*Chapter 8*

# TRADE-RELATED INVESTMENT MEASURES

## OVERVIEW OF RULES

In the late 1980s, a significant increase in foreign direct investment was taking place throughout the world. Some of the countries receiving that foreign investment, however, imposed numerous restrictions on it that were designed to protect and foster domestic industries and to prevent the outflow of foreign exchange reserves.

Examples of these restrictions include local content requirements (which require that locally-produced goods be purchased or used), manufacturing requirements (which require certain components be domestically manufactured), trade balancing requirements, domestic sales requirements, technology transfer requirements, export performance requirements (which require that a specified percentage of production volume be exported), local equity restrictions, foreign exchange restrictions, remittance restrictions, licensing requirements, and employment restrictions. Some of these investment measures distort trade in violation of GATT Article III and XI, and are therefore prohibited.

Until the completion of the Uruguay Round negotiations, which produced a well-rounded Agreement on Trade-Related Investment Measures (hereinafter the "TRIMs Agreement"), the few international agreements that provided disciplines for measures restricting foreign investment provided only limited guidance in terms of content and country coverage. The OECD Code on Liberalisation of Capital Movements, for example, requires Members to liberalize restrictions on direct investment in a broad range of areas. The OECD Code's efficacy, however, is limited by the numerous reservations made by each of the Members. In addition, there are other international treaties, bilateral and multilateral, under which signatories extend most-favoured-nation treatment to direct investment. Only a few such treaties, however, provide national treatment for direct investment. Moreover, although the APEC Investment Principles adopted in November 1994 provide rules for investment as a whole, including non-discrimination and national treatment, they have no binding force.

## LEGAL FRAMEWORK

GATT 1947 prohibited investment measures that violated the principles of national treatment and the general elimination of quantitative restrictions, but the extent of the prohibitions was never clear. The TRIMs Agreement, however, contains statements prohibiting any TRIMs that are inconsistent with the provisions of Articles III or XI of GATT 1994. In addition, it provides an illustrative list that explicitly prohibits local content requirements, trade balancing requirements, foreign exchange restrictions and export restrictions (domestic sales requirements) that would violate Article III:4 or XI:1 of GATT 1994. The TRIMs Agreement prohibited those measures that are mandatory or enforceable under domestic law or administrative rulings, or those with which compliance is necessary to obtain an advantage (such as subsidies or tax breaks). Figure 8-1 contains a list of measures specifically prohibited by the TRIMs Agreement. Note that this figure is not exhaustive, but simply illustrates TRIMs that are prohibited by the TRIMs Agreement. The figure, therefore, calls particular attention to several common types of TRIMs. We note that this figure identifies measures that were also inconsistent with Article III:4 and XI:1 of GATT 1947.

Indeed, the TRIMs Agreement is not intended to impose new obligations, but to clarify the pre-existing GATT 1947 obligations. Under the WTO TRIMs Agreement, countries are required to rectify any measures inconsistent with the Agreement within a set period of time, with a few exceptions (noted in Figure 8-2).

Figure 8-1

Examples of TRIMs Explicitly Prohibited by the TRIMs Agreement

| | |
|---|---|
| *Local content requirement* | Measures requiring the purchase or use by an enterprise of domestic products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production. (Violation of GATT Article III:4) |
| *Trade balancing requirements* | Measures requiring that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports. (Violation of GATT Article III:4) Measures restricting the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports. (Violation of GATT Article XI:1) |
| *Foreign exchange restrictions* | Measures restricting the importation by an enterprise of products (parts and other goods) used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise. (Violation of GATT Article XI:1) |
| *Export restrictions* (*Domestic sales requirements*) | Measures restricting the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production. (Violation of GATT Article XI:1) |

Figure 8-2

Exceptional Provisions of the TRIMs Agreement

| | |
|---|---|
| *Transition period* | Measures specifically prohibited by the TRIMs Agreement need not be eliminated immediately, although such measures must be notified to the WTO within 90 days after the entry into force of the TRIMs Agreement. Developed countries will have a period of two years within which to abolish such measures; in principle, developing countries will have five years and least-developed countries will have seven years. |
| *Exceptions for developing countries* | Developing countries are permitted to retain TRIMs which constitute a violation of GATT Article III or XI, provided that the measures meet the conditions of GATT Article XVIII which allows specified derogation from the GATT provisions, by virtue of the economic development needs of developing countries. |
| *Equitable provisions* | In order to avoid damaging the competitiveness of companies already subject to TRIMs, governments are allowed to apply the same TRIMs to new foreign direct investment during the transitional period described in "Trade Related Investment Measures" above. |

