• BRIEFING PAPER •

India-EU FTA: Policy Implications of Unfettered Investment Flows

Since 2007, India and EU have been negotiating a free trade agreement (FTA) — covering trade in goods and services, investments, intellectual property rights and government procurement — that is fraught with problems. Till now, ten negotiating rounds have been held. The agreement is expected to be finalized by mid-2011.

The EU remains India's largest source of foreign direct investment (FDI). Of late, there is a growing trend towards outward investments by Indian companies. A sizeable portion of India's outward investments is directed at acquiring EU-based companies. The Tata Steel's acquisition of Anglo-Dutch steelmaker Corus and Tata Motor's acquisition of Jaguar and Land Rover are prime examples of this trend. In 2007 alone, Indian corporates invested €9.5 billion to acquire EU-based companies. India has signed bilateral investment treaties (BITs) with 19 of the 27 EU member-states. Besides, India is a member of World Bank's Multilateral Investment Guarantee Agency since 1994.

One of the contentious issues came to light on January 20, 2011 when the European Commission (EC) sought an expansive mandate to negotiate on investment issues on the behalf of the European Union. In its recommendations to the European Council, the EC sought modifications in the negotiating directives for the proposed free trade agreement with India.

If these recommendations are accepted, the EC would pursue comprehensive cross-border investment liberalization and investment protection provisions under the trade agreement with India. The EC document calls for the "progressive abolition of restrictions on investment, with the aim to ensure the highest level of market access."

The EC recommendations contain several alarming proposals which should receive public scrutiny both in Europe and India. The proposals contain high standard features including a wider definition of investment, national treatment to foreign investors, free transfer of capital and investment-related returns, and curbs on the use of performance requirements. In addition, the EC has recommended investor-to-state dispute settlement mechanism through which foreign investors can invoke arbitrations against the host governments. If implemented, such investment rules could seriously undermine development priorities and restrict policy space to regulate cross-border investments in the public interest.

The Wide Definition of "Investment"

The EC has put forward a wider and open-ended definition of investment covering almost every kind of asset owned or controlled by an investor of both parties. It includes foreign direct investment, shares, debentures, loans, interests, business concessions, movable and immovable property, intellectual property rights, goodwill, technical processes and know-how.

An unduly wide definition of investment is one of the main reasons for the widespread critique of Chapter 11 of NAFTA and the failed Multilateral Agreement on Investment (MAI) negotiations at the OECD.

National Treatment

The EC has proposed national treatment (NT) and most favored nation (MFN) standards of treatment. The principle of national treatment (treating foreign and local investors equally) is highly contentious because most countries refrain from giving national treatment to foreign investors without limitations and qualifications.

It is well recognized that unlike trade, foreign investment is a much more economically and politically sensitive issue since it essentially means exercising control over ownership of national assets and resources.

Despite opening up of India's economy since 1991, foreign investment is still prohibited in some sectors such as multi-brand retail, legal services and railways (train operations). India still maintains pre-admission and post-admission restrictions in addition to sectoral equity limits on foreign investment in telecommunications, banking, insurance, media and aviation.

Interestingly, it is not only developing countries (such as India) that are extremely concerned about foreign companies acquiring control over their national assets and resources. Even within Europe (particularly in France and Germany), policy makers are concerned about the recent acquisitions of their domestic assets and resources by sovereign wealth funds and private investors from the Middle East and Southeast Asia.

Disciplines on Performance Requirements

The EC would like to "impose disciplines on performance requirements" under the proposed FTA with India.

Performance requirements are conditions imposed on foreign investors, such as local content requirements, export obligations, preference to local people in employment, location of an industry in a 'backward' region, and mandatory technology transfer.

In many policy circles, performance requirements are often viewed as inefficient and harmful, thereby hampering foreign investment and economic growth. But evidence points to the opposite result: performance requirements such as local content and technology transfer help to establish industrial linkages upstream (for instance, with suppliers) and downstream (for instance, with buyers) and contribute significantly towards the host country's economic development. In the absence of local content requirements, a foreign corporation is likely to source many inputs from outside the country, which could impede the development of local clusters in the host countries.

In the past, India had extensively imposed performance requirements in the form of export obligations on foreign companies to ensure that they earn enough foreign exchange to balance foreign exchange outgoings via repatriation of profits, royalty, and other payments.

For instance, Pepsico was allowed to operate in India in 1989 with the performance requirement that it will export products worth 50 per cent of its total turnover for 10 years. In addition, at least 40 per cent of this export obligation has to be met by selling the company's own manufactured products.

Coca-Cola's re-entry into India in the 1990s was subject to several post-admission performance requirements including disinvestment of 49 percent of its shareholding in favor of resident Indians by June 2002.

In the banking sector, it is still mandatory that not less than 50 percent of the directors of Board of foreign banks should be Indian nationals.

