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Investment Liberalization Agenda

by David C. Ranney

The Clinton administration has put investment liberalization at the center of much of its foreign policy regarding investment flows. But financial crises in Mexico, Asia, and Russia have raised serious questions about the impact of these policies—as well as those of global institutions such as the International Monetary Fund (IMF) and World Bank—on the global flow of investment capital into and out of nations.

Embedded in the North American Free Trade Agreement (NAFTA), the proposed Multilateral Agreement on Investment (MAI), the proposed Free Trade Agreement of the Americas (FTAA), and the terms of various structural adjustment programs of the IMF and World Bank is an agenda to liberalize the flow of investments (and capital generally) throughout the world. An important aspect of the logic behind liberalization is that national development is best served through unrestricted, global capital mobility. The policies that follow this logic constitute a comprehensive list of prohibitions against any conceivable national policies that would regulate capital flows into and out of a country.

Key Points

- Foreign policy concerning investment includes a common set of rules designed to liberalize capital flows.
- The institution of these rules has played an important role in the growing importance of portfolio investments that capture short-term returns through buying and selling.
- The liberalized investment agenda has eliminated (or greatly restricted) national policies that would direct foreign investment toward national economic development objectives.

Capital flows now constitute a greater portion of international commerce than does trade. There are three different types of international capital flows, each with different economic impacts: loans; foreign direct investment, in which a resident of one country obtains a lasting interest in and degree of influence over the management of a business enterprise in another country; and portfolio investment, which includes foreign purchase of domestic stocks, bonds, derivatives, and other securities. Portfolio investment tends to be short-term and gains its returns through interest payments, dividends, and most often buying and selling. Direct investment, on the other hand, seeks returns through the running of a successful enterprise.

Between 1977 and 1982 the growth of net capital flows from developed to developing nations consisted mostly of loans. Loans amounted to nearly $30 billion, while direct investment was $11 billion and portfolio investment was negative due to capital flight. During the 1980s and 1990s, however, debt payment crises in developing nations caused the IMF to refinance loans. The refinancing brought with it structural adjustment programs (SAPs) that reduced regulation on foreign direct investment. As a result of both the debt payment crisis and the liberalization of foreign investment rules, the composition of capital flows underwent a shift. Loans declined while foreign direct investment increased, and portfolio investments grew even faster than direct investments. As of 1994, the composition of capital flows from developed to developing nations was 45% direct investment, 49% portfolio investment, and 6% bank loans and other sources of capital flows.

Among the reasons for the growth of capital flows generally and their changing composition is the institution of rules in SAPs—as well as multilateral and bilateral trade agreements—that have liberalized capital markets. Although these stipulations are often characterized as deregulation, they are actually public policies that regulate what governments can and cannot do with regard to national and regional economic development policy. NAFTA provides an example of the nature of such investment-liberalizing rules. But these requirements are not limited to trade agreements. Many of the conditions in NAFTA are replicated in SAPs, in the proposed MAI, and in bilateral agreements between the U.S. and other nations. Taking NAFTA as an example, one clause requires nations to treat foreign investors and their investments "no less favorably" than domestic investors—the so-called "national treatment" clause. NAFTA also bans specific types of performance requirements on investors or investments. Among the performance requirements banned are rules requiring corporations: to export a level or percentage of a good or service; to achieve a level or percentage of domestic content; and to purchase supplies, services, or production inputs from specified sources.

NAFTA also prohibits the restriction of the transfer of the proceeds of investment activity out of a nation. This includes returns on investment such as profits, dividends, interest, capital gains, etc. It also includes proceeds from the sale or partial liquidation of an investment. The transfer rules specify that transfers may be made in "a freely usable currency at the market rate of exchange prevailing at the date of the transfer." And NAFTA stipulates that governments should permit capital transfers "without delay." These rules, in short, prohibit any regulation of capital flight, such as Chile's law that investment must remain in the country for at least a year. They also preclude the practice of requiring investors to deposit a portion of their returns in domestic bank accounts.

