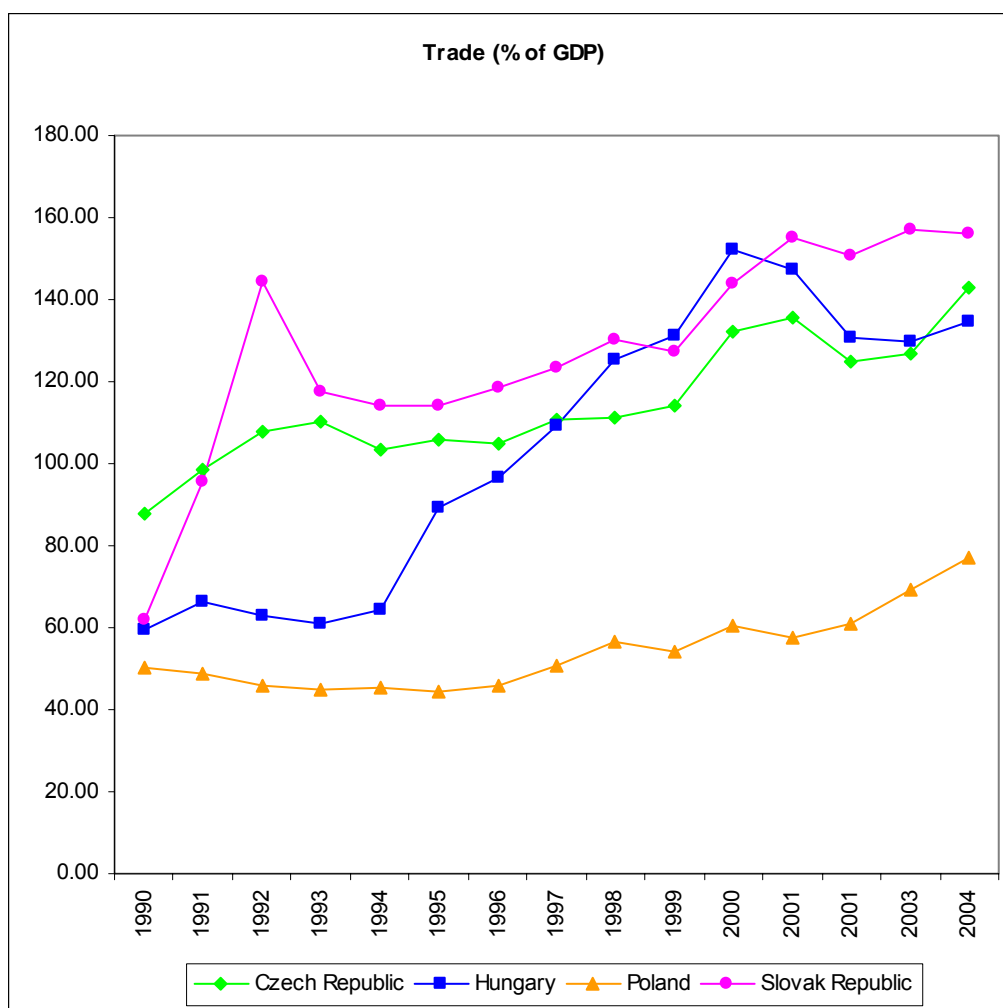
Source: World Bank, WDI Online Database.



Appendix G: (Cont'd)

Trade (% of GDP)	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2001	2003	2004	2005
Czech Republic	87.78	98.51	108.03	110.14	103.64	105.73	104.97	110.78	111.28	114.12	132.00	135.51	125.09	126.64	142.97	...
Hungary	59.68	66.49	63.16	61.02	64.32	89.30	96.49	109.25	125.30	131.37	152.03	147.19	130.61	129.85	134.51	136.57
Poland	50.16	48.97	45.87	44.90	45.38	44.25	46.05	50.74	56.79	54.24	60.65	57.80	60.75	69.27	77.17	74.45
Slovak Republic	62.09	95.62	144.60	117.70	113.97	114.07	118.76	123.24	130.12	127.10	144.09	154.92	150.60	156.87	156.29	161.69

Source: World Bank, WDI Online Database.



Appendix H: Evolution of FDI Inflows in CEC4, 1980 - 2005

Evolution of FDI Inflows in CEC4 1980 - 2005 (US\$ Million)

Country	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Czech Republic	..	..	..	..	..	..	..	..	..	257	72	393	983	654	878	2568	1435	1286	3700	6313	4987	5641	8497	2021	4987	10973
Hungary	1	2	..	..	..	..	6	2	14	187	311	1462	1480	2350	1144	4519	2274	4155	3343	3308	2770	3944	3013	2177	4670	6436
Poland	10	18	14	16	28	15	16	12	15	11	89	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4589	12890	9602
Slovak Republic	..	..	..	..	..	..	..	..	..	..	93	81	100	166	255	300	301	220	684	390	1925	1579	4094	756	1261	1908

Sources: (1) IMF, *International Financial Statistics Yearbooks*, 1999-2007, Line 78bed. (2) UNCTAD *FDI/TNC Database* and *WIR 2006*.

The sign (...) indicates a lack of statistical data that can be reported or calculated from underlying observations.

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Résumé de la thèse (Summary in French)

Motivation de l'étude

La raison pour laquelle j'ai choisi le titre « **Les Accords Internationaux d'Investissement et leur impact sur l'investissement Direct Etranger: Évidence de quatre pays de l'Europe centrale émergents** » pour ma thèse doctorale vient du fait que pendant la dernière décennie du 20^{ème} siècle, l'architecture financière internationale a été témoin de changements importants. Les années 90 ont été témoin d'une transformation importante dans la structure et la taille des flux de capitaux internationaux parallèlement à une explosion dans le nombre d'accords internationaux d'investissement (IIAs). Parmi les mouvements de capitaux privés, l'investissement direct étranger (IDE) a été témoin d'une augmentation spectaculaire de l'économie mondiale pendant les années 90. La coïncidence avec ceci est un autre fait que depuis la fin des années 1980, les quatre pays de l'Europe centrale émergents – la République Tchèque, la Slovaquie, la Hongrie, et la Pologne (CEC4) - ont fait des efforts énormes dans l'intégration à l'économie mondiale et ont attiré des quantités impressionnantes de capitaux privés internationaux. Les investissements étrangers étaient rares dans ces pays. Ils ont été soumis pendant des décennies à un système économique géré centralement, qui a été maintenu artificiellement pendant des années et a mené à des crises économiques importantes. Les réformes politiques et du marché introduites vers la fin des années 80 ont changé la situation notablement. L'ouverture financière du CEC4 est reflétée par leur conclusions d'IIAs, en particulier de traités bilatéraux d'investissement (BITs), et de la croissance significative des entrées de capitaux privés, notamment l'IDE. En fait, trois raisons ont incité le chercheur à poursuivre cette étude.

D'abord, les crises financières dont l'économie mondiale était témoin pendant les années 80 et les années 90 ont incité les gouvernements, les institutions financières internationales et les décisionnaires à changer d'attitude envers les mouvements de capitaux privés internationaux. En conséquence, pendant les années 90, parmi les mouvements de capitaux privés internationaux, l'IDE s'est développé nettement. Pour des économies naissantes, l'IDE est devenu un canal important des ressources

externes. Des crises financières - crises bancaires, crises de dette, crises monétaires, ou une certaine combinaison des trois - se sont produites avec une fréquence et une intensité inquiétantes pendant les deux dernières décennies du 20ème siècle. La crise de dette des années 80 a coûté à l'Amérique latine « une décennie perdue » de croissance économique. Dix membres du mécanisme de change européen ont été forcés de dévaluer leurs devises en 1992 et 1993. Le Mexique a souffert sa pire récession en six décennies après la dévaluation du peso en 1994-95. Et dans crise financière asiatique/globale qui a éclaté la première fois en Thaïlande en juillet 1997, la plus sérieuse de ces crises, les économies accoutumées à des taux de croissance annuels de 6-8 pour cent ont souffert des crises graves, avec le rendement tombant à 5-14 pour cent après la crise. Beaucoup d'autres économies naissantes - d'Amérique latine à l'Europe de l'Est, à l'Afrique du Sud - ont vu leurs problèmes économiques nationaux aggravés par les crises qui ont commencé en Asie. A l'automne 1998, après que la cessation de paiement et la dévaluation de la Russie et après le quasi effondrement de la Gestion du Capital à Long Terme, un fonds spéculatif important, l'agitation sur les marchés financiers internationaux s'est intensifiée à un degré presque sans précédent. Les crises financières peuvent imposer d'énormes coûts et difficultés aux pays impliqués. Les pires de ces crises peuvent détruire au cours d'une période d'un ou deux ans une grande partie du progrès économique que les travailleurs, les épargnants, et les entreprises ont réalisé durant plusieurs décennies.

Les gouvernements des pays industrialisés et des principales économies émergentes, de concert avec les institutions financières internationales (FMI, WB, BRI, et d'autres) ont travaillé dur, sur des plans pour améliorer la prévention des crises et la gestion des crises. Cet effort international de collaboration est largement reconnu comme renforçant « l'architecture financière internationale ». Cette instance a examiné les facteurs qui souvent provoquent les crises financières et a offert l'évaluation des parties de l'architecture existante ayant le plus besoin de réparation. À cet égard, un groupe de travail indépendant sur la future architecture financière internationale commanditée par le Conseil sur les relations internationales des États-Unis, a été formé, et a organisé des réunions, se concentrant sur ce qui « a été cassé » dans l'architecture existante, et sur la façon « de le réparer ». Il a émis sept

recommandations principales. La recommandation 2 concerne les mouvements des capitaux et les états: « *Recommandation 2 : Les Mouvements de capitaux - les économies naissantes ayant des systèmes financiers fragiles devraient prendre des mesures fiscales transparentes et non discriminatoires pour décourager les entrées de capitaux à court terme et pour encourager les capitaux à plus long terme qui sont moins sujet à crise, tel que l'investissement direct étranger.* » Une des racines des crises financières et des sources de vulnérabilité était la haute volatilité dans les mouvements de capitaux privés vers les économies émergentes. Ceci semble avoir incliné la composition des apports vers des composants moins risqués et à plus long terme. En conséquence, l'IDE a augmenté nettement pendant les années 90, et s'est développé, comparativement à d'autres formes d'investissements internationaux, et a compté pour environ un quart des mouvements des capitaux internationaux totaux. Les apports globaux de l'IDE ont atteint 916 milliards de \$US en 2005, comparés aux 159 milliards de \$US en 1991, suggérant une croissance d'environ 6 fois. En 2005, les actions globales de l'IDE ont dépassé 10 trillion de \$US , comparées à 1 trillion de \$US en 1991, suggérant une croissance de plus de 10 fois. Les apports de l'IDE se sont développés dans toutes les sous-régions principales, dans certaines à des niveaux sans précédent, et dans 126 sur les 200 économies couvertes par la CNUCED (la CNUCED, WIR 2006).

