



CAPITAL FLOWS IN INTERNATIONAL INVESTMENT LAW – TRENDS, FRAMEWORK AND REASONS: FOCUS ON EMERGING CHINA¹

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Abstract. International investment law scholars do not provide sufficient analysis of underlying process of investment (capital flows). As China has become the second biggest economy in the world and the third biggest investor in the world that channels outward investments mainly through state owned enterprises the question about the underlying reasons of such investments remain. To address this issue the author reviews the historic periods of capital flows and current trends; examines the theoretical framework of and reasons for foreign investment from state as well private (as against state agent) investor's perspective and assesses the underlying reasons of China's capital export policies.

Keywords: International investment law; capital flows; stages of capital flows, China's capital export policy reasons

Introduction

In pre-World War II world the need of international protection of foreign investments was not relevant or important as majority of capital flows occurred within the context of colonial expansion and imperial system gave sufficient protection (Sornarajah, 2010, p. 19). There is even a theory that the very system of imperialism and colonies that had ensured the flow of resources from colonies to metropolitan states was one of the causes of the World War II, as Germany, Italy and Japan did not have colonies which could have provide them with much needed natural resources (Johnston, 2016). Nevertheless, one of the outcomes of the World War II was a collapse of the colonial system itself. As former colonies or newly created countries tended to be hostile towards foreign investments considering them as a form of neo-colonialism and previously acceptable method of protecting foreign investments through use of military force was prohibited under United Nations Charter, the former metropolitan states, developed and resource hungry economies needed a legal framework to ensure the protection of continuous or new engagements. That's when the bilateral investment treaty (BIT) system came into existence with Germany being the first country to conclude BITs in 1959 (Vandeveld, 2005, p. 169). According to the latest United Nations Conference on Trade and Development World Investment Report there were 2 946 BITs and 358 treaties with investment provisions at the end of 2015 (UNCTAD World Investment Report, 2016, p. 101) and the total number of publicly known investor-State dispute settlement cases reached 696 as of 1 January 2016 (UNCTAD World Investment Report, 2016, p. 104).

As the international investment law system became so prolific the interest in international investment law grew too. International investment law became a separate subject at universities and separate field of research in the

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area of international economic law. International investment law scholars usually analyse issues related to notion of investment, the contents of protection given to foreign investor or his investment and procedural aspects of investment dispute resolution, whereas the underlying process of investment (capital flows) is usually overlooked and does not gain too much attention. However understanding of theoretical model and reasons for capital flows and their trends gives an insight into and is a necessary tool in investment policy process– from planning how to attract foreign investment, to considering on what to take into account while concluding BIT or how to assess foreign investment from security perspectives.

People's Republic of China (hereinafter – China) is the most populous country, the second biggest economy in the world, and currently – the biggest capital exporting developing country, which in 2015 remained the third largest investor in the world after the United States and Japan (UNCTAD World Investment Report, 2016, p. 7). China's investment was (and still is) mainly channelled through state owned enterprises (SOEs). 77 of 500 biggest companies in the world are SOEs (Cendrowski, 2015). As China's increased activities in outward investment in other countries and especially in developed economies had coincided with most recent financial and economic turbulences in the world economy, namely financial crisis of 2007-2008, global recession of 2008-2012 and still ongoing European sovereign-debt crisis, it has attracted both admirers and opponents. For admirers China is a Cinderella story and champion of development that provides a viable alternative to Washington Consensus and democracy. Whereas for opponents China is great concern and geopolitical threat that is willing to reshape the economic, geopolitical, and security order to accommodate its interests (Congress of the U.S.-China Economic and Security Review Commission, 2016, p. vii).

As majority of China's outward capital flows are directed through SOEs and there is a limited data on particular projects/firms (separate deals are still treated as state secret by the MOFCOM (Ministry of Commerce of China)), the question that such investments are driven not by market forces, but by some other state considerations remain. In order to address such issue, we need to review the historic periods of capital flows as well as current trends (part 1); to examine the theoretical framework of and reasons for foreign investment from state as well private (as against state agent) investor's perspective (part 2); and to assess the underlying reasons of China's capital export policies (part 3).

