

A Multilateral Agreement on Investment: Convincing the Sceptics

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I Introduction

We have recently witnessed an explosion of interest in a multilateral investment agreement in the press and in the academic and policy circles. The interest mainly originates in the spread of regionalism and in controversies about the merits of globalisation in general and the role of foreign investment and multinational enterprises in particular. Moreover, the recent currency turmoils and the widespread concerns about the volatility of international capital flows have provided an additional impetus to the debate on the desirability of a multilateral agreement on foreign investment.² Finally, and perhaps more importantly, the topic has been highly debated in recent months in the aftermath of the Uruguay Round. Reviewing the existing agenda of the World Trade Organization and preparing its future agenda at the recently held Ministerial Conference of the WTO in Singapore, many member countries were pressing for the inclusion of a Multilateral Agreement on Investment (MAI) on the agenda of the WTO. At the end, the topic was not included, and the countries have basically only agreed to further explore on the analytical level the issues related to trade and investment.³ For the time being, the question of whether and when an MAI will be negotiated remains uncertain.

1 The views expressed in this paper are personal and should not necessarily be attributed to the World Trade Organization. I would like to thank, without implicating, the following persons for their helpful comments: Mohamed A. El-Erian, Deputy Director at the IMF, Prof. Ernest Aryeetey of the University of Ghana, Prof. Arvind Panagariya of the University of Maryland, Robert Devlin, Chief of Integration, Trade and Hemispheric Issues Division of the IDB, Ricardo Ffrench-Davis, Senior Regional Adviser of ECLAC, Percy Mistry, Chairman of Oxford International Group and Jan Joost Teunissen, Director of FONDAD.

2 The recent meeting of 15 developing countries in India leading to a joint G-15 declaration as well as the public support of President Chirac to some of these countries' positions serve as a testimony to the general nervousness in the community of world leaders. President Chirac's statement was made at the press conference in Langkani, Malaysia on 17 November 1997 during his state visit.

3 The issues and the controversies have been amply reviewed in a number of studies including, for example, WTO (1996), UNCTAD (1996) and Graham (1996).

These controversies clearly demonstrate that there has not been enough agreement about the need for an MAI, even though the pendulum is swinging more towards the ‘multilateralists’. While the need for foreign direct investment (FDI) is generally recognised – even among the sceptics – the push for an international agreement has been rather lukewarm in some countries. This lack of enthusiasm or sometimes even an outright hostility could be a serious problem for the international trading system and for capital markets. *First*, the question of MAI divides the WTO member countries into those who support the idea of an agreement and those who are against it. In other words, this is a divisive issue which could also hamper progress in other areas of WTO jurisdiction. *Second*, the division has gone along the lines of important country groupings – developed versus some less developed countries (LDCs). This, too, is a serious business because of the interest of developed countries in having LDCs integrated into the multilateral trading system. *Third*, FDI has been growing dramatically over the last decade or so, resulting in a rapid pace of globalisation, and a significant contribution of foreign capital to investment in many countries of the world. Unfortunately, the growth of FDI has been uneven, with some LDCs benefiting more than others, leading many people in academia and policy circles to fear that the latter countries, or at least some of them, will be ‘marginalised’. *Fourth*, there does not seem to be an agreement on the need for an MAI among international public institutions that give advice on trade and investment policies to countries. For example, the recent *World Investment Report* of UNCTAD (1996a) concludes that the present system “is working well, and we could go both ways to regulate FDI – through regional and bilateral approaches or a multilateral approach”. In contrast, the WTO (1996) is quite clear about its position when it argues that, “based on the available evidence, the case for a multilateral agreement on investment is strong”. More or less the same position is taken by OECD member countries which have been negotiating their own plurilateral investment agreement. Notwithstanding the recent difficulties in resolving the remaining negotiating hurdles and the relatively limited country coverage, the OECD member countries have been sympathetic to the idea of a worldwide agreement, and hope that other countries will sign-up on the agreement.⁴

The crucial question of whether an MAI is desirable, therefore, still lingers over the heads of trade ministers and other politicians. But even if one believes that there is an unambiguous need for an MAI, the question

4 In the meantime, the negotiations among OECD countries have run into difficulties, and their outcome still remains uncertain. This paper is written on the assumption that some sort of an agreement will ultimately be reached.

remains what kind of agreement should be proposed. 'Too much' regulation can be costly, while 'too little' regulation may be imprudent. Additional questions are: Who should be responsible for the conduct and the implementation of such an MAI? Should countries seek an agreement on a relatively smaller scale such as, for example, the ongoing negotiations of the OECD, or should they aim for 'higher' goals and involve all countries that are members of, say, the WTO or some other bodies?

The purpose of this paper is to respond to at least some of these questions. The principal question is whether there is indeed a need for a multilateral agreement on investment. As we shall see, there are arguments in favour and against but, on balance, I argue that the positive side of an MAI is considerably more powerful than the negative effects. Since much has already been written about the merits of MAI, I shall only summarise the main arguments. What is novel in this paper is the attempt to address the concerns of the sceptics. Given the lukewarm reaction in some countries, it seems sensible to pay more attention to those arguments that have been critical or outright negative about an MAI. This paper will not address other important questions such as what should be the content of an MAI and who should be responsible for its negotiations and implementation.⁵

Another qualification is in order. The discussions about the merits or flaws of MAI are often clouded by misunderstandings. A first one is the fear that an MAI will not guarantee an increase in FDI for a signatory (Third World) country. This is clearly true since the argument in favour of MAI simply states that MAI is a necessary but not a sufficient condition. Proponents of MAI only argue that MAI will increase the transparency of government commitments and, hopefully, improve conditions for access of FDI. Obviously, MAI does not provide a guarantee of increased FDI. As an English saying would have it, "you can lead a horse to water, but you cannot make it drink". A second misunderstanding about MAI is the concern that the effects of FDI on economic development are not fully known. During the last WTO Ministerial Meeting in Singapore, some members argued that these effects should first be studied before governments engage in negotiations. Once again, this is more an empirical question rather than a question of substance. A third misunderstanding is that the push for a multilateral agreement is inconsistent with the recent trend towards liberalisation in all parts of the world. However, a multilateral agreement should not be interpreted as a regulatory agreement even though it would have elements of regulatory provisions. The merit of MAI would be that it increases the credibility of government commitments. As Graham recently

⁵ Some of these questions have been covered in a number of articles such as in Graham (1996).

put it, “policy reforms in nations, even in one where there is a groundswell moving in the direction of liberalisation, are likely to be more profound and enduring if these reforms are backed by international standards ...”. Moreover, “the international standards would help, or prevent any future ‘backsliding’” (1996b, p. 6).