En second lieu, les années 90 ont été témoin d'une augmentation spectaculaire du nombre d'IAs signés entre les pays. Depuis l'adoption du premier BIT entre l'Allemagne et le Pakistan en 1959, le nombre de tels traités s'est développé de façon régulière. L'augmentation la plus spectaculaire a eu lieu dans les années 90. Le nombre de BITs est passé de 385 en 1989 à 2.495 en 2005. Le nombre de pays impliqués dans le BIT atteint maintenant 176. Avec la montée de l'IDE pendant les années 90, en tant qu'un des facteurs principaux conduisant les relations économiques internationales dans l'ère de la globalisation, l'investissement international régulateur est venu au premier rang de la diplomatie économique. Des efforts pour attirer l'IDE et en retirer des avantages, sont reflétés par une prolifération des règles d'investissement aux niveaux bilatéraux, sous-régionaux, régionaux et multilatéraux. Les traités d'investissement, en particulier au niveau bilatéral, ont augmenté en nombre, et sont

devenus la « source » de base du droit international d'investissement. Dans le passé, l'investissement à l'étranger a été en grande partie réglé au niveau national. Avec l'adoption des BITs commençant vers la fin des années 80, un cadre juridique international a commencé à émerger. Tous les pays (développés, en voie de développement et transition) étaient désireux de négocier des traités d'investissement afin de promouvoir l'investissement transfrontalier. De plus, parce que les lois nationales et les politiques peuvent être changées unilatéralement, tandis que les droits et engagements bilatéraux, régionaux et les droits et les engagements multilatéraux ne peuvent pas l'être, les pays (en particulier industrialisés) ont préféré compter sur des traités comme étant une base plus stable pour leurs entreprises souhaitant investir à l'étranger.

Troisièmement, l'apparition de nouveaux pays, tels que les quatre pays d'Europe centrale – La république Tchèque, la Slovaquie, la Hongrie et la Pologne (CEC4) - dans la scène économique internationale depuis la fin des années 1980. Après la chute du mur de Berlin en 1989, les CEC4 ont eu la difficile tâche de créer des états démocratiques libres. La tâche a été rendue plus difficile car toutes leurs économies souffraient avec la dette. Les CEC4, dans leur phase de transition, ont eu besoin de capitaux d'investissement afin de maintenir ou d'introduire des changements structurels. L'affirmation que l'IDE était le seul véhicule pour l'évolution technologique et la modernisation de leurs économies a fait pression sur le CEC4 pour ouvrir leurs économies à l'IDE. Dans ce but, depuis la fin des années 1980, le CEC4 a conclu intensivement des BITs avec des pays de l'OCDE, puisque la plupart des IDE dans le monde provient du secteur de l'OCDE. Les BITs sont des accords entre deux pays pour un encouragement, une promotion et une protection « réciproques » des investissements dans chacun des autres territoires par des entreprises basées dans l'un ou l'autre pays. La signature de BITs reflète que l'établissement « de relations économiques internationales » et « de l'intégration financière » avec l'économie globale était un souci prioritaire pour le CEC4. Elle signale que l'attitude du CEC4 envers les investisseurs étrangers a changé et que son « climat d'investissement » s'améliore. Ce qui est intéressant est la protection légale et le changement des droits de propriété introduits avec un BIT. Le CEC4 a cru que l'existence d'un traité

d'investissement influencerait le choix des investisseurs étrangers pour leur pays. Ils ont complété la couverture géographique de leur réseau de BITs, en ayant d'abord signé des traités d'investissement avec leurs voisins européens. Un dispositif saisissant est que tous les BITs conclus entre le CEC4 et les pays de l'OCDE ont été ratifiés (entrés en vigueur) au début des années 90. En 1991 le CEC4 a signé avec l'UE, « l'Accord d'Europe » bilatéral qui est entré en vigueur en 1994. L'engagement du CEC4 à mettre en place des économies de marché et à participer à l'économie globale est démontré également par leur adhésion à des organismes internationaux tels que l'OCDE, le FMI, et l'OMC. Le CEC4 a rejoint l'OCDE, a accepté *les Articles de l'Accord* du FMI: Article VIII, au sujet de la convertibilité du compte courant, et a obtenu l'adhésion à l'OMC au milieu des années 90. Par la suite il est devenu membre de l'UE en mai 2004. En outre, depuis le début des années 90, le CEC4 a attiré des quantités impressionnantes de capitaux privés internationaux. La structure et la taille des entrées de capitaux parmi et à l'intérieur de chacun de ces pays ont différé largement avec l'IDE étant un composant important, indicateur d'une « qualité » plus élevée, « d'un capital stable à long terme », et « non-créditeur de dettes ». En outre, depuis le début des années 90, le CEC4 a attiré la plus grande partie de l'IDE dans la région des PECO. L'investigation des sources de l'IDE, mène au fait qu'elles proviennent principalement du secteur de l'OCDE.

Pour les trois raisons mentionnées ci-dessus, l'étude cherche à examiner empiriquement si les IIAs, en particulier les BITs conclus entre les pays du CEC4 et de l'OCDE, ont généré ces changements structurels importants dans les entrées de capitaux.

Question de recherches

Après avoir expliqué la motivation et les raisons de décider de cette matière, les questions abordées par l'étude sont :

1. Les IIAs ont-ils augmenté l'activité des IDEs dans le CEC4 ?
2. La ratification d'un BIT entre une paire composée de pays d'accueil et d'un pays d'origine a-t-elle accru l'activité de l'IDE bilatéral intérieur?

3. Le BIT exerce-t-il un impact différent sur l'IDE dans les institutions financières bien développées et efficaces ?

L'Objet de la thèse

Pour répondre aux questions de recherches ci-dessus, l'étude examine empiriquement l'impact des IIAs sur l'IDE en étudiant l'expérience des mouvements de capitaux des quatre pays de l'Europe centrale – La République Tchèque, la Slovaquie, la Hongrie, et la Pologne - au cours de la période 1992-2003. Le chercheur cherche à démontrer que les BITs ont un impact positif significatif sur l'IDE bilatéral intérieur dans le CEC4. En outre, l'auteur déclare que les « institutions » du pays d'accueil ont un rôle crucial en attirant l'IDE vers un pays. L'étude se concentre sur « les institutions financières », et argue du fait que le niveau du développement et de l'efficacité des institutions financières est crucial pour « l'environnement d'investissement » dans un pays d'accueil. Les décisions des investisseurs étrangers sont fortement influencées par le niveau de développement, de qualité et d'efficacité des institutions financières d'un pays d'accueil. Par conséquent, le but principal de l'étude est d'examiner empiriquement si l'existence des BITs attire l'IDE, et si les BITs exercent un impact différent sur l'IDE dans les institutions financières développées et efficaces. Atteindre l'objectif de cette étude exige l'examen des divers liens parmi les accords internationaux d'investissement (IIAs), l'investissement direct étranger (FDI), et les institutions financières.

Autres études

La littérature existante sur les flux de capitaux vers les économies naissantes de l'Europe Centrale s'est concentrée sur l'analyse « des causes déterminantes traditionnelles » de l'IDE dans les « économies de transition » dans son ensemble. Les deux approches principales ont été des études de type enquêtes et des analyses quantitatives formelles. Des exemples de la première sont trouvés dans Lankes et Venable (1996). Les études quantitatives sont basées sur un certain nombre de différents modèles empiriques, l'approche de la gravité étant le plus généralement adopté. Parmi les études quantitatives dans la littérature on peut mentionner les travaux

de Wang et Swain (1995), Lansbury, Paine et Smidkova (1996), Holland et Pain (1998), Claessens, Oks et Polastri (1998), Resmini (2000), Ramcharran (2000), Bevan (2000), Bevan, Estrin et Meyer (2000, et 2004), Bevan, Estrin et Grabbe (2001), Di Mauro (2001), Garibaldi, Mora, Sahay et Zettlemeier (2002), Bandelj (2002), Campos et Kinoshita (2003), Bevan et Estrin (2004), Carstensen et Toubal (2004), et Brzozowski (2006). Ces études ont employé des variables « traditionnelles », telles que l'importance du marché, les perspectives de croissance, les facteurs macro-économiques (inflation, taux de change, et déficit fiscal), les coûts salariaux, la disponibilité de main-d'oeuvre qualifiée, les considérations géopolitiques, la distance, la frontière commune, les liens commerciaux, etc... ; et des variables « spécifiques à la transition », telles que la vitesse et la méthode de privatisation. Certains ont employé les réputations de solvabilité des pays, et l'impact des annonces d'accession à l'UE.

Dans la littérature économique les BITs n'ont susciter que très peu d'attention. Le rôle des BITs a été discuté dans des revues juridiques. Là, l'objectif a été sur la question de fournir un dispositif d'engagement pour surmonter le problème dynamique de contradiction (Vandevelde, 1998 et 2000). Le plus étonnant est qu'en dépit du nombre en hausse de BITs depuis le début des années 90, il n'y ait que peu d'études sérieuses examinant l'effet de tels traités sur la localisation de l'IDE. La CNUCED a commandité une des premières analyses en 1998 (la CNUCED, 1998b).

La première étude sérieuse a été entreprise par Hallward-Driemeier (2003), observant un ensemble de données d'expert (panel data) sur les flux de sorties de l'IDE bilatéral de 20 pays de l'OCDE vers 31 pays en voie de développement au cours de la période 1980-2000. Utilisant les effets fixes du pays d'origine et du pays d'accueil, elle a trouvé peu d'évidence que l'existence d'un BIT entre deux pays stimule l'investissement additionnel du pays développé vers le pays en voie de développement signataire. Ces pays avec des institutions nationales faibles, y compris la protection du foncier, n'ont pas reçu d'avantages supplémentaires significatifs ; le BIT n'a pas agi en tant que produit de remplacement pour une plus large réforme nationale. En revanche, les pays qui ont engagé des réformes et qui ont des institutions nationales relativement fortes devraient le plus probablement tirer avantage à ratifier un traité. Que les BITs

agisse plus comme un complément que comme un produit de remplacement pour les institutions nationales signifie que ceux qui en tirent bénéfice sont sans doute ceux qui ont le moins besoin d'un BIT pour souligner la qualité de leurs droits de propriété.