## EXTENSION OF TRANSITION PERIOD

Under the TRIMs Agreement, Member countries are required to notify the WTO Council for Trade in Goods of their existing TRIMs that are inconsistent with the agreement. So far, 27 Members have notified the WTO of such measures. Figure 8-3 details the TRIMs which have been disclosed to the WTO by member countries. Most measures were local content requirements in the automotive and agricultural sectors.

The transition period for elimination of notified TRIMs expired at the end of 1999.[1] The TRIMs Agreement does, however, provide for an extension of the transition period should the Member be able to demonstrate particular difficulties. The Philippines (October 1999), Columbia (November 1999), Mexico, Romania, Pakistan, Argentina, Malaysia, Chile (all December 1999), Thailand (May 2000), and Egypt (February 2001) had requested the extension of their transition period from 1 to 7 years.

There was discussion during the third Ministerial Meeting in Seattle of granting extensions to developing countries, but no formal agreement was reached. The General Council and the Council for Trade in Goods are currently reviewing such requests continuously.

In November 2001, at the end of an extremely rocky road, an extension of the transition period for TRIMs elimination was granted up until the end of December 2003 for: Argentina, Colombia, Mexico, Malaysia, Pakistan, Romania, and Thailand, and until the end of June 2003 for the Philippines, on the condition that these countries submit elimination plans and undergo status reviews. No conditions were placed on Chile until the end of December 2001, and no decision has been reached for Egypt.

Figure 8-3

Outline of Notified TRIMs

| | Local Content | Trade Balancing | Foreign Exchange Balancing | Export Restrictions |
|---|---|---|---|---|
| Argentina | ## | ## | | |
| Bolivia | | | | * |
| Barbados | & | | | |
| Chile | ## | ## | | |
| Colombia | #, && | #, && | | |
| Costa Rica | * | | | |
| Cuba | #, * | | | |
| Cyprus | & | | | |
| Dominican Republic | * | &, * | | |

[1] Note that among the Members with TRIMs, Uganda is categorized as a least-developed country (LDC) and therefore has until 1 January 2002 for elimination.

| | | | | |
|---|---|---|---|---|
| Ecuador | # | | | |
| Indonesia | #, &, * | | | |
| India | * | | | #, &, * |
| Mexico | ## | | | |
| Malaysia | ## | | | |
| Pakistan | ##, * | | | |
| Peru | & | | | |
| Philippines | ## | | ## | |
| Romania | ##, ** | | | |
| Thailand | #, &&, * | | | |
| Uganda | * | * | | |
| Uruguay | | | # | |
| Venezuela | # | | | |
| South Africa | #, &, * | | | |

Notes

1) TRIMs for which no extension requests were filed Automotive #, Agricultural &, Other *.
2) TRIMs for which extension requests were filed Automotive ##, Agricultural &&, Other **.
3) Egypt, Nigeria, and Jordan have also informed the WTO of incentive systems for industrial promotion, but the nature and coverage of the systems is unknown.
4) Poland has also informed the WTO of income tax rebate for cash registers.

[THIS SYSTEM IS FAR TOO CONFUSING USE NUMBERS THAT CORRESPOND TO THE NOTE NUMBERS]

## ECONOMIC IMPLICATIONS

Figure 8-4 shows worldwide direct investments during 1999 and 2000. During 2000 global outgoing direct investment reached a record high of

$1,270.8 billion (approximately 15 percent from the previous year). One of the major factors in the growth in direct investments is the rapid expansion of international mergers and acquisitions (M&A).

The regional breakdown of direct investments demonstrates that approximately 90 percent of the global total comes from developed countries, which also attract approximately 70 percent of incoming direct investments. Developed countries continue to be the driving force. Developing countries are also posting record high levels of incoming and outgoing direct investments, but their share of the world total has declined.