The paper is divided into four sections. Section II summarises the main arguments in favour of MAI. Section III, which is the main part of the paper, discusses the arguments against an MAI. Section IV addresses the issues raised by the critics from a somewhat different angle by trying to evaluate the relevance of the specific arguments. Section V offers some policy recommendations.

II Arguments in Favour of MAI

There are powerful arguments in favour of MAI. Many of these have been recently discussed and documented in a WTO report (1996) which also contains a useful review of the main arguments. They are as follows.

Growing Importance of FDI. The reality of the post-war economic developments has been the growing importance of FDI in many countries of the world and in international economic relations. This trend has accelerated in the last decade. During 1986-1989, and again in 1995, outflows of FDI grew much more rapidly than world trade. Over the period 1973-1995, the estimated value of annual outflows multiplied more than twelve times (from \$25 billion to \$315 billion) while the value of merchandise exports multiplied more than eight and half times (from \$575 billion to \$4900 billion). Sales of foreign affiliates of multinational corporations are estimated to exceed the value of world trade (\$6100 billion in 1995). In many countries, FDI has already ‘taken over’ as the most important component of external financial flows, exceeding even official assistance.

The growth of FDI has its origin in powerful forces of capital movements which go hand in hand or may even replace trade flows. It is generally thought that these forces work very strongly both on the supply-side (home country) and demand-side (host country). In home countries, these forces include the benefits from increased market access and improved competitiveness due to a better access to cheaper inputs or to strengthening of the company’s capital base as result of strategic alliances with foreign partners. For the host countries, the benefits of FDI include an improved access to technology, marketing channels, organisational and managerial skills, and the contribution to domestic savings and investment.

A number of studies such as WTO (1996) and the research carried out by the Centre d'Études Prospectives et d'Informations Internationales in Paris clearly show that there is a strong element of complementarity between trade and FDI, both in the home and host countries. In other words, trade tends to encourage FDI, and FDI tends to encourage trade. The contribution to domestic resource allocation and investment can also be very positive. For example, in Czech Republic the share of total capital flows in GDP represented 17 percent in 1995 and, in the case of domestic savings, the share was even an astonishing 84 percent!⁶ The corresponding numbers in Hungary and other countries are equally impressive.⁷

The dramatic growth of FDI also has several downsides. One of these is the rising investment risk to investors as they expand their foreign portfolios of FDI. As a result, the costs of risk cover of FDI increases which, in turn, will tend to increase the costs to host countries. At the same time, as the country exposure to FDI increases, the host countries will become subject to increased risk of capital flight and vulnerability.

Transparency, Predictability and Legal Security. Foreign investors need transparent and predictable rules on which they can operate, and these rules must include legal security. Otherwise, they would require a corresponding financial return as compensation for these additional risks. In many circumstances, such risk and the corresponding rewards would be prohibitive for the host countries. A powerful argument for an MAI is, therefore, that it will provide the needed transparency, predictability and legal security. The opposite – the lack of transparency, predictability and legal security – is precisely what is often the origin of difficulties for countries to attract FDI and other types of foreign capital. Unclear, ambiguous, biased and controversial rules are the classical deterrent to foreign investors. Unwritten conventions or traditions do not have the same value as agreements signed by governments.

National Legislation Is No Alternative. Many developed and developing countries have been undergoing a rapid and profound process of policy liberalisation. The process has affected fiscal, monetary, financial, infrastructural, trade and other policies (Drábek and Laird, 1997). The process has made both outward and inward FDI more attractive but the legal provisions underlying this process are not sufficient. In fact, the absence of an international agreement can have serious consequences for

⁶ Some of these questions have been covered in a number of articles such as in Graham (1996).

⁷ See, for example, Drábek (1997).

FDI flows. First, foreign investors need a legal protection to do business. Without such a protection, the risk of doing business in a foreign country may be so excessive that they decide not to invest. Moreover, the cost of compliance may be too high, resulting in investment that would typically be highly speculative and short term. Second, national legislation is often not sufficient to provide adequate security to foreign investors. National laws and their enforcement may differ between the host and home country requiring, in the very least, an international mechanism for dispute settlement. What is typically needed is an international agreement which must be reached by governments in order to have moral authority. These agreements should be supported by national legislation in order to be enforceable. Third, given the risks of doing business in foreign countries, investors will, *ceteris paribus*, choose those countries in which the legal protection of their investment is most secure.

The need for an intergovernmental agreement can be clearly seen in the example of the financial sector. The deregulation of financial markets together with technological progress has led to an explosion of cross-border financial services. This, in turn, generated the need for international agreements among different participants in the market. Two types of agreements have emerged over time; agreements signed by private sector agents and agreements signed by governments. There are merits to both types of agreements. However, the agreements signed by the public sector have been the ones that encouraged the growth of cross-border competition.⁸

Policy Coherence. There has been a dramatic proliferation of various international agreements in the past. Many of these agreements have been signed bilaterally, others are regional (such as NAFTA and Mercosur) or plurilateral. By June 1996, the total number of bilateral investment treaties was nearly 1160, of which two thirds were signed during the 1990s (WTO, 1996 and UNCTAD, 1996). In brief, we are already facing what Jagdish Bhagwati has termed a 'spaghetti bowl' of bilateral, sub-regional and regional agreements which is associated with a number of serious systemic dangers. The existence of all these agreements and the initiative of a limited number of countries to negotiate an MAI are highly problematic. Different agreements often have different coverage of issues and may even apply different rules. Separate negotiating initiatives increase the risk of inconsistent rules established in different agreements. As WTO (1996) has pointed out, the current members of the WTO would have to sign 7503 agreements if they wished to provide the investment protection through bilateral treaties. With such a large number of treaties, inconsistencies are

8 See, for example, Drabek (1997).

virtually inevitable. All of this tends to lead to confusions, uncertainties and legal conflicts. Moreover, the presence of different agreements also increases the costs of doing business, something that is often overlooked by the proponents of bilateral and regional approaches. This, too, is an impediment to FDI. In sum, the need for rule and policy coherence is now well recognised among all major analysts who have been involved in the discussion.⁹

Marginalisation of Non-Signatories. One serious problem of regional or bilateral agreements is the marginalisation of those countries that are not signatories of these agreements and remain outside the MAI or the existing plurilateral or regional investment agreements. It is evident that foreign investors will always prefer to do business with those countries in which they have a legal protection through an international agreement. Clearly, a major disadvantage of the current OECD-sponsored initiative to negotiate an MAI is the fact that the agreement is negotiated by OECD countries. Countries that are not OECD members remain outside of the negotiation process even though it is assumed that any country will be invited to sign on the actual agreement once it is concluded.

