WORLD TRADE ORGANIZATION

WT/WGTI/W/148
7 October 2002

(02-5396)

Working Group on the Relationship between Trade and Investment

Original: English

COMMUNICATION FROM INDIA

The following communication, dated 2 October 2002, has been received from the Permanent Mission of India.

DEVELOPMENT PROVISIONS[1]

1. Development is a complex process. There is no single formula that can fit into every economic situation in such a manner that it inevitably leads to growth. Developing countries, therefore, need policy space so that they can determine for themselves how the process of economic development can be speeded up and the welfare of their citizens enhanced. This also includes the policy space to determine the manner in which investment shall be regulated and channelled. Any multilateral discipline that seeks to limit this policy space, by its very definition, would reduce the policy options available to developing countries to use foreign investment for promoting development.

2. The basic assumption underlying the proposal for multilateral disciplines on investment is that the principle of free trade, which permeates WTO rules in respect of goods and services, would apply equally to movement of capital. If conditions of a perfect market prevail, then freedom of international capital movement could possibly lead to benefits both for home and host countries and for investors. This is not a realistic situation. In a paper[2], Barry Eichengreen of the University of California, Berkeley states that:

> "efficient markets paradigm is fundamentally misleading when applied to capital flows. Limits on capital movements are a distortion. It is an implication of the theory of the second best that removing one distortion need not be welfare enhancing when other distortions are present. There are any number of constellations of distortions, especially in developing countries for which this is plausibly the case. If the capital account is liberalized while import-competing industries are still protected, capital may flow into sectors in which the country has a comparative disadvantage, with immiserizing effects. If a downwardly-inflexible real wage causes too many resources to be devoted to capital intensive activities, then a capital inflow may further aggravate this misallocation, again reducing the incomes and welfare of domestic

---

[1] Members are in the process of learning in the Working Group on the Relationship between Trade and Investment in accordance with the mandate outlined in paragraphs 20-22 of the Doha Ministerial Declaration read in conjunction with the Chairman's statement at the Ministerial Conference. The paper is a contribution to the learning process without prejudice to India's position on the need to establish any multilateral framework on investment within the WTO. India reserves the right to revert to the subject as and when its technical knowledge increases.

[2] Eichengreen, B, 2001, "Capital Account Liberalization: What Do the Cross-Country Studies Tell Us?", http:\\elsa.berkeley.edu/users/eichengr/bourgignonpaper6.pdf.

> residents. If information asymmetries are endemic to financial markets and transactions, then there is no reason to assume that financial liberalization, either domestic or international will be welfare improving. And even if information asymmetries in domestic markets are judged insufficiently severe to undermine the case for domestic financial liberalization, the same may not be true of international financial liberalization to the extent that international financial transactions take place among agents separated by greater physical and cultural distance. Insofar as these problems are most severe when the transactions in question involve developing countries, where the capacity to assemble and process information is least advanced, there can be no presumption that capital will flow into uses where its marginal product exceeds its opportunity cost."

3. Studies by Gordon Hanson, Brian Aitken and Harrison have highlighted cases where foreign investment may have lowered host-country welfare.

4. The point is that financial flows in no way resemble flows of goods and services. There is no tangible, direct linkage between buyers and sellers. Money, by its very nature, is more fluid, less transparent, in its movement. It has been the experience of many developing countries in recent years that overwhelming emphasis on external capital, be it in the form of commercial borrowing or investment resources, carries within itself the seeds of possible economic crisis, which, in the case of impoverished developing countries, can assume the form of a huge human disaster with its own implications in terms of political and economic stability in the region and, indeed, in the world as a whole. Developing countries must never subscribe to any doctrine that would limit policy flexibility in this important area. The problem is further compounded by the fact that money can assume many different forms from time to time with the result that it is, even now, difficult to monitor its movement.

5. The developing countries would also need policy flexibility to determine the form of investment that would lead to highest growth. There is a need to focus on those investments that contribute to the expansion of trade, as clearly indicated by Ministers at Doha. The definition of investment would have important implications for the development dimension. Greenfield investments, for example, would be of more significance than mergers and acquisitions as they could have more beneficial spread effects on the economy. Likewise, developing countries would need to guard against the crowding out effect of foreign investment, as pointed out in UNCTAD's World Investment Report of 1999. Any movement of capital that would cause serious damage to the domestic industry, particularly small- and medium-sized enterprises and have adverse effects on employment would need to be carefully regulated. Developing countries need to retain the ability to screen and channel foreign investment in accordance with their domestic interests and priorities. Bilateral investment treaties have been favoured the world over precisely for the flexibility they provide to the host country in this regard.

6. The need to establish home-country and investor responsibilities and obligations even while we talk of host-country obligations was made by UNCTAD in the April 2002 meeting of the Working Group. While foreign investment could generate positive changes in the economy through the induction of capital, technology, managerial and marketing skills, it could also have various negative effects. It need not necessarily bring in any significant new technology as empirical evidence presently indicates, generate little value added for employment or develop linkages with domestic industry in the host country. The objective of global profit maximisation by trans-national corporations rather than by each new subsidiary may sometimes result in conflict of interests with the developing host country being the loser in many cases. It is important, therefore, that the Working Group discusses also a binding code of conduct on investors with a further stipulation that it shall be enforced by home countries through a set of precise domestic laws that can be activated by any host country.

7. There is a need to have a fresh look at performance requirements. Empirical studies have shown that affiliates of certain trans-national corporations buy the bulk of their inputs from parent companies and other affiliated companies leaving only a small proportion for unaffiliated suppliers within the host country or in third countries. UNCTAD's Trade and Development Report 2002 has highlighted the poor record of generation of value added and linkages by trans-national corporations. It is also an undeniable fact that until recently performance requirements were an integral part of the growth strategy of all developed countries. It is important, therefore, that performance requirements on employment generation, transfer of technology, export performance requirements, manufacturing requirements, training and research and development requirements etc., remain available to developing countries to ensure that foreign investment contributes to the achievement of development policy goals.

8. The General Agreement on Trade in Services (GATS) does not impose any prohibition on performance requirements. It further envisages limitations on national treatment in respect of sectors covered by commitments. This point is relevant particularly because there has been some attempt to draw a parallel between mode 3 of GATS and investment disciplines.

9. Another point to which attention needs to be drawn is the possible damaging effect of capital outflows on balance-of-payments. There are many recent cases of such damage to the economies of developing countries. While this calls for further policy flexibility to maintain restrictions on outflows, there is also a strong case for performance requirements such as export obligations and foreign exchange neutrality to moderate the adverse effects of capital outflows.

10. Capital is a factor of production and, as such, is not more or less significant than any other factor of production. If disciplines aimed at freer movement of capital are being considered then in the interests of the development needs of developing countries, the need to simultaneously build in disciplines facilitating movement of labour, particularly professionals and skilled personnel, could be a compelling argument.

11. To conclude, money falls in the category of neither goods nor services. WTO is a trade-negotiating forum: it is neither a forum of bankers, nor of monetary economists. The less-developed countries in the WTO do not have the skills and the expertise that the richer countries have. Perhaps the best contribution that can be made to the cause of development is to understand the limitations of developing countries and focus only on trade issues within the WTO.

____