1. Trends of capital flows

Although the need of protection of foreign investment started after the end of World War II and subsequent decolonization process, the actual flows of capital between capital exporting states (developed states) and capital importing states (developing states) started much earlier.

There is no agreed or uniform classification of stages on capital flows in international investment law. Professor Muchlinski (Muchlinski, 2007, pp. 8-25) analyses capital flows from the point of view of phases of multinational enterprise growth and describes them in four periods: i) first period (1850-1914) saw the emergence and rise of mainly British and some European companies that were engaged in capital export to obtain raw materials and agricultural produce from mainly African and Asian colonies to industrialized North (North to South capital flows); ii) in second period (1918-1939) many states turned into nationalistic economic policies and companies were using international cartels as complementary business strategies to direct investments – Britain still held 39,8 per cent of world capital stock, whereas US – 27,7 per cent; iii) the main characteristic of third period (1945-1990) lies in capital flows between mainly developed economies (North to North) and it is divided into period of American Dominance (1945-1960), which saw flows of capital from United States of America to war torn and devastated Europe that allowed US to accumulate 49.2 per cent of total world stock in late 1950s, and period of Renewed International Competition (1960-1990), which saw revival of European investors (German, Italian, Swiss companies) as well as emergence of Japan as a developed economy; the fourth period (1990 onwards) saw liberalization of investment regimes, shift from raw materials and manufacturing towards services based FDI and adoption of global production chains.

Professor Vandevelde (Vandevelde, 2005) identifies three periods in development of international investment law that partially corresponds to stages of capital flows suggested by professor Muchlinski: Colonial era (prior to World War II), Post-Colonial Era (end of World War II till collapse of Soviet Union) and Global Era. In the Colonial Era (prior to World War II) the community of nations was largely limited to the European powers and newly independent states in the Americas, the use of force was a legitimate mean of protection of state interests, thus development of international law was limited. States were primarily interested in establishing trade relations, investment-related provisions were included in treaties of friendship, commerce and navigation. Protection was bestowed only to natural person (alien) and his physical property. The Post-Colonial Era saw separation of trade law that became based on multilateral treaties from fragmented investment law, decolonization and creation of scores of newly independent but economically undeveloped, yet anti-investment countries, emergence of socialist block countries led by Soviet Union which promoted view that the best path to economic development lay in extensive state regulation of economy and not the free market. The hostility of developing countries and Soviet bloc states toward foreign investment caused developed states to strengthen their efforts to provide legal protection for foreign investment through international investment agreements. In the Global Era, the disintegration of the Soviet bloc, loss of alternatives to foreign investment as a source of capital, led to explosion of bilateral investment treaties (BITs) and liberalization of investment and trade regimes.

However, neither professor Muchlinski, nor professor Vandevelde address the most recent changes in international investment law, nor assess the emergence of China as the central figure in capital export. First of all, notwithstanding to the almost universal acceptance of the Washington consensus, majority of developing states have not seen a promised development. On the contrary the Argentina's experience with liberalization and 56 investment disputes (until 2014) that followed in the aftermath of Argentina's 2001 economic and financial crisis renewed discussions about neo-colonialism and restrictions of sovereignty. Bolivia, Ecuador and Venezuela withdrew from 1965 Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States (Ripinsky, 2012). Secondly, amid financial crisis of 2007-2008 and global recession of 2008-2012 the foreign direct investment inflows fell from a historic high of 1.979 trillion USD in 2007 (UNCTAD World Investment Report, 2009, p. 3) to 1.114 trillion USD in 2009 (UNCTAD World Investment Report, 2010, p. 2). Even in 2015 the capital flows have not reached pre-2007-2008 crisis level with foreign direct investment inflows reaching 1.762 trillion USD (UNCTAD World Investment Report, 2016, p. 3). Thirdly, China became major investing country with overall 1.332 trillion USD foreign direct investment stock at the end of 2014, adding 182.7 billion USD in 2015 (UNCTAD World Investment Report, 2016, p. 41). It also became the leading investor in developed economies, as well as in African countries (UNCTAD World Investment Report, 2016, p. 48) and largest source of investment for least developed countries (UNCTAD World Investment Report, 2016, p. 74). Finally, the decision of Britain to leave European Union on 23 June 2016 and promises of new US administration on 'new nationalism' and 'America first' shows the retreat of major economies from ideas of liberalism and free movement of capital.