The Controversial Issue of Capital Transfers

Another problematic issue pertains to the rights of investor to transfer capital and investment returns freely into and out of host country without any delay and restrictions.

The EC demands that all transfers (including profits, dividends, capital gains, royalties, fees and returns in kind) related to investments between India and Europe should be made "freely." Such commitments would entitle foreign investors to compensation if a host country imposes currency and capital controls that would prohibit foreign investors to transfer money into and out of the country. Besides, free transfer provisions are very broad in scope as they include profit, dividends, capital gains, royalties, fees and returns in kind.

The EC's insistence on the free transfer of capital and investment-related returns is baffling particularly when there has been a rethink in the international policy circles on active capital account management in the wake of the global financial crisis.

Throughout the developing world, policymakers have deployed a wide range of exchange restrictions and capital controls when faced with balance-of-payment problems and volatile capital flows.

Not long ago, many large developing economies including India, China, Thailand and South Korea had imposed restrictions on transfers of capital and investment-related returns. Most of exchange restrictions were related to remittance of dividends and profits from foreign investments.

Till 2000, India maintained strict restrictions on remittance of dividends related to FDI in 22 specified consumer goods industries, ranging from soft drinks to electronics. The dividend balancing provision (repatriation of dividends to foreign investors is to be balanced by foreign exchange earnings of the company over a period of 7 years) was introduced to overcome scarce foreign exchange as India was experiencing severe balance of payment crises since 1960s. The provision of dividend balancing for FDI was removed in 2000.

There is no denying that the free transfer of capital and investment-related returns has become an important component of several North-South FTAs (e.g., US-Chile FTA). Besides, bilateral investment treaties (BITs) also contain provisions relating to the free movement of capital and investments. The US-Ecuador BIT is a prominent example.

However, in the wake of the Argentine financial crisis of 2001, serious questions have been raised about the ability of host countries to impose capital controls that are inconsistent with their bilateral trade and investment treaty commitments.

In December 2001, Argentina had introduced restrictions on capital outflows to maintain financial stability. Under the restrictions, both foreign and domestic investors were barred from transferring funds abroad and wire transfers required prior central bank approval. The authorities had also imposed a ban on foreign currency futures transactions. In 2005, the Argentine authorities introduced several new restrictions on capital inflows to discourage speculative flows entering the country.

In response to capital controls which adversely affected the rights of foreign investors, numerous investor-state claims were filed against Argentina. Close to fifteen US investors submitted claims to investor-state arbitration stating that capital restrictions breached commitments of the US-Argentina BIT.

In several instances, investor-state arbitral tribunals ruled against Argentina and awarded hundreds of millions of dollars to US investors. To date, Argentina has maintained that it is not liable under its investment treaties because capital controls were imposed for a legitimate purpose to restore financial and macroeconomic stability.

Particularly in the case of developing countries, the extensive use of investor-state claims in such situations can delay and weaken their policy response to overcome a currency or financial crisis.

It would be a grave mistake for India to surrender the ability to impose currency and capital controls when faced with sudden stops and reversals of capital inflows or trade shocks.

Given the overriding presence of short-term volatile capital flows in its foreign exchange reserves, the Indian economy remains vulnerable to a sudden reversal of capital inflows. India protected itself from the contagion unleashed by the Southeast Asian financial crisis because of a restricted capital account.

Therefore, New Delhi should not accept such legally binding provisions on capital transfers under the FTAs (and BITs) and maintain the policy space to deploy appropriate forms of currency and capital regulations.

Capital Controls Gain Credence

Capital controls (on both inflows and outflows) are indispensable tools in the hands of the developing countries to protect and insulate the domestic economy from volatile capital flows and other negative external developments.

In the aftermath of the global financial crisis, several countries are realizing the importance of capital controls to prevent and mitigate financial crises. In 2010, a number of developing countries (from South Korea to Brazil to Indonesia) introduced various kinds of capital controls to tame surging hot money flows which could pose a threat to their economies and financial systems.

Nowadays even the IMF endorses the use of capital controls, albeit temporarily and subject to exceptional circumstances. In the present uncertain times, the imposition of capital controls becomes imperative since the regulatory mechanisms to deal with volatile capital flows are national whereas the financial markets operate at a global scale. Recent experience suggests that capital controls are more efficient if used as part of the macro-prudential toolkit.

If bilateral trade and investment treaties banning capital controls become de rigueur it means a country using them to defend its economy from external shocks will end up compensating foreign investors.

The US has been aggressively pushing for removal of capital controls under the ambit of its bilateral trade and investment agreements. In January 2011, more than 250 international economists urged the Obama administration to reform US trade and investment treaties that restrict the use of capital controls.