Problems With Current U.S. Policy

The size of capital flows and their changing composition give rise to important issues. These issues have specific implications for U.S. foreign policies concerning liberalized investment.

The reduction or elimination of capital controls, which is a universal aspect of these rules, has led to the growing dominance of portfolio investment in the composition of global capital flows. This trend is particularly pronounced in Mexico and Canada in the wake of NAFTA. In Mexico, between 1990 and 1994, 78% of foreign investment was portfolio investment. The comparable figure for Canada was 89%. In Canada, portfolio investment has grown at six times the rate of direct investment since January 1989, when the Canada-U.S. Free Trade Agreement (CUFTA) began being implemented. Without financial controls or regulation, growing dependence on this form of investment has played a destabilizing role in economic development, opening nations to speculative investment from the outside and forcing governments to raise interest rates, which discourages domestic investment.

In the case of the Mexican peso crash of 1994, for example, as the crisis began to unfold, speculators scurried to move their capital out of the country. Since NAFTA rules prohibited Mexico from restricting such capital flight, the government attempted to keep even more capital from leaving the country by raising interest rates, which already ranged from 20% to over 80%. High interest rates discourage domestic investment by making credit far too expensive.

NAFTA also impacted capital flows by enhancing the ability of corporations in NAFTA nations to establish financial institutions in each other's national territory. NAFTA did include some limitations on this activity in Canada and Mexico, but these limitations are being eroded. In Mexico's case, loosening restrictions on the ownership of financial institutions was part of the price of the bailout from its 1994 financial crisis. In Canada, the government's restrictions are under attack from Canadian banks that want to merge and become players in global banking. In both cases, NAFTA has significantly reduced the ability of governments to regulate capital flows and given control to private concerns.

Either eliminating or greatly restricting regulation of capital flows also fails to distinguish between the development potential of different industries and does not allow policymakers to steer direct investment into particular industries as part of an economic development strategy. This is important if a region wishes to take advantage of existing infrastructure and potential networks of economically linked firms to maximize employment of regional residents. National regulations can also be directed toward employment or wage enhancement of particular groups of workers—indigenous people, women, or (in the U.S. context), African-Americans and Latinos, whose disadvantaged labor market position often requires public intervention.

It is important to note here that industrial policy, targeted job training, priority hiring, and targeting specific industries and firms to be the beneficiaries of local purchasing requirements are examples of components of a package of economic development policies that have great potential for employment and wage enhancement for localities and regions. These practices are either greatly constrained or totally prohibited by liberalized investment rules.

Key Problems

- Without controls or regulations, the growing dominance of portfolio investment has played a destabilizing role in economic development, opening nations to speculative invasion from the outside.
- Liberalized investment rules undermine national and local government policies that attempt to ensure that direct investment will enhance the employment and wages of unemployed or underemployed workers.
- By opening the banking industry to foreign control, the liberalized investment agenda has compromised the ability of national governments to use economic policy for the benefit of their own people.

Liberalized investment rules also tend to forbid policies that seek to intensify employment potential and other multiplier effects of investment by enhancing national or local content of finished products. The nonlabor national content of items produced in Mexico's maquiladora industry, for example, is only 1.4%; and, overall, the nonlabor domestic content of Mexico's total exports has declined from 61% in 1983 to 9% today. Foreign investments that produce low-wage jobs in firms without links to the rest of the national or local economy offer minimal benefits for the receiving nation. But foreign investments that provide both fair wages and high local content produce multiplier effects that ripple throughout the economy. Sound economic development policy ought to be directed toward attracting such multiplier investments, but liberalized rules preclude setting such priorities.

Finally, liberalized investment rules tend to open up all industries, including banking, to foreign control. Such total deregulation seriously compromises the ability of national governments to use monetary and other economic policies for the benefit of their own people.