La deuxième étude, Banga (2003) examine l'impact des BITs sur les apports globaux de l'IDE vers 15 pays en voie de développement de l'Asie du sud, de l'est et de l'Asie du Sud-Est pour la période 1980-81 1999-2000. Elle entreprend des analyses séparées pour les apports de l'IDE des pays développés et en voie de développement utilisant des données d'expert (panel data) pour dix pays en voie de développement pour la période 1986-87 1996-97. Elle constate que les BITs ont un impact significatif sur l'IDE total. Mais ce sont les BITs avec les pays développés plutôt qu'avec les pays en voie de développement qui s'avèrent avoir un impact significatif sur les apports de l'IDE aux pays en voie de développement.

La troisième étude, Egger et Pfaffermayr (2004a) emploie le plus grand liste disponible des stocks extérieurs de l'IDE fournis par l'OCDE, qui contient l'IDE des pays de l'OCDE dans à la fois les économies de l'OCDE et les économies n'appartenant pas à l'OCDE pour évaluer l'impact des BITs. Ils limitent leur étude à la période de 1982 à 1997. Ils constatent que les BITs exercent un effet positif significatif sur l'IDE extérieur, s'ils sont mis en application réellement. D'ailleurs, même la signature d'un traité a un effet positif?, bien qu'inférieur et dans la plupart des spécifications un effet insignifiant sur l'IDE.

La quatrième étude, Tobin et Rose-Ackerman (2005) analyse l'impact des BITs des pays développés vers les pays en voie de développement de 1984 à 2000, avec des données ramenées à une moyenne au-dessus des périodes de cinq ans, couvrant 63 pays. Dans le modèle des effets fixes, Tobin et Rose-Ackerman trouve qu'un nombre plus élevé de BITs signés avec un pays à revenus élevés accroît l'IDE qu'un pays reçoit comme part aux flux de l'IDE global seulement à des niveaux peu élevés de risques politiques. C'est seulement quand un pays atteint un niveau de risque politique peu élevé que les BITs peuvent devenir importants pour les pays d'accueil afin d'attirer l'IDE. C'est seulement une fois qu'un pays atteint un bas niveau de risque

politique minimum que les BITs peuvent devenir important pour que les pays d'accueil attirent l'IDE. Dans une analyse bilatérale additionnelle, ils ne trouvent pas d'effet statistiquement significatif de BITs signés avec les USA sur des flux de FDI provenant des USA vers les pays en voie de développement.

La cinquième étude par Salacuse et Sullivan (2005) fournit trois analyses en coupe des apports de l'IDE à jusqu'à 99 pays en voie de développement dans les années 1998, 1999 et 2000, respectivement, ainsi qu'une évaluation des effets fixes des flux bilatéraux de l'IDE à partir des USA vers 31 pays en voie de développement au cours de la période 1991-2000. Ils constatent que la signature d'un BIT avec les USA s'associe à des apports plus élevés de l'IDE dans les deux types d'évaluations, tandis que le nombre de BITs signés avec d'autres pays de l'OCDE est statistiquement insignifiant.

La sixième étude par Neumayer et Spess (2005) constate que plus un pays signe de BITs, plus importants sont les flux d'IDE vers ce pays. Leur étude inclut 119 pays au cours de la période 1970-2001.

La septième étude par Desbordes et Vicard (2006) étudie si la qualité des relations diplomatiques entre un pays et le reste du monde influence le volume d'IDE qu'il reçoit. Leur échantillon d'étude inclut 88 pays en voie de développement au cours de la période 1991-2000. Les résultats économétriques indiquent que la qualité des relations diplomatiques et l'existence d'un conflit armé sur le territoire de pays d'accueil influencent fortement le choix d'implantation des entreprises multinationales. Un des canaux par lesquels la qualité des relations diplomatiques influence l'IDE est leur contribution au nombre de BITs signé par un pays d'accueil. En outre, la signature de BITs correspond à un canal important par lequel les bonnes relations diplomatiques exercent un impact positif sur le volume d'IDE reçu par un pays d'accueil.

Le besoin de cette étude

À la connaissance du chercheur, la littérature manque d'études sur l'impact des IIAs sur l'activité des IDEs intérieurs dans le CEC4. La question de savoir si les BITs

affectent réellement l'IDE dans les pays du CEC4 n'a pas été abordée. En d'autres termes, l'impact des BITs sur l'IDE dans les pays du CEC4 demeure encore inconnu en dépit de la prolifération des traités d'investissement conclus par le CEC4 et leur attraction de quantités impressionnantes d'IDE pendant les années 90. L'autre sujet qui n'est pas abordé dans la littérature disponible est le rôle « des institutions financières » en attirant l'IDE dans les pays du CEC4. Le niveau de développement des institutions financières, leur efficacité et comment elles interagissent avec les BITs n'ont pas reçu l'attention qu'elles méritent dans la littérature disponible. Par conséquent, il y a un manque dans la littérature et un besoin de cette étude.

Contribution de la thèse

Cette étude apportera une contribution importante à la littérature sur les flux de capitaux et d'IDE dans le CEC4, en vérifiant l'impact positif significatif des IIAs et le niveau de développement des institutions financières et l'efficacité sur l'IDE.

a. Impact des IIAs sur l'IDE dans le CEC4

La présente étude s'ajoute à la littérature existante sur les causes déterminantes de l'IDE dans le CEC4 en examinant empiriquement l'effet de l'IDE (des apports et des actions) sur les IIAs conclus par le CEC4. C'est la première tentative d'examiner empiriquement la signification du BITs, du code de l'OCDE de la libéralisation des mouvements des capitaux comme étant un accord régional d'investissement, l'article VIII du FMI comme étant un financier international, et les dispositions relatives à l'investissement de l'OMC comme étant un accord multilatéral d'investissement pour attirer l'IDE dans le CEC4. La question de savoir si les traités internationaux d'investissement attirent réellement l'IDE vers le CEC4 n'a pas été abordée (traité). Cette étude vise à vérifier empiriquement que les règles internationales d'investissement d'ampleur influencent le flux de l'IDE vers le CEC4. L'auteur se concentre sur les BITs et s'attend à ce que l'activité d'investissement entre les paires pays d'origine et pays d'accueil changent positivement par suite de la ratification de BITs. Clairement, un BIT n'est pas une condition nécessaire pour recevoir l'IDE. Nombreuses sont les paires de pays d'origine et pays d'accueil source avec un IDE

substantiel qui n'ont pas de BITs. Le Japon, par exemple, la deuxième plus grande source d'IDE dans le monde a conclu seulement douze BITs, en date du juin 2006, et n'a aucun BIT avec le CEC4. En outre, les USA n'ont pas de BITs avec la Hongrie. Et, il y a également des nombreux exemples de pays qui ont conclu beaucoup de BITs et qui cependant n'ont reçu que peu d'entrées de capitaux.

b. Impact du niveau de développement des institutions financières et l'efficacité sur l'IDE, et le rapport entre les BITs et les institutions financières vis-à-vis du FDI.

En dépit du rôle crucial que les institutions financières jouent dans une économie, la littérature sur l'IDE semble avoir ignoré l'importance du niveau de développement des institutions financières et l'efficacité en ce qui concerne l'IDE. Cette étude ajoute à la littérature existante en examinant empiriquement si le niveau de développement et l'efficacité des institutions financières ont un rôle significatif en attirant l'IDE dans le CEC4, et si les BITs ratifié ou non exerce un impact différent sur l'IDE dans les institutions financières bien développées et efficaces.

Tandis qu'il semble normal d'arguer du fait que les BITs servent de dispositif d'engagement, et que les investisseurs étrangers considèrent les BITs comme améliorant l'« environnement d'investissement », la capacité d'un pays à tirer profit des retombées et des facteurs externes de l'IDE pourrait être limitée par la « qualité » des institutions locales. Dans un effort d'examiner plus avant l'impact des BITs sur l'IDE, l'étude prend sa réplique de l'emphase récente sur le rôle des « institutions » dans la littérature sur les mouvements de capitaux, particulièrement de l'IDE. Elle souligne le rôle « des institutions financières » et argue du fait que le manque de développement des institutions financières locales et de leur efficacité peut limiter la capacité d'un pays à tirer profit des retombées de l'IDE. Bien que la plupart des IDEs se fondent de par leur nature sur le capital venant de l'étranger, il est important d'identifier que les décisions des investisseurs étrangers dépendre de manière décisive de l'ampleur du niveau du développement et de l'efficacité des institutions financières nationales. Le progrès accompli en établissant une infrastructure financière et des marchés financiers

est important pour les investisseurs étrangers parce qu'il facilite l'accès aux marchés financiers locaux. Les institutions financières bien développées et efficaces encouragent les investisseurs étrangers à mettre en place des opérations, car elles peuvent avoir plus facilement accès aux finances locales complémentaires, et qu'elles font face à des coûts de transaction inférieurs pour des services financiers locaux, tels que le système de paiement. D'ailleurs, leurs clients aussi, sont plus susceptibles d'avoir accès au crédit bancaire, ce qui devrait accélérer la demande de leurs produits qui sont souvent achetés à crédit.

L'importance du rôle joué par le système financier pour l'économie réelle a été fréquemment souligné dans la littérature économique. Il a un rôle clé dans la répartition des ressources en canalisant les fonds des ménages vers les entreprises, il offre des opportunités de risques-partagés pour les ménages et les sociétés et il aide des agents à économiser sur les coûts de transaction et d'information. Un système financier développé et efficace est donc une part importante de l'« environnement d'investissement » dans une économie. Schumpeter il y a près d'un siècle, a identifié l'importance des intermédiaires financiers bien développés en mettant en valeur l'innovation technologique, l'accumulation du capital, et la croissance économique. L'argument porte sur le fait que les institutions financières fiables, en abaissant les coûts de conduites des transactions, s'assurent que le capital est alloué aux projets qui rapportent les rentabilités les plus élevées, et met donc en valeur, l'activité de l'IDE.

Hypothèses de recherche

Dans cette étude le chercheur présume que :

HYPOTHÈSE 1 : Les flux d'investissement étranger seront positivement liés aux traités d'investissement bilatéraux (BITs) conclus entre le pays d'origine d'un investisseur étranger et un pays d'accueil.

HYPOTHÈSE 2 : Les flux d'investissement étranger seront positivement liés aux accords régionaux et multilatéraux d'investissement conclus par un pays d'accueil.