Thus, there are two main advantages of a truly multilateral MAI. First, it is a 'complete' instrument while regional, bilateral and plurilateral agreements are not. Second, a non-MAI would have to be a stand-alone agreement which would still have to be integrated into international law.

Competition for FDI. It is sometimes argued that governments should adopt policies of fiscal incentives to encourage FDI. In practice, the policies have indeed been adopted quite frequently. However, while there may be a theoretical argument in favour of such incentives under rather extreme conditions, the general position of most economists is that incentive schemes are distortionary, inefficient and also costly. Moreover, a system of fiscal incentives may not even be effective to achieve the desired objective of attracting FDI because other countries that provide more generous fiscal incentives may divert FDI away from those countries that provide less generous incentives. Last but not least, competition for FDI is intense as more and more countries are hoping for a greater share of FDI inflows. Richer countries can provide more attractive incentives leading to further marginalisation of poorer countries.

In order to reduce the likelihood of further marginalisation of poorer

⁹ The need is recognised even by those who may not necessarily favour an MAI but may prefer to rely on a set of regional, bilateral and plurilateral agreements such as UNCTAD (1996: 161).

countries and the waste of resources needed to finance these incentives, the recourse to fiscal incentives as a stimulus to attract FDI must be eliminated. The problem is, however, how to convince countries to stop using incentives even if they know that these policies are wrong. In the presence of competition from other countries using fiscal incentives, it is very unlikely that any single country will be willing to abandon the practice of fiscal incentives unilaterally. The country will be prepared to do so only if other countries are prepared to give up their policies of fiscal incentives as well. Such a concerted action would clearly require an international agreement.

III The Opposition to MAI

The arguments against an MAI are relatively less powerful but have so far been effective enough to block all serious attempts for multilateral negotiations of FDI rules. The arguments are less powerful because they have been supported by fewer countries, and because their intellectual merit tends to be weaker. In addition, the arguments are often not directed at MAI but rather at FDI and 'globalisation' in general. We shall, therefore, make the corresponding distinction in our treatment of the criticism in the following presentation. We shall start with the criticism that, in my view, does not stand on firm foundations and can be remedied through negotiations of an MAI (Section A). The separate question of 'globalisation and its effects' is the subject of Section B. Finally, sensible criticism of MAI is discussed in Section C.

A. Responding to Concerns of Critics of MAI

The criticism of MAI can be divided into the following categories.

Security Considerations. Security considerations are arguably the one legitimate reason that can give governments a certain degree of discretion over decisions concerning foreign investments. Most writers, including economists, would probably agree that investment decisions concerning, for example, defence industries or police would justify governments giving preferences to domestic suppliers and investors over foreign ones. The problem that is often encountered in practice, however, is that the definition of what constitutes a security interest for a country is ambiguous and, as a result, countries have defined their security interests differently. For some this may mean a protection of special interest groups. Thus, for example, speaking on the eve of a Confederation of British Industries Conference on Zimbabwe, President Mugabe insisted that his

“government will play a leading role in the choice of foreign partners”. He went on to say that privatisation and foreign investment will be used to give the country’s black majority a greater share of the white-dominated economy.¹⁰ For others, it may mean a greater concern with equity which is what the Indian Prime Minister Deve Gowda had in mind when he argued that India wants “growth with equity”.¹¹ Doing business with Cuban companies that had been established from American assets nationalised by Fidel Castro’s government has also been seen by many American politicians and commentators as contrary to the American ‘security interests’. For others still, the security interest may call for a protection of certain industries or companies, often identified as the ‘national jewels’.

Negotiations of MAI are, therefore, unlikely to succeed unless countries have a clear understanding of what constitutes a national interest, and this understanding does not fundamentally deviate among countries. At present, this is not the case as we have already noted in the case of the Helms-Burton Act and the Cuba issue. Similar concerns have also been raised in the case of the recently proposed merger between Boeing and McDonnell Douglas. In reviewing the merger proposal, the EU competition body has been approaching the application for approval on the basis of ‘users’ impact. The competition authorities assess the merits of the case on the grounds of its effects in user countries rather than its effects on domestic competition.

Security interests are often also associated with the loss of sovereignty. The fear of ‘losing control’ due to globalisation, of losing the right to tax the residents on their territories and of foregoing the right to promote economic activities that are a national priority, are all examples that fall into this category. Clearly, no country has ever succeeded in hermetically closing its market to the power of technology and information, and it is unlikely that it will succeed in doing so against the forces of competition. No advocate of MAI has also ever proposed that countries will not be able to tax their own citizens. The countries may need to increasingly harmonise their tax regimes but they will do so to protect *their own interest*.¹² The promotion of certain economic activities is more controversial. Generally, this form of discrimination is not acceptable even on the grounds of ‘infant industry’, but certain exceptions can be envisaged. For example, measures to promote a regional balance, the unimpeded access to information or even environmental standards have long been an acceptable area of the so-

10 “Role of state vital, says Mugabe”, *Financial Times*, 5 March 1997, p. 7.

11 “India talks the talk”, In: *Wall Street Journal*, 10 March 1997.

