

COMMUNICATION FROM THE UNITED STATES

The following communication, dated 12 September 2002, has been received from the Permanent Mission of the United States.

**COVERING FDI AND PORTFOLIO INVESTMENT IN A WTO INVESTMENT
AGREEMENT**

I. INTRODUCTION

1. For a number of reasons, investment agreements must have a broad, open-ended definition that includes all types of investment, including portfolio investment. Long-standing U.S. practice is to have the broadest definition of investment, covering both direct and portfolio investment. European bilateral investment treaties also cover all types of investment.

2. In UNCTAD's recent study of investment treaties, the number of bilateral investment treaties grew fivefold during the 1990's, from 385 to 1,857, with 173 countries concluding these instruments. Moreover, the number of treaties signed by developing and emerging market countries increased dramatically, rising from 63 at the end of the 1980s to 833 at the end of the 1990s.¹ Many of these treaties were with the US and Europe, and the preponderance cover both direct and portfolio investment. This growth indicates increasing acceptance by developing and emerging market countries of the need to cover both direct and portfolio investment in order to maximize the gains from investment liberalization and protection.

A. WHAT IS PORTFOLIO INVESTMENT?

3. The principal difference between FDI and portfolio investment is the extent of control. A direct investment is one in which the investor obtains a lasting influence in, and a degree of influence over the management of, a business enterprise. Portfolio investment is all other investment, including investments in financial assets without the expectation of significant management control of the real assets on which the financial assets are based. Other examples of portfolio investment include, interests in concessions agreements, contractual rights, (such as rights embodied in intellectual property interests), debt interests in business enterprise, and ownership interests in tangible and intangible property, such as leases, mortgages, and liens.

¹ UNCTAD, Bilateral Investment Treaties, 1959-1999 (2000).

4. For statistical purposes, governments and international organizations may require a minimum level of ownership for an investment to be treated as FDI. The OECD and IMF, in compiling FDI statistics, consider a direct investment to be one in which ownership is at least ten per cent of the voting securities of an incorporated business enterprise, or the equivalent interest in an unincorporated business enterprise.

5. While useful for statistical categorization, the "ten per cent" rule may be too rigid for practical use in a legal agreement. For example, an investor might own only nine per cent of an investment but still exercise effective control over the investment because other shareholders have extremely limited holdings. The extent to which an investment confers control is the most reliable indicator of whether it represents direct or portfolio investment.

B. WHY INVESTMENT AGREEMENTS SHOULD COVER PORTFOLIO INVESTMENT AS WELL AS FDI

1. Portfolio investment is vital for economic growth and development.

6. Developing and emerging market countries benefit from portfolio capital inflows. Portfolio investment adds to national savings, helps broaden and deepen financial markets in developing countries to mobilize capital more efficiently, broadens the array of lending available to domestic businesses, promotes large-scale investments that capture economies of scale, and stabilizes the local economy by spreading credit risk. The investment and financial development impact of capital account liberalization, which reflects increased FDI and portfolio investment, has been shown to increase economic growth in developing countries by 0.5 per cent annually.² Excluding portfolio investment from the definition of investment would be counter productive for countries that hope to use foreign investment to bolster their own growth.

2. Portfolio investment is key to financial market deepening. Relegating portfolio investment to second-class status discourages the creation of sound financial markets.

7. A well-developed financial market is able to match willing sellers of capital with willing buyers in such a way that both parties can expect to benefit from the transaction. To meet the various needs of its customers, the financial market ideally has a range of instruments on offer, including equity, debt, and the many variations on these concepts that are found in modern financial centers. Granting fewer rights to the holders of portfolio capital than to direct investors would only create a bias against portfolio investment and stall the development of an efficient, diversified capital market.

3. The definition of "portfolio investment" covers a broad range of investments that are in common use worldwide.

8. Denying the benefits of an investment treaty to portfolio investments means leaving out such standard types of investments as minority equity holdings, such as of shares and stocks; bonds, debentures, and other forms of debt interests in a company; contractual rights, such as under turnkey contracts, production or revenue-sharing contracts, and concessions; rights conferred pursuant to law, such as licenses and permits; and other investments such as leases, mortgages, liens, and pledges.

9. One could ask whether it is worth negotiating an investment treaty that leaves such a wide array of investments without coverage. Certainly such a treaty could not be called "comprehensive."

² "International Financial Integration and Developing Countries," World Economic Outlook, IMF, October 2001, p. 143.

4. Offering fewer protections to portfolio investors than direct investors increases the risks associated with portfolio investment, raising the cost of borrowing foreign capital, which is a drag on the economy.

10. Developing countries, already contending with scarce economic resources, can little afford to worsen the terms facing domestic borrowers who wish to raise capital abroad. Recent research shows that increased openness to portfolio investment benefits the liberalizing country by decreasing the cost of capital in that country and giving domestic investors access to global financial markets, which enables them to share risk with other investors.³ An IMF study of 38 developing countries over the period 1980–1999 found that capital account liberalization generally leads to greater capital inflows and, with good management of these inflows, more domestic investment and higher growth. The growth effects of liberalization on developing countries came from both FDI and portfolio investment.⁴

5. It is not always possible to decide what constitutes a portfolio investment.

11. There is no easy way to distinguish between direct and portfolio investment in many cases. For example, a venture capitalist might loan a foreign start-up company a large amount of money, underlying a large share of the start-up's assets. The venture capitalist may not hold any evidence of ownership because no shares have been issued, only debt or have measurable control over the start-up. This type of start-up capital is critical to many successful businesses.