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An alternative foreign policy relative to capital flows should be grounded in mutually agreed-upon objectives for the regulation of these flows among the parties involved. It should be noted, in addition, that insofar as possible these objectives should be universalized to prevent the existence of regions without rules where capital could flow. This suggests that the basic principle of regulating capital flows toward mutually agreed-upon objectives must necessarily be implemented in a variety of contexts, including bilateral and multilateral trade pacts, policies of the IMF and World Bank, and special international agreements such as the MAI. New policies regarding international investment flows should be based on the following five objectives:

Key Recommendations

- Capital controls are needed to limit speculative assaults and alter the balance between portfolio and direct investment.
- Performance requirements on investments and modification or elimination of national treatment rules are needed to enable governments to develop and implement industrial and other economic development policies.
- Democratic enforcement and dispute resolution machinery are needed so that capital controls and performance standards are rigorously executed and fairly applied.

1. Regulations should limit speculation that results in rapid capital outflows such as occurred during the Mexican peso crisis. These regulations should be directed toward both internal and external sources of such speculation.
2. Controls should encourage direct investment as the predominant form of capital flow, reversing the trend toward portfolio investment.
3. Regulation of capital flows should allow for development strategies aimed at particular sectors or industries.
4. Regulations should encourage development that increases links to the local and national economy, yielding higher multiplier effects of investment.
5. Investment rules should not interfere with the ability of governments to implement national economic monetary and fiscal policies and to regulate banking practices within their countries.

Guided by these objectives, the following alternatives to current U.S. foreign policy should be considered:

- All policies governing capital flows should establish the right of nations or localities to plan for local economic development objectives, including raising employment levels, enhancing employment opportunities for targeted populations, and raising wage levels in specific industries. There should be provisions for nations exercising this right to offer special treatment to firms that will meet these objectives. Such special treatment should be based on a development plan to avoid the abuse of this provision.
- Performance requirement bans need to be eliminated. The lifting of many such bans could facilitate the implementation of policies that link industries in supplier chains and maximize local employment and wage targets. Performance requirements can also enhance the multiplier effects of investment. Examples of such requirements could include the establishment of domestic content targets and inducements to purchase from local suppliers.
- Capital transfer restrictions need to be replaced by positive policies that would limit rapid capital outflows and encourage direct (as opposed to portfolio) investments. Specific "speed bump" controls are needed to slow capital flight. These controls could take the form of an international transactions tax (e.g., the Tobin tax) or a national tax on financial assets held for less than a target length of time (e.g., the Keynes tax), or they could require that financial assets remain in the country for a specified period (as is currently the case in Chile). Lessening dependency on foreign portfolio investments not only lends more stability to national economies but also enables governments to utilize fiscal policies (government taxing and spending) to achieve economic development objectives.
- It is important that there be national control over banking so that each government can manage its money supply and regulate investment. Forbidding restrictions on foreign ownership of both financial and nonfinancial corporations undermines the effectiveness of national and local economic policy.

These proposed reforms are based on the premise that capital flows across borders can be beneficial to national and local economic development. But such flows must be regulated to ensure that economic development is broadly distributed. It is essential, therefore, that all modifications of national treatment rules, any application of performance requirements, and all restrictions on capital flows be components of larger economic development planning efforts. For this reason there is a need for new institutions and processes to ensure that restrictions on capital flows are applied fairly.

Corporate accountability to more than just monied interests must be a cornerstone to any investment watchdog process. Parties other than investors and financial institutions should be allowed to initiate a review of the application of capital flow regulations. Governments (including local governments), labor organizations, and NGOs should also have standing to bring complaints if they feel that the lack of enforcement of capital controls is damaging to their development goals or that controls are being applied unfairly. The process of review must be transparent and should include procedures that would generally fall under the heading of due process in U.S. law. Finally, remedies must have sufficient teeth to make the proposed capital controls effective, and corporations as well as governments should be subject to penalties.

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