Figure 8-4

Direct Investment Around the World ($, billions)

| | 1999 | | 2000 | |
|---|---|---|---|---|
| | Amount of outflow | Amount of inflow | Amount of outflow | Amount of inflow |
| Total | 10.058 | 10,750 | 11,499 | 12,708 |
| Developed Countries | 9,457 | 8,298 | 10.463 | 10,052 |
| Developing Countries | 580 | 2,220 | 995 | 2,402 |
| Russia and East Europe | 21 | 232 | 40 | 254 |

Source: World Investment Report 2001 UNCTAD.

Some governments view TRIMs as a way to protect and foster domestic industry. TRIMs are also mistakenly seen as an effective remedy for a deteriorating balance of payments. These perceived benefits account for their frequent use in developing countries. In the long run, however, TRIMs may well retard economic development and weaken the economies of the countries that impose them by stifling the free flow of investment.

Local content requirements, for example, illustrate this distinction between short-term advantage and long-term disadvantage. Local content requirements may force a foreign-affiliated producer to use locally produced parts. Although this requirement results in immediate sales for the domestic parts industry, it also means that this industry is shielded from the salutary effects of competition. In the end, this industry will fail to improve its international competitiveness. Moreover, the industry using these parts is unable to procure high-quality, lowpriced parts and components from other countries, and will be less able to produce internationally competitive finished products. The best the domestic industry can hope to achieve import substitution, but the likelihood of further development is poor. The consumer in the host country also suffers as a result of TRIMs. The consumer has no choice but to spend much more on a finished product than would be necessary under a system of liberalized imports. Since consumers placed in such a position must pay a higher price, growth of domestic demand will stagnate. This lack of demand also hinders the long-term economic development of domestic industries.

## FUTURE CHALLENGES

As noted above, some developing countries have been granted an extension for TRIMs elimination until the end of 2003 at the latest. Japan will be closely monitoring whether or not these countries actually eliminate their TRIMs in line with the elimination plans submitted with their extension requests.

From this perspective, the moves being seen in some developing countries to introduce new TRIMs are something that cannot be ignored if the TRIMs Agreement is to be implemented faithfully. Therefore, when necessary, resolution should be sought through WTO dispute settlement procedures.

Even developing countries should realize that they must eventually break their dependence on TRIMs. Japan and other developed countries should extend whatever assistance is necessary, both technical and otherwise, to facilitate the phasing-out of TRIMs.

It goes without saying that Japanese companies investing overseas are expected to increase the amount of parts they purchase locally for contribution to the local economy. Such efforts, however, should be carried out in economically viable forms tailored to the local corporate environment, rather than enforced through TRIMs or other policy-based regulations.

Faced with the rapid internationalization of developed countries' industrial bases, many developing countries are intensifying their efforts to attract foreign investment, hoping to draw on outside capital for their own industrial and economic development. We would note in this regard a new trend that is particularly prominent among Asian countries: relaxing investment restrictions to create an environment that is more attractive and inviting to prospective investors. We can say that developing countries should promote further measures to attract investors.

## Efforts to Establish New Rules Regarding Investment in WTO

### *1. Current Status of International Rules on Investment*

Despite the enormous expansion of the share of foreign direct investment (FDI) in international economic activities, no comprehensive multilateral investment agreement has yet been created to liberalize and protect investment and facilitate investment activities. Many investors are faced with problems such as foreign investment restrictions and a lack of transparency in host country laws. International disciplines need to be developed further to redress this situation, and it should be explored not only through bilateral and regional channels, but also by the establishment of a multilateral agreement on investment.

Multilateral rules relating to investment are so far represented by the Convention on the Settlement of International Disputes Between States and Nationals of Other States, which provides procedures for settling international disputes on investment, and the Convention on the Multilateral Investment Guarantee Agency, which provides for the establishment of MIGA as a means of promoting private direct investment in developing countries. The target and scope of these agreements is, however, limited.

Members of the OECD began negotiating a "Multilateral Agreement on Investment" (MAI) in 1995, but discussion stalled over the excessive liberalization commitments, the handling of general exceptions, and the inclusion of provisions regarding environmental and labour issues. France withdrew from the negotiations on the grounds that the high standard of discipline would violate national sovereignty, leading to the suspension of the negotiations in 1998.