HYPOTHÈSE 3 : Plus le « risque pays » d'un pays d'accueil est bas, plus les flux d'investissement étranger sont élevés.

HYPOTHÈSE 4 : Plus « le risque macro-économique » d'un pays d'accueil est bas, plus les flux d'investissement étranger sont élevés.

Performance économique (PIB, et perspectives de croissance)

H : Plus la performance économique d'un pays d'accueil indiqué par le PIB et la croissance, est haute, plus les flux d'investissement étranger sont hauts. Le PIB indique également l'importance du marché, donc, plus l'importance du marché d'un pays d'accueil est grande, plus les flux d'investissement étranger sont hauts.

Stabilité de prix (taux d'inflation)

H : Plus l'instabilité des prix d'un pays d'accueil, reflétée par un taux d'inflation élevé, est haute, plus les flux d'investissement étranger sont faibles.

Développement et efficacité des institutions financières

H : Plus les institutions financières d'un pays d'accueil, sont développées et efficaces, plus les flux d'investissement étranger sont élevés.

Position de dette extérieure

H : Moins, les engagements résultant de la dette extérieure d'un pays d'accueil dépendent de sa production ou de ses revenus à l'exportation, plus sa solvabilité est grande, et plus les investissements étrangers sont importants.

H : Moins les paiements du service de la dette d'un pays d'accueil (intérêt et principal) dépendent des revenus d'exportation, plus sa solvabilité est grande, plus les investissements étrangers sont importants.

Position de liquidité internationale

H : Plus les niveaux de réserve d'un pays d'accueil dépendant de ses importations de biens et services et/ou de ses engagements de dette extérieure sont élevés, plus sa solvabilité est grande, plus les investissements étrangers sont hauts.

HYPOTHÈSE 5 : Plus la compétitivité internationale d'un pays d'accueil indiquée par des coûts unitaires de main-d'oeuvre relativement bas ajustés à la productivité est haute, plus les investissements à étrangers sont élevés.

La Méthodologie de recherche

Méthode économétrique d'évaluation

L'impact des IIAs - BITs, code de l'OCDE de la libération des mouvements de capitaux, de l'article VIII de FMI, et de l'adhésion à l'OMC - sur l'activité de l'IDE bilatéral intérieur (les flux et les stocks) de 22 pays de l'OCDE vers le CEC4 est évalué pour la période de 1992 à 2003 inclus. C'est la période pour laquelle les données sont disponibles. L'étude évalue également l'impact de l'importance des fondamentaux économiques principaux du CEC4, comme, le marché, les perspectives de croissance et la stabilité macro-économique ; le niveau du développement et d'efficacité des institutions financières ; la solvabilité du pays, indiquée à la fois par la position de liquidité internationale et par la capacité de gestion de la dette extérieure ; et la compétitivité internationale, indiquée par les coûts unitaires de main-d'œuvre et la qualité de la main-d'oeuvre, sur l'IDE bilatéral vers l'intérieur dans le CEC4.

La rareté des données au sujet de l'IDE dans le CEC4 crée des contraintes importantes au développement d'une analyse économétrique. Une stratégie pour minorer ce problème est d'employer la méthodologie de panel data dans le procédé d'évaluation. Les spécifications économétriques utilisent les effets spécifiques produits par un tandem de deux pays pour reprendre les effets inobservables invariants de temps qui pourraient affecter l'IDE intérieur bilatéral. Les effets spécifiques produits par un tandem de deux pays sont pris en compte parce que l'on pourrait suspecter qu'il y a des facteurs rendant le CEC4 attrayant pour les investisseurs étrangers de l'OCDE

qui ne sont pas reprises par les variables explicatives, et qui sont des invariants de temps, comme les attaches historiques, la culture, la langue, la frontière commune, la connaissance de la mentalité de la population du pays d'accueil. Les méthodes d'effets fixes et des effets aléatoires sont employées dans les évaluations. L'essai de Hausman (1978) est appliqué pour détecter l'efficacité de la méthode d'évaluation, et pour examiner s'il y a une corrélation entre les effets spécifiques par paire de pays et les variables explicatives.

Données

Des données sont à l'origine rassemblées par le chercheur. Un éventail de données proviennent des statistiques financières internationales du FMI, des Indicateurs de Développement Mondial et Finance du Développement Global de la Banque Mondiale, d'International Direct Investment Statistics de l'OCDE, et de FACTBOOK 2006 de l'OCDE, de World Investment Reports de la CNUCED, FDI/TNC, et de la base de données (électronique) en ligne d'instruments internationaux d'investissement.

La structure de la thèse

En termes de format cette dissertation comprend les sept chapitres suivants :

Le chapitre un élabore le concept de l'IDE et présente des définitions conformément au FMI et aux recommandations de l'OCDE. Il explique le rôle de l'IDE dans les flux de capitaux internationaux, ses caractéristiques et comportement en ce qui concerne d'autres flux financiers. Après, il décrit les divers types d'IDE, les perspectives à la fois à partir du pays d'origine et à partir du pays d'accueil. Il discute également le rapport entre la globalisation (la mondialisation) et l'IDE. En conclusion, il regarde la tendance globale des flux d'IDE au cours de la période 1985-2005.

Le chapitre deux présente des faits sur la structure et la taille des entrées de capitaux dans le CEC4 de la fin des années 1980 jusqu'en 2005. Il examine la composition, la taille et le modèle des différents types d'entrées de capitaux. D'abord, le chapitre compare les trois types importants d'entrées de capitaux : L'IDE, les investissements de portefeuille et d'« autres » investissements dans chaque pays au

cours de la période de l'étude. Les données disponibles suggèrent que l'IDE est un composant important dans la structure financière du CEC4. Ces pays ont attiré des quantités impressionnantes d'IDE depuis les premières étapes de leur transition à une économie de marché. Ainsi, l'attention du chapitre se déplace sur les entrées de capitaux de type IDE dans le CEC4. Il regarde l'évolution de l'IDE dans chaque pays. Alors il compare la taille de l'IDE (les flux et les stocks) parmi les quatre pays, en ce qui concerne la région des PECO, et le monde. Après, il présente et analyse les différents indicateurs de la pénétration de l'IDE dans le CEC4. Un effort sérieux est fait dans ce chapitre dans l'étude de l'attribution géographique de l'IDE vers et à partir du CEC4 (l'IDE intérieur et extérieur). Le chapitre étudie les sources (pays d'origine) de l'IDE dans le CEC4. Les données suggèrent que la majorité de l'activité de l'IDE dans le CEC4 provient du secteur de l'OCDE. Pour ce qui concerne l'IDE extérieur partant du CEC4, les données disponibles suggèrent que l'IDE extérieur partant du CEC4 n'est pas encore remarquable et semble être faible.

Le chapitre trois élabore le cadre juridique international pour l'IDE et se concentre sur les accords internationaux qui directement concernent et affectent l'IDE. Ce cadre inclut les accords bilatéraux, régionaux et multilatéraux d'investissement, qui constituent les « sources » de droit international de l'IDE. Avec la montée de l'IDE en tant qu'un des facteurs principaux conduisant les relations économiques internationales dans l'ère de la globalisation (mondialisation), l'investissement international régulateur est arrivé au premier plan de la diplomatie économique. Le chapitre commence d'abord, par discuter les sources et les principes du droit de l'investissement international et présente une vue d'ensemble historique de la croissance des IIAs. Après, il élabore les méthodes et les instruments en service: les BITs, les accords d'investissements régionaux et multilatéraux. Il explique la notion des BITs, comment et pourquoi ils ont commencé à se développer et à se développer en nombre pendant les années 90, et l'importance de l'entrée en vigueur des BITs. Puis, il se concentre sur le Code de libération des mouvements des capitaux de l'OCDE en tant qu'accords d'investissement régional. En relation au code de l'OCDE, le chapitre mentionne l'article l'Article VIII du FMI, au sujet de la convertibilité du compte courant, et à sa pertinence avec l'IDE. Les dispositions connexes par investissement de l'OMC sont

discutées dans le cadre de l'accord multilatéral d'investissement. Le coeur du chapitre est la section qui discute les questions clés et les dispositions incluses dans les BITs. Il discute les caractéristiques de l'IIA à différents niveaux, et analyse les avantages et les inconvénients des BITs, des accords régionaux et multilatéraux d'investissement. En conclusion, le chapitre présente une liste de BITs conclus par le CEC4 jusqu'en juin 2006.

Le chapitre quatre passe en revue la littérature internationale sur les causes déterminantes de l'IDE. Les différentes théories des causes déterminantes de l'IDE sont discutées en les divisant sous quatre titres importants : les théories des Marchés parfaits, les théories des marchés imparfaits, d'autres théories, et les théories basées sur d'autres facteurs.

Le chapitre cinq présente le cadre théorique de l'étude. Il élabore le projet de théorie « intégrée » sur laquelle le modèle théorique de l'étude est basé. Afin d'examiner l'impact des IIAs sur l'IDE dans le CEC4, l'étude propose d'adopter une théorie « intégrée » intégrant la théorie « éclectique » de Dunning (paradigme d'OLI) avec la théorie de « risque de pays », parce que ces deux théories ont été les plus réussies et les plus fortes dans leurs explications de l'IDE. Les facteurs de ces deux théories peuvent être utilisés également comme des « spécificités de la localisation » des « facteurs d'attrait » dans « l'approche pull and push » qui a été employée couramment et adoptée dans la littérature des mouvements de capitaux. Ainsi, le cadre théorique est basé principalement sur des « facteurs d'attrait » « spécificités de la localisation ». La théorie « éclectique » de Dunning (paradigme d'OLI) intègre trois théories : les théories de la propriété, de la localisation, et de l'intériorisation. La théorie du « risque pays », à son tour, consiste en deux composants importants : les facteurs de « risque macro-économique » et de « risque politique ». Le risque (macro-économique et politique) constitue un élément crucial pour les décisions d'investissement à l'étranger. Le chapitre élabore en détail les deux théories. Après, il explique le mécanisme d'intégration des deux théories. Puis, il analyse la manière dont la théorie intégrée peut être utilisée pour expliquer l'impact des IIAs sur l'IDE dans le

CEC4. En conclusion, le chapitre formule des hypothèses de recherches que l'étude vise à évaluer au chapitre six qui est consacré à l'analyse empirique.