12 See, for example, the need for coordination policies of fiscal incentives to promote FDI in the previous section.

called 'green light measures' in most bilateral and international agreements, and they should also be acceptable in a future MAI.¹³

Other Political Arguments. Closely related to the 'security interests' are other political objectives of governments. These may include a variety of interests such as (a) national priorities¹⁴, (b) 'social engineering' which identifies an attempt to restructure the countries' political and other institutions in accordance with the demographic characteristics of the society concerned;¹⁵ and (c) 'economic power' argument. This argument states that indigenous firms in developing countries will be destroyed and will not be able to compete with economically powerful transnational corporations. This argument is, for example, implied in the recommendation of UNCTAD (1996) when it suggests that "liberalisation of FDI would be too soon at present time since many LDCs have not yet adjusted to liberalisation measures adopted in the Uruguay Round". Finally, (d) some politicians have called for measures to protect countries from foreign investors on the grounds protecting 'culture' which could be destroyed through globalisation of investment. All of these arguments are identical or similar to those already discussed above and must be addressed through political discussions. There is very little that an economic theory can contribute. Perhaps the only exception concerns the 'economic power' argument which has a strong reflection in the 'new trade' theories.

Corporate Practices. Another critical argument concerns what I call 'corporate malpractices' for the lack of a better word. What I am referring to are practices of MNCs such as 'transfer pricing' which are often used as an example of the power of MNCs depriving host country governments of fiscal resources and leading to persistent dependence of these countries on MNCs. Similar criticism has been made by corporate critics when they argue that MNCs are taking advantage of globalisation to get around environmental and operating rules such as rules on labour conditions. In doing so, one needs to add, MNCs do not necessarily violate any law or rule in either in the home or the host country. However, the critics see these practices as unethical and highly detrimental to the development of

13 The legitimacy of certain types of subsidies, typically associated with policies to correct for elements of market failure, is also recognised in the WTO Agreement on Subsidies and Countervailing Measures, Article 1.

14 The position has been strongly articulated in the recent declaration of the Group of Fifteen (1996).

15 For example, such calls have been made for Malaysia by Khor (1996) who calls for a 'fine tuning' of the social and economic fabric through equity distribution. These issues are similar, if not identical, to those discussed under the heading of 'Security interests' above.

poor countries. They fear that a full-blown international treaty such as an MAI, facing approval by each signatory's parliament, will simply hand corporations more power if it is signed.¹⁶

Status Quo (UNCTAD Proposal). The need for an MAI has been contested by UNCTAD. In its annual report on foreign investment, UNCTAD (1996) concluded that the "current arrangements (concerning foreign direct investment regulation) are working well in providing an enabling framework that allows FDI to contribute to growth and development and in supporting a high and growing volumes of FDI".¹⁷ UNCTAD goes on to suggest that the current arrangements also "allow for countries of similar strength to enter into agreements". They also suggest that "transnational corporations are flexible and experienced enough in operating diverse policy frameworks and they can adapt to regulatory differences among countries". Rule coherence could be ensured in a "number of ways, e.g. by negotiating a global model bilateral investment treaty. Allowing countries and regions to develop their own approaches fosters policy competition which leads to a relatively rapid spread of best practices to FDI".¹⁸ The UNCTAD position is based on a detailed analysis of various agreements and, given its importance as a platform for the voice of developing countries, its proposal must clearly be taken very seriously.

However, the preservation of *status quo* hardly provides a satisfactory answer. We have already demonstrated above that there are strong arguments to support the idea of MAI. These have not been in any way repudiated or altered by the UNCTAD study. One implication of the UNCTAD proposal is that it will be necessary to create differentiated approaches to regulatory frameworks for FDI in order to allow for different national characteristics and conditions. This clearly would be highly impractical and costly as we have argued above. While it may be true that transnational corporations are flexible and can adjust to national differences, it will be naive to think that they will not seek less costly alternatives. These less costly alternatives must surely include those regulatory frameworks that reduce administrative costs of designing and implementing 'tailor-made' regulations. To me it is inconceivable that transnational corporations would accept a system in which they have to deal with hundreds of regulations as economically meaningful. Moreover, the high administrative costs

16 See *Journal of Commerce*, article on 'Giants', quoting the recent studies from the Washington-based Center for Public Policy and the Geneva/Gland-based Worldwide Fund for Nature.

17 UNCTAD (1996), p. 161.

18 *Ibid.*, p. 163.

of the present system will continue to discourage many potential investors who would find the regulatory framework expensive and lacking transparency.

Negotiation Strategy. One, and the least serious, argument against the MAI, has been that many countries are not ready for negotiations of multilateral investment rules. Some argue that they do not have the necessary administrative support, others point out that they do not fully understand the issues. In a meeting of experts from recent international organisations in Bangladesh in June 1997, Mr. Alamgir Farouk Chowdhury, the Bangladesh's Commerce Secretary stated: "In conferences we cannot play a meaningful role and as a result our comparative advantages are undermined. ... The least developed countries often do not know their obligations and rights under the world trading system."¹⁹ Some LDCs have also expressed their preference for negotiations on a regional basis. There is clearly not a universal agreement that trade and investment dispute should be resolved on the multilateral level. For example, in the recent Asian Executive Poll conducted by the Far Eastern Economic Review and Asia Business News 49.7 percent of respondents thought that bilateral negotiations are the best way to resolve trade disputes. The corresponding figures were 80 percent in Indonesia, 68.4 percent in Malaysia, 57.1 percent in South Korea and even in Singapore and in Australia the respondent preferred bilateral dispute settlement mechanism – 55.6 percent and 52 percent respectively.²⁰

These criticisms should in my view be treated as 'procedural'. They should not, therefore, be a stumbling block to countries' concerns about their negotiating strategies. Without spending much time on this argument, it is probably true that foreign investment rules are a relatively new subject and some countries may simply feel uncomfortable to join in discussions and negotiations. However, it is very unlikely that foreign investment constitutes a more difficult subject for countries to digest than, say, commercial policy affecting merchandise trade. Technical assistance and advice would go a long way in making sure that countries are well informed and can actively participate in negotiations. Moreover, even the most insecure governments will sooner or later work out for themselves their negotiating strategies and should be able to participate in the negotiations. Thus, the present reluctance to do so should be seen as temporary and a matter of proper timing rather than a resentment in principle. Furthermore, many countries' governments would feel much more self-

19 Reported in *Financial Times*, 4 June 1997.

20 See *Far Eastern Economic Review*, November 28, 1996, p. 39.

confident if they entered the negotiations in informal alliances of like-minded governments of other countries.