12. Because portfolio and direct investment are not always easily distinguished, removing portfolio investment from the definition of investment would require case-by-case analysis to determine which kind of investment a given investor had made, or intended to make, and whether it was covered by the investment agreement. At best, this would complicate the investment process considerably; at worst, it could lead to disputes between treaty partners and weaken the treaty's ability to promote overseas investment in general.

6. Portfolio investment is a concomitant of direct investment.

13. It is not possible to isolate foreign direct investment from portfolio flows, because direct investors will be engaged in portfolio investment as they manage their cash flows. For example, the treasurer of Ford's operations in Europe will be in and out of the "portfolio" markets as he manages the cash and other financial assets involved in the business. Any classic direct investment of any size and autonomy will have a similar treasurer's function, and be an active portfolio investor. Portfolio investment characteristically accompanies direct investment across borders. An agreement limited to FDI denies the benefit of the agreement to portfolio investor partners and to the portfolio operations within a direct investment and thus will act to discourage FDI.

7. Restrictions on portfolio capital flows to capital-starved countries is not a long-term solution to financial instability.

14. In the aftermath of the financial crises of the 1990's, there has been criticism of capital market liberalization for promoting short term capital inflows – sometimes referred to as "speculative capital" – into emerging market economies. The problem is not with capital market liberalization, or with short term capital flows per se. Empirical research by the World Bank demonstrates that in the long run, volatility tends to *decrease* following liberalization and integration with world financial markets.

³ "International Portfolio Flows and Security Markets", Rene M. Stulz, in *International Capital Flows*, edited by Martin Feldstein, University Chicago Press, 1999, pp. 257-293. Pre-publication working paper.

⁴ "International Financial Integration and Developing Countries", World Economic Outlook, IMF, October 2001, pp. 152-159.

One study, which examined a sample of 103 countries from 1980 to 1996, found that portfolio investment was only slightly more volatile than FDI. Among 85 emerging market countries over the same interval, the levels of volatility of FDI and portfolio investment were actually equal.⁵ However, the *process* of capital account opening has been shown to raise, temporarily, the danger of volatility.⁶ This argues for a careful approach to financial liberalization itself, mostly through the establishment of supportive macroeconomic and structural policies, in particular, improved bank regulation, prudential standards, and other safeguards.

15. In the Asian financial crisis, certain countries were vulnerable to sudden capital outflows in part because their domestic banks had too much exposure in short-term foreign currency-denominated borrowing. In some cases, bank customers were permitted to borrow short-term in hard currency even though proper credit analysis would have shown they were not good risks for such lending. The solution is not to restrict portfolio investment *per se*, but to improve financial supervision, surveillance, and risk analysis, such as through standards developed by the Financial Stability Forum, which was established shortly after the Asian financial crisis to strengthen international financial cooperation and stability.

8. Excluding portfolio investment defeats the purpose of an international investment agreement.

16. Governments should be as open to portfolio investment as they are to direct investment. There is general agreement on the positive role of investment in promoting sustainable growth in developing economies. This is true of both direct and portfolio investment flows. Potential investors would have to question the commitment to liberalization and investment protection of a country that would not agree to extend treaty rights to portfolio investment.

17. Including portfolio investment in the definition of investment does not mean that host governments will not be able to treat portfolio investment differently from direct investment. Most regulations of the financial markets need not violate the agreement, as they need not discriminate between foreign and domestic investors. In a U.S. Bilateral Investment Treaty (BIT), for example, the transfers provision permits financial market regulators to prevent or delay a transfer if necessary for the proper functioning of the market, and allows for the mandatory reporting of transactions that may be required by financial regulations.

II. CONCLUSION

18. The United States favours a broad definition of investment that includes both direct and portfolio investment. Our experience, based on negotiation of more than forty BITs, the NAFTA, and the ongoing FTAA and bilateral FTAs with Chile and Singapore, is that a broad, open-ended definition is necessary to maximize the benefits of investment liberalization and protection. We believe that covering portfolio investment can contribute to the development agenda of this round by making developing and emerging market countries more attractive hosts to foreign capital, deepening local financial markets, and furthering global economic integration. We would be interested in exploring with our colleagues how best to realize the advantages of portfolio investment coverage while responding to the challenges, for example, through technical assistance and capacity building in

⁵ "Negative Alchemy? Corruption, Composition of Capital Flows, and Currency Crises", Shang-Jin Wei and Yi Wu, Working Paper 8187, National Bureau of Economic Research, March 2001.

⁶ "Globalization, Growth, and Poverty: Building an Inclusive World Economy", World Bank, 2001.

the areas of bank supervision and regulation. The task ahead is to build on our shared experience of covering portfolio investment in our bilateral treaties, and to internationalize it in a high-standards investment agreement from which all WTO members may benefit.