Le chapitre six présente l'analyse empirique de l'étude. Il spécifie le modèle économétrique qui est basé sur les facteurs de la théorie « intégrée », discute les variables avec leurs rapports prévus et présente les sources des données. L'analyse empirique adopte la méthodologie du panel data pour le procédé d'évaluation. Les spécifications économétriques emploient des effets spécifiques par paire de deux pays pour prendre en compte tous les effets et facteurs inobservables invariants de temps qui pourraient affecter l'activité bilatérale de l'IDE intérieur entre le pays d'origine et le pays d'accueil qui ne sont pas couverts par les variables explicatives. Des effets fixes et des effets aléatoires sont employés pour les évaluations. Un Test de Hausman (1978) est appliqué pour détecter s'il y a une corrélation entre les effets spécifiques produits par un tandem de deux pays et les variables explicatives. Après, le chapitre présente les résultats de l'évaluation sous différentes caractéristiques. Il vérifie la constance des résultats en présentant plusieurs régressions sous plusieurs caractéristiques. En conclusion, il discute en détail les résultats empiriques.

Le chapitre sept présente les implications de politique des résultats principaux de l'étude. En conclusion, une conclusion générale présente le caractère unique de l'étude, récapitule la dissertation, et discute des prolongements possibles de la matière et des champs pour davantage de recherche.

Résultats et implications

L'étude a trouvé que la ratification de BITs entre les pays de l'OCDE et le CEC4 exerce un effet positif significatif sur l'IDE intérieur bilatéral dans le CEC4 au cours de la période à l'étude. A la fois, l'acceptation du Code de la Libération des Mouvements des Capitaux de l'OCDE, comme étant un accord régional d'investissement, et de l'article VIII du FMI, au sujet de la convertibilité de compte courant, n'a aucun effet significatif sur l'IDE intérieur dans le CEC4. Il était intéressant de voir que l'adhésion à l'OMC a un effet positif significatif sur l'IDE intérieur dans le CEC4. Parmi les fondamentaux économiques, la taille du marché s'est révélée une

cause déterminante forte de l'IDE intérieur, tandis que, la croissance économique n'a montré aucune signification. Il a été trouvé que, des institutions financières bien développés et efficaces, une position élevée de liquidité internationale, et des obligations élevées de dette extérieure, également, ont un impact positif significatif sur l'IDE centripète. Des taux d'inflation élevés reflétant l'instabilité macro-économique se sont révélés être un moyen de dissuasion fort à l'IDE intérieur. En outre, l'effet du niveau des taux de change réels compétitifs et la franchise commerciale se sont avérés ambigus. En outre, l'étude a trouvé que l'IDE intérieur dans le CEC4 a été marginalement affecté par la tendance globale dans les flux de l'IDE pendant les années 90.

L'analyse suivante présente les résultats de l'étude, évalue les implications de la politique pour chaque conclusion et les traite une par une.

- **Rôle des TBIs (Traités bilatéraux d'investissement)**

Première conclusion: Les TBIs exercent un impact positif significatif sur les flux bilatéraux de d'IDE dans le CEC4.

Ce résultat vérifie l'importance significative des IIAs au niveau bilatéral (BITs), en attirant l'IDE dans les quatre pays de l'Europe centrale. C'est la variable centrale, par conséquent, il représente une conclusion principale. Il prouve qu'indépendamment des principes fondamentaux économiques de l'économie, qui peut attirer les flux de BITs, les politiques de l'IDE et les accords d'investissement internationaux jouent également un rôle important. Les pays peuvent attirer chez eux l'IDE de plusieurs manières. Le point le plus important est l'« environnement d'investissement » et l'« attitude envers les investisseurs étrangers ». En fait, les décideurs politiques dans le CEC4, à la suite de leur phase de transition, se sont concentrés pour attirer chez eux, l'IDE en concluant des BITs. La conclusion de BITs reflète le fait que ces pays se sont tournés vers des politiques « favorables au marché ». Leur objectif était d'assurer la protection légale internationale, de réduire les obstacles, de créer des cadres « favorables aux investisseurs » et de d'encourager l'IDE. Ces accords internationaux visent à

encourager l'investissement en garantissant des protections légales pour les droits de propriété des investisseurs étrangers. Les investisseurs sont plus rassurés parce que leurs droits, protégés par le droit international, peuvent être renforcés par la jurisprudence internationale. Le CEC4 avait des institutions très faibles, comparées à celles des pays développés de l'OCDE, et « le risque politique » du point de vue des investisseurs étrangers a été considéré très haut. Ainsi, le CEC4 afin d'attirer l'IDE venant de leurs voisins européens développés et d'autres pays de l'OCDE n'a pas eu d'autres choix que d'offrir des garanties de politique au niveau international.

Il est remarquable de mentionner que les soucis de compétitivité du CEC4 pour l'IDE a mené, aussi, à l'adoption de droits nationaux établissant des régimes spécifiques pour l'IDE et à leur libération étendue, en termes d'entrée et d'autres conditions. Le CEC4 a présenté des lois nationales, des règlements et des « codes » spécifiquement pour l'IDE – La Hongrie en 1988, la Pologne et la Slovaquie en 1991, et la République Tchèque en 1992 (la CNUCED, 2004b). En plus des règlements de politique nationale pour l'IDE, ils ont offert des incitations aux GCO conçus pour attirer l'IDE des pays en concurrence et pour compenser les facteurs de risque potentiels qui pourraient décourager l'investissement. Tandis que les lois abordant spécifiquement l'IDE sont de grande importance pour les investisseurs étrangers et semblent influencer leurs décisions, le système légal entier d'un pays est aussi bien directement applicable. Le droit commercial d'un pays, ses lois foncières, les lois concernant les sociétés ou le travail, même la procédure civile ou le droit pénal, et naturellement les lois concernant le système judiciaire ou la fonction publique, sont également importants. Ces lois créent l'environnement légal pour la gestion des sociétés et établissent directement un ensemble de règles applicables et reflètent les tendances répandues de politique.

Un point d'importance particulière est que les CEC4, à leur étape préliminaire de transition, fin des années 1980 et début des années 90, ont été considérés de façon ou d'une autre « risqués » pour les investisseurs étrangers, en termes de « qualité des institutions », d'application de contrat, de droits de propriété, de règle du droit, du transfert de fonds, de prise de propriété, et de règlement des conflits. Les investisseurs

étrangers ont eu des préoccupations concernant de telles questions. Il est vrai que les investisseurs internationaux font toujours face à des risques parce que les changements des prix du marché et des opportunités ne peuvent pas être à l'avance parfaitement prévus. Cependant, dans le CEC4 - à leur étape préliminaire de transition - le risque dépasse le risque du marché ordinaire. Les investisseurs peuvent avoir peu confiance dans la fiabilité et l'équité des droits de propriété et de l'application du gouvernement. Les investisseurs pourraient se plaindre que les règles sont peu claires et variables avec le temps. Dans le cas extrême, la méfiance peut être si grande qu'il y a peu ou pas d'investissement. Ainsi, pour les gouvernements du CEC4, la manière principale d'attirer l'IDE était d'améliorer l'environnement politique/économique global pour réduire le risque. Une façon de réduire le risque pour les investisseurs étrangers est d'avoir des droits de propriété bien définis et obligatoires. Les droits de propriété obligatoires mènent non seulement à des quantités plus élevées d'investissement courant mais créent également un environnement stable du marché qui peut favoriser l'IDE. La confiance en l'application des droits de propriété réduit l'incitation à s'assurer contre le risque politique et réduit le coût de faire des affaires. Les investisseurs étrangers préfèrent faire des affaires dans les environnements avec des droits de propriété établis de longue date. Le CEC4 dans la fin des années 1980 n'a pas eu les systèmes légaux et les structures institutionnelles en place pour imposer en juste proportion des lois de droits de propriété.

Etant donné la faiblesse de l'environnement politique/légal domestique dans le CEC4 à leur étape préliminaire de transition, les investisseurs étrangers recherchent des solutions de rechange conçues en fonction leurs besoins. Ceci peut être fait au cas par cas, mais les coûts de transaction peuvent être réduits si le pays d'accueil s'engage à un cadre de base. Avec d'autres institutions internationales, c'est ce que fait le BITs. Il fournit des règles exécutoires pour protéger l'investissement étranger et pour réduire le risque auquel les investisseurs font face. Les BITs protègent et favorisent l'investissement étranger par une série de dispositions de politique, y compris de garanties d'un niveau élevé de traitement (NT et NPF), de protection légale de l'investissement en vertu du droit international, et l'accès à la résolution de conflit international. Ainsi, vers la fin des années 80, le CEC4 a recouru aux accords

internationaux, et aux traités bilatéraux conclus avec différents pays de l'OCDE afin de fournir des garanties d'internationales aux investisseurs de l'OCDE. L'impact positif significatif des BITs sur l'IDE intérieur bilatéral de l'OCDE vers le CEC4 démontre clairement que les BITs ont été utilisés avec succès dans les années 90 au travers du processus de transition des pays de l'Europe centrale vers une économie de marché. Leur fonction la plus significative semble être celle de fournir des signaux d'une attitude favorisant l'IDE. D'ailleurs, ceci confirme le fait qu'au début de l'étape de transition, les BITs étaient nécessaires et très importants pour le CEC4.

Un thème qui est tout à fait approprié à la transition et particulièrement aux pays avec des institutions nationales faibles, qui en cédant, ou se conformant aux engagements des BITs, obtiennent le résultat désiré de flux plus élevés d'IDE. Les pays avec des institutions nationales faibles acceptent probablement plus afin d'obtenir plus des BITs. Cette étude a vérifié que la très grande prolifération des BITs pendant les années 90 en a fait des dispositifs standards du climat d'investissement pour n'importe quel pays intéressé à attirer l'IDE. Les BITs sont des instruments efficaces puisqu'ils offrent aux pays la liberté de choisir les partenaires pour adopter un accord et le concevoir en fonction de leurs situations spécifiques. Ils offrent aux pays la flexibilité de conclure ces accords avec les pays qui sont les investisseurs principaux, évitant les pays qui sont moins intéressants ou qui peuvent insister sur des dispositions non désirées. En outre, ils peuvent être négociés rapidement. Leur souci principal a été dès même le début, la protection de l'investissement, dans le contexte plus large des politiques qui favorisent et promeuvent l'IDE : la protection des investissements contre la nationalisation ou l'expropriation et des assurances sur le transfert libre des financements et une disposition pour des mécanismes de règlement des discussions entre les investisseurs et les États d'accueil. Les BITs couvrent également un certain nombre d'autres domaines, en particulier, la non-discrimination dans le traitement, et dans certains cas, l'entrée des entreprises sous contrôle étranger, la subrogation dans le cas du paiement d'assurance par l'agence de garantie de l'investissement du pays de source, et d'autres matières.