Mechanism of Global Negotiations. There are strong arguments against MAI, however, on the grounds of the inefficient mechanism of global negotiations. First, bilateral treaties can be negotiated faster and more easily than multilateral treaties. Prolonged negotiations could create uncertainties and further delay of FDI. Clearly, the negotiations of MAI in the OECD is a response to the recognition that a WTO deal is not imminent and that a separate OECD initiative was required to push forward with an international agreement. Second, commitments negotiated by like-minded governments are often 'stronger' and deeper than those achievable at the multilateral level (see also UNCTAD, 1996: 163). Third, there is a risk (and fear of LDCs) that multilateral negotiations could be dominated by the agenda of the strongest economies. LDCs fear that their priorities – restrictive business practices, technology transfer, standard of behaviour of TNCs in host countries and labour mobility – would not receive adequate attention. The issue is not the same as in the case of trade where countries are both importers and exporters while FDI originates in developed countries only (UNCTAD, 1996: 166). Fourth, some LDCs may also fear that they will be forced to adopt too strong liberalisation measures too fast. However, this is very unlikely. As Graham (1996b, p. 16) pointed out, "the task (of negotiating an MAI) would centre around negotiation, nation by nation, sector by sector, of the exceptions of the main obligations. ... The yeoman's work of creating such an agreement will not rest on drafting the language of the obligations, but rather on the negotiation of what exceptions will be allowed." Fifth, the resentment against MAI among some LDCs may have been also tactical. They wanted a further negotiation of other important issues such as the agreement on textiles or agriculture and are holding back on MAI as a bargaining chip.

A higher efficiency of a regional approach notwithstanding, the case for multilateral negotiations remains strong. A regional approach does not exclude a multilateral approach, *pari passu*. In such a scenario, regional agreements may always be extended to other countries. Alternatively, elements of regional agreements may become a basis of an MAI.²¹ Whatever road is taken, both approaches may be fully and mutually supportive. The

21 I am aware of the dangers of going the 'regional road.' The proliferation of regional agreements is precisely what I have criticised above in the context of the UNCTAD proposal. However, the proliferation does not seem to be an issue at present time and is unlikely to become one if multilateral negotiations are started concurrently.

crucial conditions for success is that the number of all the regional approaches will eventually be reduced to one – an MAI and that the regional agreements tend to push the market openings faster than it would be the case under an MAI.

B. Costs and Benefits of Globalisation: Theoretical Arguments and Empirical Evidence

Perhaps the most sensitive criticism has been targeted on economic benefits of globalisation. As demonstrated in this paper, the merits of FDI and globalisation are undeniable even though globalisation may also have adverse effects. The positive features are recognised even by the most vocal critics of globalisation who acknowledge that FDI and globalisation in general have positive economic effects.²² However, the economic arguments of the critics concern other aspects of globalisation, which, in my view, are not substantiated.

Decapitalisation and Denationalisation. The negative, or poor impact of FDI on development is based on two types of arguments – fear of globalisation which corresponds to what Graham termed “the residual of the 1970s thinking”. The argument does not have a strong following these days but it is still pursued by institutions such as The Third World Network (see Atan, 1996). The proponents of these ideas claim that FDI leads to ‘decapitalisation’ of host countries and their ‘denationalisation’. ‘Denationalisation’ is seen as the result of fundamental weaknesses of developing countries which do not have economic power to compete with strong MNCs. The same critics go on suggesting that FDI has an adverse impact on balance of payments, savings and, through the ‘decapitalisation’ effect, on domestic growth.

These arguments are not viable and receive declining support from academics, policymakers, journalists and other experts. There is no theoretical reason to provide support for these ideas, and the empirical evidence clearly contradicts them as illustrated by the economic successes of Southeast Asian countries.

Sustainable Development. More recently, we have seen an emergence of critiques of globalisation by various advocacy groups, using a variety of arguments that range from ‘social issues’ to ‘labour standards’ and ‘environment’. The main idea is that globalisation does not promote sustainable development. Thus, the criticism is typically not directed

22 The recognition is well documented in UNDP (1997).

towards multilateral rules on investment *per se*; it is concerned with the functioning of the multilateral system in general and of the WTO in particular. The concept of 'sustainability' is blurred as different groups define it differently. 'Sustainable development' can refer to poverty (e.g. Woodward, 1996), the environment, income distribution, or to other aspects of economic development such as gender issues, health, education etc. Some identify the problems of 'sustainability' with the deficiencies of the multilateral system of trade and finance.²³

With these concepts, it is clearly difficult if not impossible to argue one way or the other. What can be said, however, is that the support for multilateralism and for MAI should not be seen as a lack of compassion or concern for economic development. Those who support MAI usually believe that FDI is 'good' for the host country and its economic development. Labour standards and environmental issues have also been discussed by the ministers participating at the Ministerial Conference in Singapore who agreed to explore the issues in the activities of international organisations with the appropriate mandate.²⁴ This, by the way, has significantly narrowed the range of issues for negotiations under the umbrella of an MAI.

Positive Linkages Between Trade and FDI. One of the frequently heard arguments against an MAI among politicians is that the linkages between trade and FDI are not known. It is said that we should not move ahead with an MAI until we are sure that FDI is beneficial for the host and home countries. This view is clearly incorrect in that the empirical evidence already exists and points quite strongly to a positive relationship between trade and FDI (see e.g. WTO, 1996 and UNCTAD, 1996a). In addition, I have compiled what I believe to be all the major studies that address the question of the extent to which trade and FDI are substitutable or complementary from both the home and host countries' perspectives. The summary of my compilation is presented in the following discussion.

Impact on Trade. Most of the literature points to the case of complementarity between trade and FDI. Even though the relationship may be slightly stronger in the case of the host country's imports than the host country's exports, the evidence is quite striking. It is possible that the degree of complementarity varies from country to country and from investor to investor. The impact is positive for the *host* country as FDI

23 A concise presentation of all of the main ideas can be found in IISD (1996). See also Helleiner (1996).

24 For example, labour standard issues have been put on the agenda of the ILO. The status of environmental issues in relation to trade remains more dubious but continues to be outside the WTO agenda.

leads to more exports and imports including imports of technology which is typically one of the main objectives of the host countries. The impact of FDI on trade is also positive in *home* countries as FDI stimulates the country's exports and imports. There is obviously room for further tests, but the strength of the existing evidence is already powerful. Calls for additional work in this area should not be used as a pretext for stalling negotiations on MAI.