Investor-to-State Claims

The EC has specifically proposed investor-to-state dispute settlement provisions (in addition to state-to-state) under the FTA. The investor-to-state dispute settlement mechanism remains highly contentious because it gives special rights to investors to completely bypass the domestic legal system and seek redressal before a panel of international arbitrators.

Modeled on the controversial Chapter 11 of North American Free Trade Agreement (NAFTA), investor-state dispute settlement mechanism will allow investors to bring claims against governments of both trading partners before a panel of arbitrators with hardly any public participation or accountability.

NAFTA, a trade agreement between Canada, Mexico and the US, became effective in 1994. Private corporations from NAFTA member-countries have exploited the provisions of the agreement to challenge a wider range of regulatory measures on health, environment and public safety that infringe on their expansive investment rights.

Most problematic is the interpretation of the concept of "expropriation," which can restrict the ability of governments to carry out social and developmental measures that might adversely affect the profits and businesses of foreign investors.

Investors from NAFTA member-countries have used provisions under Chapter 11 to sue governments and demand cash compensation for government policies and regulations which affect their investment rights. According to Canadian Centre for Policy Alternatives, the Canadian government has already paid out NAFTA damages totalling $CAD157 million and incurred millions more in legal costs.[1]

[1] Scott Sinclair, "NAFTA Chapter 11 Investor-State Dispute," Canadian Centre for Policy Alternatives, 2010 (available at www.policyalternatives.ca).

In April 2009, the Swedish energy giant, Vattenfall, brought a €1.4 billion lawsuit against the German government before the World Bank's arbitration tribunal, International Centre for Settlement of Investment Disputes, for allegedly violating the provisions of Energy Charter Treaty. The company accused Germany of imposing environmental restrictions on its upcoming coal-fired power plant in Hamburg. In August 2010, both parties reached an agreement regarding the termination of the arbitral proceedings. However, the exact terms of agreement have not been made public.

Given the fact that the investment treaty arbitration is increasingly viewed as an unfair method for resolving investment disputes, it would be unwise for the political establishment in India and Europe to accept such controversial provisions under the proposed bilateral trade agreement.

Rethinking Investment Liberalization

Contrary to popular perception, rapid economic development has occurred amidst tight regulations on the entry of foreign investments in the two most successful cases of the post World War II period, namely, Japan and South Korea. China — the latest "success story"— too has imposed stringent restrictions on foreign investment including mandatory technology transfer, screening, negative list and sectoral limits.

Of late, several countries (both developed and developing) are tightening existing investment rules or to enacting new rules to regulate foreign investments and to protect "strategic sectors" from foreign investors. In many countries including India, attempts are being made to screen foreign investments from a security perspective.

The EC proposals strongly protect investors' rights in legally binding form backed by investor-to-state dispute settlement mechanism. Surprisingly, the EC proposals make no mention of responsibilities of investors towards human rights, society and natural environment. Instead of granting far reaching rights and privileges to investors under the FTA, efforts should be made to strengthen the institutional and legal structures for holding them accountable for their actions.

With the entry into force of the Treaty of Lisbon on 1 December 2009, there is a renewed demand for radical reforms in the EU investment policy. The Lisbon Treaty strengthens the EU's ability to develop and manage international investment policy. The European civil society organizations have called for "a balanced investment policy that is not merely concerned with investor rights, but holds investors accountable and promotes and protects public interests, human rights and environmental sustainability."[2]

At a time when there is an urgent need to reform existing EU bilateral investment treaties in accordance with the Lisbon Treaty, Burghard Ilge, a policy researcher based at Both Ends (Amsterdam), points out that this EC move is an attempt to block such reforms besides locking-in existing provisions with even greater rights to investors.

According to Myriam Vander Stichele, senior researcher at SOMO (Amsterdam), the EC recommendations reveal its commitment to neoliberal economic thinking strongly backed by Germany and other capital exporting countries.

The global financil crisis has underscored the need for greater regulation and supervision of private capital flows. The solution is not simply to strengthen the exceptions under the proposed India-EU FTA. Rather the discredited framework of unrestrained investments across borders should not be pursued under the ambit of bilateral trade and investment agreements.

In particular, India should retain the ability to deploy all tools to manage cross-border investment flows. Not long ago, India had opposed the inclusion of investment issues at the multilateral level under the WTO framework at the Cancun Ministerial Conference.

New Delhi and Brussels should not sign a lopsided bilateral trade agreement that would legally bind them to serve the private interests of investors while constricting the policy space to intervene in the public interest.

Against the backdrop of the global financial crisis, any prospective trade and investment agreement which restricts the ability of governments to regulate cross-border investments in accordance with developmental priorities of member-countries will remain highly contentious.

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[2] Seattle to Brussels Network, "Change EU Investment Policy: Now is the Time," January 2011 (available at http://www.s2bnetwork.org).