- **Rôle d'un accord régional d'investissement (code de l'OCDE)**

Deuxième conclusion : Le code de l'OCDE de la libération des mouvements des capitaux, en tant qu'accord régional d'investissement, n'a pas un impact significatif sur l'IDE intérieur dans le CEC4.

L'impact insignifiant de l'adhésion à l'OCDE et l'acceptation du code de l'OCDE de la libération des mouvements des capitaux comme accord régional d'investissement sur l'IDE bilatéral des pays de l'OCDE vers le CEC4 est dû au fait que les quatre pays d'Europe Centrale, les Républiques tchèque et Slovaque, la Hongrie et la Pologne de l'Europe, ont conclu des BITs individuels avec les pays membres originaux de l'OCDE vers la fin des années 80 et le début des années 90 et ont rejoint l'OCDE par la suite (la République Tchèque en 1995, la Hongrie et la Pologne en 1996 et la République slovaque en 2000). Les dispositions incluses dans le code de l'OCDE sont déjà prises dans les BITs. En outre, les BITs stipulent les dispositions qui sont beaucoup plus la préoccupation des investisseurs étrangers, tels que la protection légale internationale par la disposition de règlement des conflits de l'État investisseur, la compensation pour les dommages et pertes, les droits de propriété, la protection contre la prise de la propriété telle que la nationalisation ou l'expropriation, le traitement non-discriminatoire (NT et NPF), le libre transfert des financements, le rapatriement du capital, les bénéfices et le revenu. D'ailleurs, les BITs sont exécutoires, tandis que le code de l'OCDE n'est pas exécutoire.

- **Rôle d'un accord monétaire international**

Troisième conclusion : L'acceptation de l'article VIII du FMI, au sujet de la convertibilité du compte courant, n'a pas un impact significatif sur l'IDE intérieur dans le CEC4.

L'insignifiance de l'impact de l'acceptation de l'article VIII du FMI, au sujet de la convertibilité de compte courant, est due au fait qu'elle est déjà prise dans les BITs. En

fait tous les BITs fournissent des dispositions au sujet du transfert des financements. Les BITs exigent que les pays d'accueil garantissent le libre transfert des paiements liés aux investissements comme étant un aspect important de la protection de l'investissement. Cette condition s'applique seulement aux transferts liés à l'investissement venant de l'étranger réalisé par des investisseurs d'une partie dans le territoire d'une autre partie. Les catégories principales des paiements à l'égard desquelles ce droit de transfert libre s'applique sont les montants principaux et additionnels pour maintenir ou augmenter l'investissement, les bénéfices, l'intérêt, les plus-values, les paiements de redevance, la gestion, l'assistance technique ou d'autres honoraires et, les retours en nature ; procède de la liquidation totale ou partielle des investissements, des remboursement des prêts. La disposition inclue également les paiements effectués par un pays d'accueil en compensation pour une expropriation d'investissement ou pour des pertes enregistrées par les investisseurs étrangers en raison d'un conflit armé ou d'une émeute civile et des paiements qui résultent des démarches de règlement de différends. Les dispositions sur le transfert des financements dans les BITs exigent souvent des pays d'accueil de s'assurer que les transferts peuvent être faits sans délai, en devises librement utilisables ou librement convertibles, au taux de change normal applicable à l'heure du transfert.

Puisque le motif le plus important d'entreprendre des investissements à l'étranger est de faire du profit, ce qui importe le plus pour les investisseurs étrangers est la garantie et l'assurance concernant le transfert des fonds, le rapatriement du capital, les bénéfices, et les dividendes. Ainsi, un des points les plus critiques qui amène la décision de la localisation des investisseurs étrangers est la garantie du rapatriement du capital. Les articles de l'accord du Fonds monétaire international (les fonds) constituent un traité international et la Charte des financements. Bien que les engagements établis sous les Articles des Financements servent à libéraliser les flux d'investissement à un certain nombre d'égards importants, ce n'est pas un accord international d'investissement. L'article VIII (2) (a) des articles de l'accord du FMI prévoit que les membres de FMI peuvent « ne pas imposer de restrictions à l'établissement des paiements et des transferts pour des transactions internationales courantes » sauf là où de telles restrictions sont approuvées par le FMI. Cette disposition protège la capacité

d'un investisseur à rapatrier le revenu provenant de l'investissement, mais ne couvre pas les paiements et les transferts provenant de la liquidation de l'investissement et de la mise en route d'un nouvel investissement. En outre, le terme « transactions internationales » se rapporte à des transactions entre les résidents et les non-résidents. Ainsi des transactions entre une filiale étrangère et d'autres sociétés dans un pays d'accueil ne sont pas considérées comme étant internationales dans ce sens. En outre, l'engagement dans l'article VIII (2) (a) s'étend seulement à la mise en route de paiements et de transferts extérieurs. Ainsi dans le cas des paiements et des transferts investissements connexes, la disposition protège la capacité d'un non-résident à transférer les montants à partir d'un investissement mais ne s'applique pas aux encaissements et aux transferts liés à la fabrication d'un investissement (la CNUCED, 2004b, et c). Cette conclusion suggère que la libéralisation du compte courant n'a pas un impact significatif sur les décisions des investisseurs étrangers. Les BITs ont des dispositions plus complètes au sujet du transfert des fonds, et des dispositions au sujet de la protection légale internationale, qui semblent être plus importantes pour les investisseurs étrangers.

- **Rôle des accords multilatéraux d'investissement**

Quatrième conclusion : L'adhésion à l'OMC a un impact positif significatif sur l'IDE intérieur dans le CEC4.

L'étude a constaté que l'adhésion du CEC4 à l'OMC a un impact favorable significatif sur les décisions des investisseurs étrangers et a attiré l'IDE comme plateforme d'exportation. Dans la décennie depuis que les premières réformes majeures du commerce ont été présentées, les pays du CEC4 ont fait des pas géants en s'éloignant des régimes commerciaux autarciques et des tendances d'échanges déformés qui ont caractérisé la planification centrale. Le CEC4 peut être considéré comme s'intégrant véritablement et entièrement dans le système de commerce mondial. Le défi principal pour ces pays a impliqué de renforcer la capacité de larges institutions basées sur le marché et de celles qui sont plus spécifiquement liées au commerce, comme le secteur financier, des douanes et les facilitations commerciales ce qui les ont rendus capables

de mieux apprécier les avantages et d'assumer les responsabilités de la participation au système de commerce multilatéral.

La politique commerciale d'un pays est un maillon-clé dans la transmission des signaux des prix du marché mondial à l'attribution de ressource domestique et à l'intégration efficace de l'économie dans le système de commerce mondial. Ainsi, il n'est pas étonnant que ces pays de l'Europe centrale souhaitant échapper aux inefficacités de la planification centrale et augmenter le choix du consommateur, ont fait de la réforme de la politique commerciale un premier composant important de prix plus variés et des réformes orientées vers le marché. L'intégration dans le système de commerce du mondial dépend fondamentalement de l'existence de politiques et d'institutions dans un pays et de ses partenaires commerciaux qui sont adaptés à l'échange mutuellement bénéfique des biens et des services basés sur la spécialisation et l'avantage comparatif. L'intégration efficace des économies en transition implique ainsi non seulement leurs propres politiques et institutions commerciales, mais également ceux de leurs partenaires commerciaux qui modifient l'accès au marché et les termes de l'échange. L'intégration implique de se conformer aux règles de conduite qui régissent le système de commerce multilatéral (Michalopoulos, 1999a). Ces règles ont été établies et sont mises en application dans le cadre des accords administrés par l'OMC. Ces accords incluent le commerce de marchandises (GATT), les échanges des services (AGCS), aussi bien que d'autres aspects de l'échange international des biens et des services, tels que Les droits de propriété intellectuelle relatifs au commerce (TRIPS), Les normes sanitaires et phytosanitaires (SPS), Les marchés publics de fournitures etc. Les politiques et les institutions régissant ces sujets sous la planification centrale étaient soit radicalement différents ou complètement manquants. Ainsi, l'adhésion à l'OMC est un élément essentiel, peut-être même une condition nécessaire pour l'intégration totale dans le système de commerce mondial.

L'adhésion à l'OMC est importante pour un certain nombre de raisons : d'abord, parce que l'adhésion promeut l'établissement du cadre juridique et les institutions basés sur le marché en appui au commerce international qui étaient absents sous la planification centrale ; en second lieu, parce que l'adhésion à l'OMC fournit de

meilleures garanties pour l'accès au marché par la fourniture de statut sans conditions de la NPF ; et en évitant des mesures arbitraires qui limitent l'accès au marché aux non membres ; et troisièmement, parce que l'OMC a établi un mécanisme obligatoire de règlement des différends, qui, au moins jusqu'ici, s'est révélé être efficace dans la résolution des conflits commerciaux (Michalopoulos, 1999a, et b). L'impact favorable significatif de l'adhésion à l'OMC sur l'IDE intérieur suggère que les pays avec des institutions faibles doivent continuer à faire des efforts pour renforcer leurs possibilités institutionnelles dans des secteurs tels que le développement du secteur financier, l'administration douanière et la facilitation du commerce, qui leur permettrait d'apprécier plus, les avantages de l'adhésion à l'OMC. La faiblesse de fonctionnement des institutions fondamentales du marché empêchent une intégration efficace dans le système de commerce, ainsi, le marché et les réformes commerciales sont des conditions nécessaires pour attirer l'IDE et pour obtenir les pleins avantages de son effet de retombées sur l'économie.

- **Rôle de stabilité macro-économique**

Cinquième conclusion : Les taux d'inflation élevée ont un impact négatif significatif sur l'IDE intérieur dans le CEC4.

L'étude a constaté que l'instabilité macro-économique reflétée par un taux d'inflation élevée est un moyen de dissuasion fort pour l'IDE. Une telle conclusion suggère que la stabilité des prix est très importante et souhaitable pour attirer les investissements étrangers. Beaucoup d'analystes croient que la banque centrale devrait se concentrer principalement sur les moyens de stabiliser les prix. Un niveau stable des prix semble être la condition la plus conductrice de production et d'emploi maximum durable et de taux d'intérêt à long terme modérés; dans de telles circonstances, les prix des marchandises, des matériaux, et des services modifiés par l'inflation et peuvent servir ainsi de signaux et de guides plus clairs à une répartition des ressources efficace. En outre, on pense qu'un climat de prix stables encourage l'économie et, indirectement, la formation de capital, parce qu'il empêche l'érosion des valeurs des

actifs par une inflation imprévue (conseil des gouverneurs du système de réserve fédérale, 1994).