Impact on Employment. Another line of criticism against globalisation has been the impact of FDI on employment and wages and, in general, on labour markets. An interesting aspect of the criticism is that it usually does not come from critics of an MAI in developing countries, but from labour interests in developed countries. Nevertheless, the criticism has been also made in LDCs which we shall now address.

There is nothing in theory to suggest that FDI should lead to a permanent decline of employment. The issue is, therefore, once again empirical. Unfortunately, the employment effects are notoriously difficult to measure. The first attempts to measure the impact of 'globalisation' on employment date back to the early 1970s. Since then, the employment effects in LDCs have been studied by a great number of specialists and institutions. In particular, the ILO has had a long history of analysing the employment impact of MNCs, and taking a fairly sympathetic view of the plight of LDCs. Its work has been recently reviewed by Bailey, Parisotto and Renshaw (1993). As they point out, there are no precise employment figures to provide a statistical basis for empirical assessments, and this makes it extremely difficult to make comparison over time or cross-country. Nevertheless, what they find is that MNCs generate new employment in the host countries. My additional review of the literature leads to the same conclusions even though the effects may not always be immediately visible. For example, Bailey *et al.* (1993) also suggest that "the upsurge in FDI which was registered in the late 1980's mainly took the form of a reshuffling of ownership patterns of existing multinationals through mergers and acquisitions, and thus had an 'employment-acquiring' rather than 'employment-creating' impact. Employment growth in export processing zones (EPZs), moreover, partially supplanted employment in labour-intensive production in industrialised regions".²⁵ But even the ILO studies come out relatively clearly to suggest that the employment expansion is a function of growth of the FDI inflows.

25 See Parisotto (1993), p. 34. Once again, these conclusions are also evident from the review of the literature on the employment impact on the home countries that we have collected at the WTO.

Impact on Wages. Related to the criticism of FDI and its impact on employment are the wage policies of MNCs. The critics often charge the MNCs with ‘exploitation’ and paying wages that are well below the wage levels in the home countries or even below the ‘social minimum’ in the host countries. Once again, the problem is primarily empirical.

Unfortunately, the empirical literature on the impact of wages is even more limited than that concerning employment. This is partly due to a lack of statistics but there is also a fairly general shortage of studies. From the literature I have reviewed, the indications are that the evidence can be divided into two groups – evidence on the impact of wages in host countries and that concerning home countries. For some countries – typically *host* countries – the empirical evidence is fairly encouraging, i.e. a significant boost to the growth of wages as a result of FDI (see Fenstra and Hanson, 1995a,b and Welge and Holtbrügge, 1992). This runs against the idea that transnational corporations only pay ‘market rates’ and will leave the host countries if they have to pay higher wages than their local competitors. The evidence about the impact of globalisation on wages in *home* countries is perhaps even more scarce even though more and more studies are currently undertaken. One of the earlier studies was Leamer (1993) who found that globalisation led to a decline in the American wage level.

The third crucial question is whether trade (and FDI) is important for domestic growth and reduction of poverty. The answer to the question concerning the impact on growth is unequivocally affirmative as supported by empirical evidence reviewed in a number of studies.²⁶ The impact of FDI on poverty has also been subject to a growing body of literature. Even though the answer is more complicated, as discussed at length, for example, in UNCTAD (1996b), the evidence is once again pointing to a positive contribution of FDI to poverty alleviation. In China, for example, FDI has been instrumental in significantly expanding the low-skill employment and, therefore, reducing poverty (Mallampally, 1996). The evidence from Latin America also supports the finding that economic growth combined with liberalisation of economic policies has led to a reduction in the proportion of people living in poverty in Mexico, Argentina and Chile (Urani, 1996). A study of Husain (1996) provides a cross-country and comprehensive assessment.²⁷

In sum, the concerns about the employment and wage effects originate primarily from the home countries which fear that FDI will lead to reloca-

26 For the most recent review see, for example, van den Berg (1996).

27 There are obviously some people who would still advocate the return to protectionists policies such as Mosley (1996) who argues that tariff liberalisation and removal of agricultural input subsidies have been detrimental to economic growth and to poverty alleviation.

tion of firm activities and thus to job losses. Interestingly enough, however, it is not the home countries that are typically reluctant to negotiate the MAI.

Marginalisation of Africa and Other LLDCs. Closely related to the argument of ‘decapitalisation’ and ‘denationalisation’ are the views that globalisation and the accompanying flows of FDI are responsible for the relative impoverishment of Africa and many other least developed countries (LDCs). In other words, globalisation is said to lead to the so-called ‘marginalisation’ of these regions and countries and growing income disparities. For example, Woodward (1996) argues that “while the Asian countries have benefited from globalisation, Africa and other least developed countries have been harmed”. The critics of globalisation often point to the empirical evidence which shows that the positive effects of globalisation have not been spread equally. Eight developing countries, which account for about 30 percent of GDP of all developing countries, received about two-thirds of all FDI going to this group of countries. The share of exports in GDP increased for the group of developing countries between 1983 and 1993 but the increase was also due to only a small number of countries (10).²⁸ As a result, the gap between the world’s poorest economies and the rest of the world has increased. As WTO (1996) has pointed out, however, there were 35 developing countries in 1994 whose merchandise exports were below the 1985 level. Since the value of world trade more than doubled during the same period, the share of these countries in world trade dropped dramatically. Similar conclusions would be reached if we were to analyse the growth and distribution of global FDI.

The above example shows how differently, and sometimes incorrectly, empirical evidence can be interpreted. The low level of trade and FDI in Africa can clearly be also a symptom of low level of income rather than the effect of the growth of FDI in other parts of the world. The first elementary question is whether Africa and other LDCs have been hurt by inflows of FDI. That is clearly not the case since the problem of these countries has been a lack of FDI. The second crucial question is whether, globalisation effects – positive or negative – represent a sufficient condition for economic growth in any given country. The answer is again negative. Many other factors are also important such as domestic policies which in the case of Africa have played a clearly negative role.