### *2. WTO Considerations on Investment Rules*

#### 1) Disciplines in existing agreements

Some of the agreements concluded in the Uruguay Round address aspects of investment.

#### a) Agreement on Trade-Related Investment Measures (TRIMs)

The TRIMs Agreement prohibits trade-related investment measures that violate the general elimination of quantitative restrictions and national treatment, both basic principles of the GATT.

**b) Agreement on Subsidies and Countervailing Measures**

The SCM Agreement covers "specific subsidies" with a view to addressing those subsidies with a particularly high trade-distorting effect. "Specific subsidies" are those subsidies granted by host governments only to specific businesses or industries as an incentive to attract investment (tax breaks, for example), and fall within the "yellow" (subject to elimination) category as defined under the Agreement. Because the SCM Agreement deals with the granting of subsidies related to trade in goods, it does not cover all investment incentives.

**c) General Agreement on Trade in Services**

Article I:2 of the GATS specifies four modes of trade in services, of which the third, commercial presence (supply of services by a service supplier of one Member through commercial presence in the territory of another Member), covers direct investment in services (branch establishment by banks, etc.). General obligations that must be applied in all service sectors include most-favoured nation treatment and transparency, while obligations with respect to national treatment and market access are undertaken in these sectors according to the specific commitment for each sector and mode.

**2) Considerations under the Working Group on the Relationship between Trade and Investment**

As noted earlier, while a number of existing WTO agreements contain some investment-related disciplines, no comprehensive and integrated investment rules have yet been formed.

Many WTO Member countries, Japan included, have pointed to the need to create such rules in the WTO. In the Ministerial Declaration of the Second Ministerial Conference, which was held in Singapore in December 1996, it was agreed to establish a Working Group on the Relationship Between Trade and Investment. The Working Group met 15 times between 1997 and 2001, engaging in a broad range of considerations from analysis of the economic effect of FDI and its impact on development policy to discussion of actual provisions, including a definition of investment, transparency, and a development provisions.

At the same time, the Singapore Ministerial Declaration also noted that "the work undertaken shall not prejudge whether negotiations will be initiated in the future", and that "future negotiations, if any, regarding multilateral disciplines in these areas, will take place only after an explicit consensus decision is taken among WTO Members regarding such negotiations." The Working Group mandate was therefore limited in terms of considering more concrete aspects of investment rules.

**3) Key Elements of an Investment Framework**

Considerations to date have focused on the key elements of an investment framework, spearheaded by those Member countries supportive of the WTO creation of such rules. Main elements are: 1) the agreement should secure a transparent, stable and predictable conditions for international investment; 2) investment as defined in the agreement should basically comprise FDI; 3) transparency and non-discrimination (national treatment and MFN treatment) obligations should form the heart of the agreement; 4) dispute settlement procedures should only deal with state-to-state disputes; and 5) the development policies and the right of host countries to regulate should be respected.

**4) Fourth WTO Ministerial Conference Discussion and Results**

The Fourth Ministerial Conference, held in Doha, Qatar in November 2001, achieved little convergence between Japan, the EU and other WTO Members in favour of immediately launching negotiations toward the creation of a WTO investment framework. India, Malaysia, many African nations, as well as other Member countries perceived such negotiations to be premature and pushed instead for further Working Group considerations. After some coordination, the Ministerial Declaration noted that the Working Group would focus in the period until the Fifth Ministerial meeting on the clarification of investment framework components, with negotiations taking place after the Fifth Session on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations.

The chief reason that developing countries opposed the initiation of negotiations was a contradiction in needs. On the one hand, they recognize the importance of attracting investment to promote economic development. On the other, they also want to maintain development policies such as restriction of direct investment by foreign companies as a means of fostering domestic industry. Further, they are already heavily burdened by the implementation of existing agreements, and do not feel ready to deal with the creation of rules in a new area.

Member countries have to agree on negotiation modalities at the Fifth

Ministerial Conference, scheduled for 2003. The Working Group will need to engage in intensive considerations to lay the groundwork for the Ministerial, keeping in mind the specific content of a future investment framework.