D'ailleurs, un principe majeur de la politique monétaire est que la stabilité des prix est un moyen d'arriver à ses fins - de favoriser une croissance économique durable. Selon William Mc Donough, ancien président de la Federal Reserve Bank de New York, la stabilité de prix est à la fois importante et souhaitable parce qu'un niveau de prix en hausse – l'inflation - même à des taux modérés impose des coûts économiques substantiels à la société. Tous les pays subissent ces coûts. Ils occasionnent, par exemple, (i) une incertitude accrue au sujet des résultats des décisions économiques et de la rentabilité ; (ii) des effets négatifs sur le coût capitaux résultant de l'interaction de l'inflation avec le système fiscal ; (iii) une efficacité réduite des systèmes des prix et du marché ; et (iv) des déformations qui créent des incitations perverses à s'engager dans des activités non productives (Mc Donough, 1997, P. 2).

Ainsi, une question clé à laquelle les banques centrales ont à faire face , est quelle stratégie poursuivre dans la conduite de la politique monétaire. Un choix de stratégie monétaire devenue de plus en plus populaire ces dernières années est de cibler l'inflation, qui implique l'annonce publique des cibles numériques de moyen à long terme pour l'inflation avec un engagement par les autorités monétaires à réaliser ces objectifs (Mishkin et Posen, 1997). Une fois qu'un engagement a été pris dans la stabilité des prix comme objectif de politique monétaire - et que cet engagement a été confié à une banque centrale indépendante - il y a plusieurs approches possibles pour mettre en application cet objectif. Alors que le choix dépendra de l'histoire, des conditions économiques, et des traditions d'un pays, toutes les approches réussies partagent deux dispositifs importants : d'abord, elles se concentrent sur un horizon temporel à long terme et, en second, elles fournissent une norme transparente pour l'évaluation de la politique. Pour plusieurs de ces approches, ce qui guide la politique monétaire est une cible annoncée ; une telle cible est un moyen prouvé de donner de façon crédible au public l'engagement à la stabilité des prix et au verrouillage de ce fait des prévisions d'inflation (Mc Donough, 1997).

- **Rôle des institutions financières**

Sixième conclusion : Les institutions financières bien développées et efficaces ont un impact significatif positif sur l'IDE intérieur dans le CEC4.

Afin d'examiner le rôle des « institutions » en attirant l'IDE, l'étude s'est concentrée sur « les institutions financières » et a constaté que le niveau de développement et l'efficacité des institutions financières ont un impact positif significatif sur l'IDE. D'ailleurs, le manque de développement des institutions financières locales peut limiter défavorablement la capacité d'une économie à tirer profit des avantages potentiels de l'IDE. Ceci démontre que les pleins avantages des flux financiers stables à long terme ne peuvent être réalisés en l'absence d'institutions financières fiables. L'impact positif significatif de la « qualité des institutions financières », reflétée par la diffusion des taux d'intérêt, sur l'IDE signifie que les réformes financières dans le CEC4 sont assez avancées pour avoir un secteur bancaire ou des institutions financières comparables aux économies avancées et à celles de l'UE, et est conforme à l'acquis communautaire. D'ailleurs, un tel résultat démontre clairement que les réformes financières apportent un résultat et que le développement et l'efficacité du secteur financier est un facteur crucial pour l'attraction du capital stable à long terme.

En ce qui concerne le rapport entre les BITs et les institutions financières vis-à-vis de l'IDE, il n'y a aucune preuve que les BITs se comportent différemment en présence des institutions financières bien développées et efficaces. Les évaluations des deux limites d'interaction – le BIT avec la profondeur financière et le BIT avec l'efficacité - se sont avérées insignifiantes. C'est une preuve irréfutable que chacune a un rôle séparé et crucial en créant « un environnement d'investissement » favorable. Les BITs ratifiés et les institutions financières développées et efficaces ont des impacts distincts et séparés sur l'IDE. En présence d'institutions financières bien développées et efficaces les BITs n'exercent pas un impact différent sur l'IDE. En outre, le niveau de

développement et l'efficacité des institutions financières se sont avérés avoir un rôle plus important dans l'attraction de l'IDE que la présence de BITs.

Les institutions financières sont les protagonistes essentiels dans l'intégration des transactions dans le temps ; en particulier, la canalisation de l'épargne et de l'investissement, l'organisation des paiements et l'application de la discipline financière. Bien que la plupart de l'IDE par sa nature se fonde sur le capital étranger, il est important d'identifier que les décisions d'investisseurs étrangers dépendent de façon cruciale de l'ampleur du niveau de développement et de l'efficacité des institutions financières locales. La progression en établissant une infrastructure financière et des marchés financiers est très importante pour les investisseurs étrangers parce qu'elle facilite l'accès aux marchés financiers locaux. Les institutions financières bien développées et efficaces encouragent les investisseurs étrangers à mettre en place des opérations, car elles peuvent avoir accès aux finances locales complémentaires plus facilement, et qu'elles font face à des coûts inférieurs de transaction pour des services financiers locaux. D'ailleurs, leurs clients aussi, sont susceptibles d'avoir accès au crédit, ce qui pourrait accélérer la demande de leurs produits qui sont souvent achetés à crédit.

La grande importance du système financier dans nos vies quotidiennes peut être illustrée en passant en revue ses différentes fonctions. Le système financier dans une économie moderne a sept fonctions de base : (1) la fonction épargne, fournissant une sortie potentiellement profitable et à faible risque pour l'épargne étatique ; (2) la fonction de richesse, fournissant un moyen de stocker le pouvoir d'achat jusqu'à nécessaire pour de futures dépenses sur des biens et des services ; (3) la fonction de liquidité, fournissant un moyen de lever des fonds en convertissant des valeurs et d'autres actifs financiers en soldes de trésorerie ; (4) la fonction de crédit, fournissant une offre de crédit pour soutenir la consommation et les dépenses d'équipement dans l'économie ; (5) la fonction de paiements, fournissant un mécanisme pour effectuer des paiements pour acheter des biens et des services ; (6) la fonction risque, fournissant un moyen de protéger les entreprises, les consommateurs, et les gouvernements du risque contre les risques aux personnes, à la propriété, et au revenu ; et (7) la fonction de

politique; fournissant un canal pour que la politique du gouvernement atteigne l'objectif de l'emploi élevé, d'une inflation basse, et d'une croissance économique durable.

- **Rôle de la position de liquidité internationale**

Septième conclusion: La position élevée de liquidité internationale s'est reflétée par à niveau élevé des réserves - indiquant la solvabilité du pays - a impact positif significatif sur l'IDE intérieur dans le CEC4.

Un des principaux résultats de l'étude était qu'un niveau élevé des réserves d'un pays, à la fois en mois d'importations et en dette extérieure totale, a un impact positif très significatif sur l'IDE intérieur. Le rapport des réserves en mois d'importations indique la capacité d'un pays à maintenir des niveaux d'importation avec de l'argent comptant courant disponible. Quand ce rapport - réserves en mois d'importations est élevé – cela signifie que le pays d'accueil a une plus longue période d'importation couverte, qu'il est en meilleure position de liquidité - au moins en liquidité à court terme - ainsi le pays ne fera pas face à des problèmes de balance de paiements dans un avenir proche. Cette question est très importante pour les investisseurs étrangers, dans le sens où elle concerne directement leur transfert de financements, le rapatriement de capital, les bénéfices, les dividendes, les transferts liés à la liquidation des capitaux, etc. Quand un pays d'accueil fait face à un problème de balance de paiements, il pourrait mettre des restrictions sur le transfert des financements. Ceci pourrait créer des problèmes graves aux investisseurs étrangers et occasionner des difficultés dans leurs transactions. Par conséquent, la position de liquidité internationale d'un pays d'accueil est cruciale pour les investisseurs étrangers. Pour cette raison des niveaux élevés de réserves sont très souhaitables, puisqu'ils indiquent la position de liquidité internationale d'un pays ou le risque de liquidité, qui celui-ci à son tour affecte la solvabilité d'un pays.

- **Rôle de la compétitivité internationale**

Huitième conclusion :

(a) Les bas coûts unitaires relatifs de la main-d'œuvre en ce qui concerne les pays de l'OCDE ont un impact positif significatif sur l'IDE intérieur dans le CEC4.

(b) Le niveau secondaire d'éducation de la main-d'oeuvre n'a pas d'impact significatif sur l'IDE intérieur dans le CEC4.

L'étude a trouvé que les coûts unitaires relatifs de la main-d'oeuvre dans le secteur industriel du CEC4 en ce qui concerne les pays de l'OCDE ont un effet fortement significatif sur l'attrait de l'IDE. D'une part, le pourcentage de la main-d'oeuvre ayant atteint l'enseignement secondaire ne montre aucune signification. Un tel résultat démontre clairement l'importance de la compétitivité internationale d'un pays en attirant l'IDE. En fait, l'index utilisé pour les coûts unitaires relatifs de la main-d'oeuvre dans le CEC4 reprend le taux de change réel compétitif, et le niveau d'éducation de la main-d'oeuvre. C'est une preuve importante que l'IDE « de recherche d'efficacité » et l'IDE « de recherche de ressource » sont sensiblement corrélés avec le facteur international de compétitivité. Les investisseurs étrangers mettent fortement en balance ce facteur contre d'autres facteurs avant de prendre leur décision pour la localisation de leur investissement à l'étranger. D'une part, aux fins d'attirer l'IDE, l'investissement dans l'enseignement secondaire semble être suffisant. Par conséquent, les gouvernements peuvent choisir d'investir plus dans l'éducation au delà de ce niveau, pour d'autres objectifs nationaux.