28 These figures come from Brahmabhatt and Dadush (1996).

C. Sensible Criticism: The Costs of Globalisation and MAI

Arguably the most important critical argument about globalisation and MAI concerns adjustment costs of globalisation. The intentions of 'globalisers' have typically been good but in their zeal to push for 'multilateralism' they have often presented 'globalisation' as costless. Adjustment costs have so far been largely ignored until the recent work of Rodrik (1997). Moreover, many critics have also pointed to two negative features of globalisation – growing income inequality and poverty within each country and the marginalisation of some countries. These are grave errors of judgments in my view because it is often the adjustment costs that particularly scare off some countries from market openings. In other words, we have 'thrown the baby out with the bathwater'. Furthermore, given the recent financial turmoil affecting capital and foreign exchange markets in Mexico, Argentina, the Czech Republic and Thailand, many developing countries are asking the fundamental question of what net benefits will an MAI bring to them?

Adjustment Costs. Let us start with the question of costs and, in particular, with the question of adjustment costs. There is no doubt in my mind that a deeper globalisation implies an economic (and possibly other type of) adjustment and such an adjustment leads to adjustment costs. Domestic firms may be replaced by foreign firms, companies may relocate abroad in the search for cheaper labour, the growth of domestic wages may be constrained by the threat of companies to relocate abroad, inefficient industries have to restructure, firms will have to adopt new technologies and production processes, governments have to adjust the pattern of budgetary expenditures and to changes in the budgetary base and so on. All this takes time and resources and should be recognised by countries when considering the negotiations of MAI.

Equity Considerations. The other negative aspect of globalisation concerns income distribution. Suppose first that a country makes the equity issue a top social priority. Suppose further that a deeper market opening (i.e. globalisation) increases income inequality. Should the country's government be concerned? Or, suppose that a government has a policy of maintaining a fine social balance among different races or other social groups in order to maintain a social order and political stability. This is what is sometimes known as 'social engineering'. I have quoted an example of such policies above. Suppose further that globalisation would disturb this fine balance. Again, should the government be concerned? The answer to both questions is in my view – yes, it should.

Political Stability. Widening income inequality, increasing poverty or the break up of the social balance among different social groups can all be highly politically destabilising. Political instability, in turn, would seriously complicate the pursuit of other economic policies, however rational and sensible they may be. Ultimately, it will also discourage inflows of foreign capital which requires politically stable regimes as a condition for long-term investment. There are countries in which the question of rising income inequality and poverty does not raise social reaction but there are countries which are very sensitive to these issues. Similarly, there are countries which do pursue a policy of maintaining a social balance while there are other, more homogeneous countries, where the social issue is not a matter of serious concern.

It then all boils down to empirical evidence. What is the empirical evidence that income inequality and poverty worsen during globalisation? Are such changes permanent or temporary? In countries without large 'social safety nets', the answer is relatively clear. The evidence provided from different sources such as UNCTAD (1996 and 1997) and Rodrik (1997) shows that globalisation has increased income inequality among countries and even within countries individually. This is not only a matter in developing countries but also in developed countries.²⁹ These features are not surprising. As countries open up to foreign capital, returns to capital will increase since productivity of foreign capital tends to be higher than that of domestic capital. In the meantime, foreign capital may displace some less efficient domestic firms, and workers may be unemployed as they seek new job opportunities.

It should also be kept in mind that these changes may not be permanent. For example, as the displaced labour is retrained, it will improve its chances to be re-employed and, quite likely, to access a market with better paying jobs. The practical problem is that the reversal in the income inequality trends only rarely has enough time to work itself out through the system. The governments will typically look for ways of mitigating the impact of income inequality through budgetary transfers or perhaps even protectionist policies.

IV The Politics of MAI Negotiations

The brief overview of various arguments concerning MAI shows how history can often repeat itself. Most of the critical arguments are quite famil-

²⁹ See, for example, Laura D'Andrea Tyson, "Inequality Amid Prosperity", In: *International Herald Tribune*, 12-13 July, 1997, 6.

iar. Many have been already used in the past in discussing the merits of industrial policies but have been since abandoned or, at least, considerably muted. The fears of 'marginalisation' of the weak, the appeal for protection against foreign competition, the emphasis on improper business practices rather than the acknowledgement of positive effects of foreign business activities, these are all arguments that have been used before even though the context might have been different.

Nevertheless, it would be too easy to attribute the resistance to MAI to ignorance of basic facts or lack of access to information, even though both have played a role. Why have these arguments reappeared with such an intensity and, in general, why is there in a few number of countries such a strong opposition to MAI?

The explanation seems to me to be various political pressures that always emerge whenever international agreements are proposed. Such political pressures have, of course, different origins in different countries, but several common denominators can be identified. We could start with what may be called a 'cost-benefit' analysis of an MAI. As noted above, the critics would point out that there are strong arguments against FDI and, consequently, against the establishment of MAI. This suggests that supporters of MAI have not paid adequate attention to these concerns, and that each side has so far been more preoccupied in the pursuit of its own position rather than understanding the positions of its opponents. Yet the polemics should be relatively mild. Most of the criticism reviewed above, however, has either a weak theoretical foundation or poor empirical support, or both. But at the same time, there are three arguments that are sensible and should not be disregarded. The first one is that governments feel that they are fully entitled and, typically, that they are required to protect their national interests. After all, if the United States can challenge foreign companies for investing in Cuba on national security grounds, it is only reasonable to expect that other countries also have their genuine security concerns which should be acknowledged in negotiating any MAI. The second sound argument concerns equity considerations which may be a top priority of governments whenever they make policy changes. And third, governments may attach a high degree of importance to overall political stability and social cohesion which may cause delays or even prevent them from adopting policy measures that may be economically optimal. I shall return to these three questions further below.

Another political battle has emerged from the perception of the distribution of gains from an MAI among countries. We have seen that many developing countries feel vulnerable when they come to negotiate a multi-lateral agreement. Many also fear the impact of globalisation. *Pari passu*, some countries also argue that MAI is to primarily benefit developed coun-

tries. What can be said about the distribution of gains from globalisation? Take, for example, the case of the impact on employment and wages. The evidence that I have been able to collect points fairly strongly to *positive* effects of globalisation on employment and wages of those countries in which MNCs operate. However, the overall effects in developing countries have so far been relatively modest since the bulk of FDI is still located in developed countries where MNCs have most of their activities. Hence, the gains from globalisation will most likely not be distributed equally over time between the developed and developing countries – the latter may benefit relatively less in the beginning even though the pattern is likely to be reversed at a later stage. Moreover, the distribution of gains has also been skewed among developing countries, which has driven a wedge into the cohesion among these countries.