On the one hand such new developments emphasised the raise of Chinese outward investment and raised suspicions (and security concerns) about China's outward investments. On the other one, in the author's opinion such developments show a tendency for a new phase in capital flows – a contemporary phase, which marks end of Washington consensus and liberalisation of economy and trade as prevailing ideas, where developing economies support free capital flows more than the most developed economies (USA and UK) and where substantial capital flows start to move South to South.

2. Theoretical framework of and reasons for investment and capital flows

Every state pursues economic development as it ensures the growth of wealth and prosperity of the country and its people. Every state is a sovereign and based on political or economic realities it decides on its own path of development of economy. Although the common knowledge dictates for states to be open to foreign investment, from the legal point of view the state is not bound to accept any foreign investment or investor, unless it desires

so or has committed to accept it according to an international treaty. States have alternatives to foreign investment as states can borrow and use such money to develop their economies. However, usually there is a limit on how much will be lent to a state and economic logic dictates that the less developed the country, the less it will be able to borrow.

Therefore the foreign investment (movement of capital through export from capital exporting state to equivalent import of capital) occurs when a capital importing country (usually a developing country) has an asset, which it cannot exploit (or do so efficiently) by itself and there is a foreigner who possesses financing, technology or know-how, which allows to develop such an asset or develop it more efficiently (Bambalas, 2013, p. 753). As long as state has a need for development or a particular asset and cannot do it by itself, and there is a foreigner who sees such asset as an opportunity to earn profit, the setting for foreign investment is ready.

Professors Dozer and Schreur indicate that from economic point of view direct investment involves a) the transfer of funds, (b) a longer-term project, (c) the purpose of regular income, (d) participation of the person transferring the funds at least to some extent in the management of the project, and (e) business risk (Doz and Schreur, 2008, p. 60). In essence it reflects the definition of foreign direct investment provided Organization of Economic Cooperation and Development. However that's where the analyses of legal scholars end and the mere possibility to earn profit does not explain why foreign investor eventually makes the investment.

However in economic literature there are a plenty of studies examining motivations, determinants and impact of foreign investment (Castro, 2000, pp. 7-35; Blonigen, 2005; Franco et al, 2010). The dominant theory in economics was formulated by professor Dunning and is called the eclectic (OLI) paradigm. Eclectic (OLI) paradigm is used to explain the underlying reasons the companies decide to engage into foreign investment instead of less capital demanding export or licensing activities (Dunning, 2008). OLI stands for ownership, location and internalisation advantages. Ownership (O) advantages (e.g. trademark, production technique, marketing and entrepreneurial skills, returns to scale, technology and information, managerial, organisational systems etc.) refer to the competitive advantages of the enterprises seeking to engage into foreign investment over companies already located in the target country. Location (L) advantages (e.g. existence of raw materials, low wages, special taxes or tariffs, legal and regulatory system, transport and communication costs) refer to the advantage given by specific location of an asset (either in home or host country). Finally internalization (I) advantages refer to advantages of company's own production rather than producing through a partnership arrangement such as licensing or a joint venture, because the internal production costs are lower than costs in the market. Companies that eventually invest abroad and try to exploit the resource that state has fall within one of following four categories: natural resource seekers, market seekers, efficiency seekers and strategic asset or capability seekers (Dunning, 2008). The natural resource seekers seek physical resources, plentiful supplies of cheap and well-motivated unskilled or semi-skilled labour or technological capability, management or marketing expertise and organisational skills. The market seekers want to sustain or protect existing markets, or to exploit or promote new markets. The efficiency seekers pursue rationalisation of the structure of established resource-based or market-seeking investment. Finally the strategic asset seekers acquire the assets of foreign corporations, to promote their long-term strategic objectives – especially that of sustaining or advancing their global competitiveness.