Limitations de la présente recherche

Une des limitations de cette recherche est la contrainte des données. Les études analysant l'impact des BITs sur l'IDE dans les pays développés ou en voie de développement ont l'avantage de couvrir une longue période de temps, par

exemple, depuis le début des années 80. Malheureusement, cela est impossible dans le cas du CEC4. Ces pays ont été centralement planifiés et les données sont seulement disponibles depuis le début des années 90. Cette étude emploie des données de l'OCDE sur les stocks bilatéraux et les flux de l'IDE, comme rapporté par les pays membres de l'OCDE. De telles données n'étaient même pas compilées sous une forme disponible pour le public jusqu'en 1993, avec le premier annuaire international annuel de statistiques d'investissement direct de l'OCDE. Puisque les données sont collectées à partir des sources nationales dans chaque pays, il y a une variation substantielle de la couverture par pays d'origine et par année, et une variation de la mesure de l'activité de l'IDE elle-même. L'ensemble des données utilise une liste de données mal équilibrées de la période 1992 à 2003. Par exemple, pour estimer l'impact des IIAs sur l'IDE, ayant comme variables dépendantes **le stock de l'IDE bilatéral intérieur**, les données pour la République Tchèque sont disponibles pour la période 1997-2003. Pour la Pologne pour la période 1994-2003, et pour la République slovaque elles sont disponibles pour la période 2000-2002. Dans le cas de la Hongrie seulement, les données sont disponibles pour la période 1992-2003. L'étude fait face à une plus grande difficulté en cas de flux bilatéraux de l'IDE. Pour cette raison, les résultats principaux de l'étude sont basés sur des évaluations utilisant **le stock intérieur de l'IDE bilatéral**, en tant que variable dépendante, puisque les **régressions** ont un plus grand nombre d'observations.

Une autre limitation est la mesure de l'activité des BITs. Il y a des points substantiels de mesure qui déterminent comment définir cette variable. On peut observer quand les pays passent des traités bilatéraux d'investissement les uns avec les autres, mais ces traités diffèrent certainement entre eux sur de nombreuses dimensions qu'il est très difficile mesurer. En outre, le même traité sur le papier peut avoir conséquences différentes pour différentes paires de pays selon les pratiques unilatéralement adoptées par les pays avant de signer le traité. En raison de ces difficultés, cette étude mesure l'activité du traité d'investissement comme variable binaire prenant la valeur de « 1 » si deux pays ont un traité bilatéral d'investissement en place en année (t) et après, « 0 » autrement. Par conséquent, un simulacre est inclus dans le panel regression qui prend la valeur de « 1 » une fois qu'un BIT a été ratifié

entre une paire de pays d'accueil source. La signification du coefficient sur cette variable est alors un essai de l'importance du traité. En conséquence, il pourra estimer l'impact des BITs.

Une autre limitation est le problème potentiel d'endogénéité. L'étude ne peut pas examiner empiriquement la direction de la causalité entre les BITs et l'IDE. D'autres études examinant l'impact du BIT sur l'IDE (Hallward-Driemeier, 2003, Egger et Pfaffermayr, 2004a, et Neumayer et Spess, 2005) ont examiné cette question de l'endogénéité, parce qu'elles ont des données sur une plus longue période. Leur période d'étude s'étend du début des années 80 jusqu'en 2000, et leur échantillon de pays est plus grand. Ils ont examiné l'impact des BITs sur l'IDE dans les pays en voie de développement. Dans le cas de cette étude, les contraintes de données sur des flux bilatéraux de l'IDE et les stocks intérieurs de l'IDE bilatéral des 22 pays source de l'OCDE vers les pays d'accueil du CEC4 ne permettent pas à l'étude d'employer certaines procédures économétriques. Par exemple, l'étude ne peut pas examiner l'impact de la ratification du BIT sur les stocks intérieurs de l'IDE bilatéral pendant des années avant la ratification et des années après ratification. Mais dans tous les cas, l'étude ne s'attend pas à ce qu'il y ait qu'il y ait une causalité inverse, et que le CEC4 a conclu des BITs en raison de l'IDE existant. C'est-à-dire que le CEC4 n'a pas conclu le de BITs avec les 22 pays de l'OCDE pour couvrir l'IDE existant. Au contraire, selon les chiffres statistiques, les investissements à l'étranger étaient rares dans le CEC4 pendant les années 80. Ils ont reçu des quantités impressionnantes d'IDE pendant les années 90, après leur ratification des BITs.

Le caractère unique de cette étude

Cette étude est originale parce qu'elle apporte une contribution importante aux causes déterminantes de l'IDE. Elle est unique parce qu'elle touche à des horizons précédemment encore inconnus liés à l'impact des IIAs, aux niveaux bilatéraux, régionaux, et multilatéraux sur l'IDE. D'autres études comme Hallward-Driemeier (2003), Banga (2003), Egger et Pfaffermayr (2004a), Salacuse et Sullivan (2004), Tobin et Rose-Ackerman (2005), Neumayer et Spess (2005), Desbord et Vicard (2006) ont seulement examiné l'impact des BITs sur l'IDE. Certains de ces auteurs ont

constaté que les BITs exercent un effet positif significatif sur l'IDE intérieur (Banga, 2003, Egger et Pfaffermayr, 2004a, Neumayer et Spess, 2005, Salacuse et Sullivan, 2005, Desbord et Vicard, 2006). D'autres ont trouvé un rapport très faible entre les BITs et l'IDE (Hallward-Driemeier, 2003, et Tobin et Rose-Ackerman, 2005). Il y a clairement un désaccord et une contradiction dans les études mentionnées. Une partie de la variation est expliquée par des approches et des méthodologies empiriques différentes. Certaines études regardent les dyades d'un pays tandis que d'autres regardent le nombre cumulé des BITs et des flux totaux de l'IDE. En plus, il y a des différences dans les variables dépendantes car les diverses études regardent les flux totaux de l'IDE, les apports bilatéraux de l'IDE, les apports de l'IDE comme part des flux globaux de l'IDE et les entrées de l'IDE comme part de l'IDE global allant dans les pays en voie de développement. En outre, les différences dans les résultats sont dues aux différents échantillons de pays et aux différentes périodes de temps. Toutes ces études ont examiné l'impact des BITs sur l'IDE dans les pays en voie de développement. Seule l'étude d'Egger et de Pfaffermayr (2004a) prend en compte à la fois les pays de l'OCDE et les pays n'appartenant pas à l'OCDE. Étant donné les résultats contradictoires et les modèles de spécifications différents, il est difficile de déterminer lequel est exact. La conclusion la plus simple est que cette recherche est complètement différente et unique. Cette étude est la première à fournir une preuve quantitative rigoureuse sur l'impact des IIAs aux niveaux bilatéraux, régionaux, et multilatéraux sur l'IDE. C'est-à-dire, cette étude est la première à estimer l'impact de l'adhésion à l'OCDE, au FMI, et à l'OMC sur l'IDE, en plus de l'impact des BITs sur l'IDE. À la connaissance du chercheur, Rose (2005) était le premier à estimer l'effet de l'adhésion à l'OMC, au FMI et à l'OCDE sur le commerce international. Utilisant le modèle standard de « pesantur » du commerce de marchandises bilatéral et une **large ensemble de données d'experts (a large panel data set)** couvrant une période de plus de cinquante ans et 175 pays, ses résultats ont indiqué que l'adhésion à l'OCDE (mais ni l'adhésion à l'OMC ni au FMI) a eu un grand effet positif constant sur le commerce. Cette étude a constaté que parmi les institutions internationales, l'adhésion à l'OMC (mais ni à l'OCDE ni au FMI) exerce un impact positif significatif sur l'IDE. Une autre différence est que Rose (2005) n'a pas estimé l'impact des BITs. Par conséquent, cette étude est complètement différente des autres études (sur l'IDE ou sur le

commerce) dans le sens qu'elle a conduit une recherche très originale et complète, en examinant l'impact des BITs sur l'IDE, en plus de l'adhésion à des institutions économiques internationales, tels que l'OCDE, le FMI et l'OMC.

En outre, l'analyse empirique de l'étude a utilisé des variables et des indicateurs non utilisés précédemment dans la littérature empirique disponible sur l'IDE. Par exemple, le niveau du développement des institutions financières utilisant les disponibilités de liquidités du secteur financier (M3/GDP), le crédit domestique fourni par le secteur bancaire (BANKCR), la qualité et l'efficacité des institutions financières utilisant la progression du taux d'intérêt (INTSPREAD), le coût des capitaux locaux utilisant les taux d'intérêt de prêt réels (REALRATE), la position de liquidité internationale d'un pays et la solvabilité de pays utilisant les rapports des réserves aux niveaux des importations (RES/MGS) et à la dette extérieure (RES/EDT), la santé financière d'une économie utilisant les obligations de dette extérieure relatifs à la production (EDT/GNI), les revenus de l'export (EDT/XGS), ou les services de dette extérieure vers les revenus d'exportation (TDS/XGS). L'impact de tels indicateurs sur l'IDE n'a pas été examiné plus avant dans la littérature empirique disponible. Par conséquent, cette étude s'ajoutant à la littérature empirique existante, est unique et originale.

Recommandations pour davantage de recherche

Cette étude a traité de l'impact des IIAs, en particulier, des BITs sur l'IDE intérieur bilatéral dans le CEC4. Ma recherche a constaté que les BITs exercent un impact positif significatif sur l'IDE dans le CEC4. Les CEC4, vers la fin des années 80 et du début des années 90, avec ses institutions faibles, ont gagné et ont tiré bénéfice de la conclusion des BITs avec les pays développés de l'OCDE. Ils ont conclu des BITs avec l'objectif partagé par tous d'attirer l'investissement de l'étranger et le capital afin de restructurer et développer leurs économies.

La croissance très rapide du nombre de BITs est justifiée par la foi et l'espoir des décideurs politiques que l'investissement est une condition essentielle si les pays doivent de se déplacer, globalement, vers un futur plus durable. Des investissements

sont nécessaires pour ajouter des ressources durables, des processus industriels solides, une meilleure utilisation de la ressource naturelle, aussi bien que de réaliser les facteurs économiques et sociaux au centre de l'ordre du jour de développement. Mais le rapport entre les IIAs et le développement durable demeure peu clair. Les IIAs sont vus et vendus sous le nom d'instrument de développement ; les pays signent des IIAs espérant voir des flux significatifs des investissements grâce aux protections pour les investisseurs étrangers que les accords fournissent. Indépendamment de telles réclamations, il y a encore beaucoup plus à faire afin d'évaluer l'impact des IIAs sur le développement, et dans quelle mesure l'IDE contribue au développement. Une question qui est laissée à la future recherche est dans quelle mesure les IIAs contribuent au développement durable. Cet aspect exige davantage de recherche détaillée afin d'évaluer l'impact réel des IIAs sur le développement durable.

Prototype Bilateral Investment Treaties

- 1. Austria**
- 2. Belgium – Luxemburg**
- 3. France**
- 4. Germany**
- 5. Italy**
- 6. Netherlands**
- 7. Sweden**
- 8. Switzerland**
- 9. U.K.**
- 10. U.S.A**

Prototype
Bilateral Investment Treaties