The distribution of power between, broadly speaking, the governments, the business sector and labour within each country has been another origin of political frictions. The criticism of MAI in developed countries – typically the home countries of FDI – come mainly from labour and from some opposition politicians. Governments tend to be sympathetic to the idea of MAI as documented by the ongoing negotiations at OECD. In contrast, the criticism in developing countries is more broadly based. The business sector may feel threatened by foreign competition, and it has indeed been a strong lobby against market opening in some, albeit limited number of countries. However, the strongest opposition typically comes from governments, and the main reason is their fear of loss of control. Both of these factors seem to have been playing a major role in the relatively negative stance of the Indian government – a major force behind the cautious approach to the discussions about MAI at the Ministerial meeting in Singapore.³⁰

V Proposed Solutions

I am putting my faith on negotiations. In a way, everything should be negotiable except perhaps questions related to national security. This means that even the most difficult issues could be addressed through negotiations. This must include, I believe, the adoption of MFN and national treatment principles, an agreement about the treatment of fiscal incentives and, possibly, some harmonisation of tax regimes and accounting standards. The establishment of a dispute settlement mechanism would be also important.

30 See, for example, the recent discussions in the WTO balance of payments committee as reported in *Financial Times*, 2 July 1997.

However, several difficult problems would have to be resolved before the negotiators sit down to negotiate the actual agreement. These problems include the definition of national security and the treatment of equity issues in the negotiations. Unfortunately, the ambiguities and differences of opinion surrounding the definition of 'national security' and some important equity issues are quite significant. At the same time, it should be kept in mind that some concerns of LDCs can be better handled by specially targeted policies. For example, equity concerns can be more effectively addressed through domestic policies such as budgetary transfers rather than by trade policies.

Intellectual Debate. It is clear that countries will need to complete a substantial intellectual groundwork before any negotiations of MAI on a world-wide level can be negotiated. Even if there is a general agreement about the need to negotiate MAI, there is not an agreement about (1) the venue of such an agreement, i.e. under what umbrella the agreement should be negotiated. Clearly, WTO is a logical candidate. Other substantive issues that would need to be resolved in such an 'intellectual' debate include (2) the scope of the agreement (such as investment protection, taxation, employment of foreign nationals etc.) and agreement about the definitions of concepts (such as 'national interest', 'foreign direct investment'), and (3) the range of exceptions. It may also have to include (4) the minimum standard that would be acceptable to all parties concerned. Without prejudging the range of issues, the main objective of the debate would be the need to identify the main issues for negotiations.

'Green Light' Measures. 'Green light' measures, i.e. measures to correct for a certain element of market failures, are closely related to the issue of *exemptions* discussed further below. The main point is that MAI does not exclude the possibilities for countries to promote certain economic activities, as we have already indicated earlier in the text. As we have also seen above, this support has been acceptable in most international agreements in a selected number of cases such as regional development, the promotion of certain research and development expenditures and protection of environment.

Regional Cooperation. A weak negotiating position must be a legitimate concern of many small developing countries. The problem can be addressed in at least two different ways – by building up expertise through the provision of technical assistance and through regional cooperation of these countries. Clearly, many of these countries face serious resource and manpower constraints to negotiate effectively in big international fora and

this handicap can be eased by pooling resources, information and knowledge with like-minded countries.

Transition Periods. Most importantly, the problems discussed above have, in my view, a relatively simple solution – the recognition of the concept of *transition period* for countries entering the MAI negotiations. This is not a new concept in the multilateral trading system which recognised transition periods for developing countries. I have recently proposed the same for those countries in transition that are applying for accession in the WTO (Drabek, 1996).

Transition periods would allow countries to adopt the main features of an MAI – the national treatment and the MFN principles over time and with a speed that would have to be negotiated with their trade and investment partners. It would allow them to do so as fast as practical and in a way which is minimising costs of adjustment. Developing countries in general have the possibility in the WTO system to negotiate a ‘transition period’ during which the national treatment principle need not be applied. This is after all what the critics imply when they reject the national treatment principle as discriminatory against the developing nations. The real problem, however, seems to me to be the inability to agree on what constitutes ‘security interests’ of countries, as noted above. Unfortunately, protection of ‘infant industry’ is often presented and understood by the critics as a necessity on national security grounds.

Exemptions. It should also be possible to negotiate *exemptions* from the general commitments. Many countries would be particularly interested in negotiating sectoral exemptions. A relief from the ‘national treatment’ principle should surely be possible in certain instances such as defence or the police which are seen as exceptions under standard circumstances. In addition, I see no reason why other sub-sectors could not be added to this ‘negative’ list, provided the list is transparent and relatively short to make it acceptable for other countries. Alternatively, countries could agree on a *set of criteria* to qualify industries as a special case and conditions under which they will continue to be so.

Technical Assistance. A great deal of emphasis will have to be put on technical assistance. Many developing countries and countries in transition do not have either the knowledge, the experience or the staff to deal with many complexities that multilateral agreements bring along. The technical assistance will be particularly important in LDCs and in the countries in transition to negotiate the agreement. Many countries would probably also benefit from a better cooperation with other (developing) countries with

similar interests in order to prepare themselves better for the actual negotiations.

VI Conclusion

The arguments in favour of an MAI ultimately rest on the benefits the countries can reap from such an agreement. I am convinced that, on balance, the benefits from such an agreement could greatly exceed the costs. The list of major benefits to the international community at large is impressive, and we have reviewed them in Section II. Moreover, the host countries should also consider other benefits which are particularly important for developing countries and countries in transition. For example, MAI would reduce transaction costs to MNCs resulting in greater supply of 'investible funds', or lower costs of FDI or both. The agreement would also reduce uncertainty which is typically a major component of investors' risks. Since the agreement would also most likely include elements that can be seen as 'prudential regulations' it would certainly reduce the volatility of capital flows. Moreover, MAI would be an important instrument towards avoiding unilateral restrictions against each countries' exports. Last but not least, since MAI would also include a dispute settlement mechanism, it would give weaker and smaller countries a better chance to protect their rights.

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