Rules on Outward FDI Also Necessary

By Noboru HATAKEYAMA

I wrote about the necessity of establishing international investment rules in this column for the May/June 2006 edition of *Japan SPOTLIGHT.* At that time, I stressed the aspect of inviting SME investments in developing countries as a reason for such rules. Of course, what I was writing about was on inward foreign direct investment (FDI). This time I would like to refer to outward FDI on which there are no rules whatsoever. It is completely at the discretion of a government to restrict or prohibit outward FDI.

However, before elaborating on this subject, let's look at the outlines of current international investment rules. With regards to inward FDI, there are two categories where international rules are in place. The first category includes rules in the WTO regarding FDI. These rules include TRIMs (Trade-Related Investment Measures) and general rules on the service sector – known as the General Agreement on Trade in Services (GATS) – that also apply to inward FDI.

TRIMs, for example, prohibit an investment-recipient country from requiring foreign investors to export a certain amount of output or purchase domestic parts and components. Cases that TRIMs cover are limited and, although there are certain rules on service-sector investments, no rules exist on investments in non-service sectors such as manufacturing.

The second category includes a bilateral investment treaty, a free trade agreement and a friendship, commerce and navigation treaty. These treaties stipulate protection of inward FDI and sometimes favorable treatment for FDI such as most favored nation (MFN) status, national treatment and an obligation to liberalize FDI. Of course these treaties apply only to their signatory countries and there are no general rules applied for every sort of investment.

As mentioned above, although there are some rules applied to FDI, their coverage is limited and when it comes to outward investment, there are no rules whatsoever.

Let me explain more specifically about the necessity for establishing an international investment rule on outward investment.

As of now, every country in the world faces at least two crises: the economic crisis and the crisis of climate change.

To mitigate the impact of the economic crisis domestically, the government may be tempted to prohibit outward FDI to keep jobs unaffected at home. The fundamental nature of this government conduct is exactly the same as with import restrictions a government may adopt to protect indigenous industries and keep jobs. Such import restrictions violate WTO rules in principle. However, strangely enough, the prohibition of outward FDI is not illegal. Even if a country has done so, other countries cannot protest it, at least legally, because of the absence of international investment rules.

More perplexing is the case with climate change. The EU has been implementing the "cap and trade" system to limit greenhouse gas (GHG) emissions and many other developed countries are trying to do likewise for a post-Kyoto Protocol framework. Then, companies in those countries will be unable to emit GHG above the limit (cap) placed on them. If there is a country without a cap and trade system, those companies invest in the country to escape obligations to abide by caps imposed upon them in their home countries, contaminating the air of the recipient country. Unfortunately, however, the air has no national borders. If the air of a recipient country is contaminated, the air of home countries will also be polluted in due course. Then, the cap and trade system adopted by developed countries will become meaningless. Climate change is a global issue, literally. If emitting a lot of GHG in their home countries is no good, emitting GHG in other countries should be no good either.

In this respect, the behavior of those companies investing in foreign countries to escape GHG obligations in their home countries can be compared to exporting waste to other countries. Exporting hazardous waste to other countries is prohibited in principle by an international rule called the "Basel Convention" unless destination countries accept the waste. Likewise, shouldn't a similar rule be established on outward FDI in countries that will not limit GHG emissions quantitatively? Should the government of a home country of those companies prohibit them from investing in countries not participating in the cap and trade system? Or, on the contrary, should the government be prohibited from restricting outward FDI?

As is shown in these two cases, there is an urgent need to have an international rule on outward FDI in addition to general rules on inward FDI. JS

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