The outward investments of SOEs are not unique or exclusively Chinese phenomena. Other developing states also use SOEs and UNCTAD summarized the particular correlation between eclectic paradigm and sectors that have particularly strong OLI advantages for companies from developing countries (UNCTAD World Investment Report, 2006, pp. 147-163):

i. Expertise and technology-based ownership (O) advantages manifest themselves in a number of industries such as consumer electrical and electronic products (e.g. Haier and Hisense in China), food and beverages, heavy industries and transportation equipment (e.g. Tata Motors in India) and firms that have such advantage tend to be

market-seeking (whether regional, developed or developing markets will depend on the brand and quality of goods and services) or asset-seeking (to further improve competitive advantage) investors;

ii. Advantages gained from access to home country location (L), such as access to natural resources, access to funds or financing (e.g. from state banks) availability of cheap funds, usually are enjoyed by firms and industries engaged in natural resources and natural-resource derived manufacturing (e.g. PetroChina), infrastructure services (including utilities, transportation and ports) and telecommunication (e.g. China Mobile). Such firms usually are market-seeking investors.

iii. Specialization in part of the production value chain (I). This is often seen in industries like electronics, automobile components, garments and footwear and firms tend to be efficiency seekers (especially reducing labour costs).

According to conceptual framework provided by UNCTAD, the basic rationale for outward investment by firms in a global market economy is to increase or protect their profitability or capital value (UNCTAD World Investment Report, 2006, p. 142). Therefore we need to use OLI paradigm to assess the reasons behind investments of Chinese SOEs. However, as it is usually difficult or impossible to get all information about particular Chinese outward investments it is also important to know the reasons of China's capital export policies.

3. Reasons of China's capital export policies

China is a developmental state (Knight, 2012, p. 2). The first book on developmental state was written by professor Johnson in 1982, who called a rapid development of Japan from the ruins of the World War II into economic super power, as a "Japanese miracle" (Johnson, 1982, p. 78). Professor Johnson defined the developmental state as a state that is focused on economic development and takes necessary policy measures to accomplish that objective. In China the developmental state arose from the need of the ruling Communist Party to restore and maintain the political legitimacy that it had lost during Cultural Revolution and economic stagnation until late 1970ies (Knight, 12, p. 3, 5).

Since the start of economic reforms of Deng Xiaopin in 1978 the foreign exchange reserves of China increased from 1.67 billion USD to the peak of SD 3.97 trillion USD on August 2014, which has decreased to USD 2.998 trillion as of January 2017 (The Scale of China's Foreign Exchange Reserves, 2017). Most of such reserves was held in USD denominated bonds that gave low returns. Moreover, as on 2001 China was to become member of WTO with an eventual opening up of its domestic market, it meant that goods and services of local Chinese companies would have to compete with world-class competitors. In order to ensure continuous development and avoid collapse of local production China decided to support national champions and to create sophisticated, high value-added, brand-name Chinese companies with their own intellectual property, as well as internally restructure low-end industry (Brautigam, 2009, pp. 86-87, 91-92), which led to creation of "Going Out" strategy.

"Going Out" strategy was formally announced by the government in the year of 2000 as part of China's tenth Five-Year Plan. "Going Out" strategy encompassed the following (Bernasconi-Osterwalde et al, 2013, p. 2):

i. Encourage outward investment that can give play to China's comparative advantage, expand the scope, channels and means of international economic and technical cooperation;

ii. Continue to develop overseas contracting and labour service cooperation, encourage enterprises with competitive advantage to develop processing trade abroad, to drive exports of products, services and technology;

iii. Support enterprises in using foreign knowledge resources, and establishing research and development institutions and design centres abroad;

iv. Support strong enterprises in transnational operations, and the realization of internationalized development. Amplify the service system for outward investment in the areas such as finance, insurance, foreign exchange, taxation, human resources, law, information services and immigration control, so as to create the conditions for implementation of the “go-global” strategy;

v. Perfect the corporate management structure and internal control system, and regulate the oversight of outward investment.

In 2006 China’s government reiterated that the Better implementation of the “Going Out” strategy of 15 March 2006 involves market seeking and resource seeking policies (Better implementation of the “Going Out” strategy, 2006).

Moreover, as China has reached the upper-middle-income country status (World Bank Country and Lending Groups, 2017) it was forced to amend its internal and external policies. Since 2001, hourly manufacturing wages in China have risen by an average of 12% a year (The future of Factory Asia, 2015, p. 45) and in 2015 average monthly wage in China exceeded the ones in Philippines, Indonesia or Thailand. On the one hand it led some multinational corporations that had produced labour-intensive products in China to start looking at lower-cost alternatives elsewhere. China’s industries started to lose the competitiveness battle to lower-income nations whose average wages are lower and whose labour supply is plentiful, such as Vietnam, Thailand or Indonesia. On the other hand, Chinese companies also started losing the competitiveness battle to high-income countries that produce higher-end, more sophisticated products. Some Chinese consumers have reached a level of income to allow them to buy higher-end products, but they often perceive Chinese automobile brands, for example, as being inferior to foreign brands, even those that were actually manufactured in China. In addition to that, in order to ensure continuous China growth, one of the main aims of the Chinese government is to transfer China’s economy from investment driven, to consumption driven economy, because the returns on investment projects, such as building infrastructure have started to diminish.

It should be noted that some researchers found that Chinese companies by investing abroad invest overseas but without moving the factories abroad, even though traditionally companies undertake outward investments to exploit competitive advantages in host countries (Huang et al, 2013, p. 230). Financial Times noted the reluctance of inefficient Chinese SOEs to fire employees since 2006 (Wildau, 2016), which signal strong incentive by central government to SOEs to ensure and retain employment in China. Such internal pressures to the Communist Party within Chinese society to ensure mass employment on the one hand, and to harness the needs of emerging middle class that among other things wants brand name and higher-end and more sophisticated goods allows to better understand the recent “One Belt, One Road” initiative, which aims to China with Europe through ‘Silk Road Economic Belt’ – northern central and southern railroad corridors and connect China, Africa and Europe via ‘Maritime Silk Road’. Although “One Belt, One Road” initiative covers five major areas of interest, infrastructure construction is the dominant feature (Zhang, 2016).

Consequently, the active participation of state in encouragement and support of capital flows (outward investment), “Going Out” policy, construction of “One Belt, One Road” infrastructure while ensuring better trade channels for Chinese goods and retaining factories in China show that the main reason behind all this is the political legitimacy of Communist Party, which is safe from demands of political and civic rights from population for as long as economic growth and employment is ensured.

Conclusions

Author addressed issue on underlying reasons for China’s outward investments, which usually are done in non-transparent manner and particulate through SOEs. Legal scholars have not addressed the new role and importance of China’s outward investment flows and contemporary retreat of UK and USA from ideas of Washington consensus, and author is of opinion that a new phase in capital flows – a contemporary phase has

started to emerge. This stage marks the end of Washington consensus and liberalisation of economy and trade as prevailing economic ideas and constitutes a beginning of major capital flows from South to South countries. Legal international investment law scholars provide the theoretical framework for foreign investment but do not explain underlying reason that makes investor to actually make investment. The economics theory of eclectic paradigm (OLI model) explains the economic reasons and motivations of foreigner to engage into investment activity and can be used as a tool to determine the reasons behind investments of Chinese SOEs. Finally, underlying reason for developmental state of China, “Going Out” policy and new “One Road, One Belt” initiative is political legitimacy of the Communist Party, which is safe from demands of political and civic rights from population for as long as economic growth and employment is ensured.

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