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FDI Growth in Asia: The Potential for Treaty-Based Investment Protection

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In recent years, Asia, the world's export powerhouse, has become a major source of foreign direct investment (FDI). Combined annual outbound FDI from and between east, south and south-east Asian countries has exceeded US$100 billion every year since 2003.[1]

Capital-exporting countries in Asia have also been broadening and strengthening their networks of international investment agreements (IIAs). This increased activity by governments reflects an appreciation of the importance of investment protection in safeguarding their investors and hedging against risk.

As national economies and supply chains in Asia become more and more intertwined, with elements of the production process outsourced across Asia, it becomes more and more important to create stable and predictable conditions for investment as part of a comprehensive foreign economic strategy. Governments may choose to negotiate comprehensive free trade agreements (FTAs) or economic partnership agreements (EPAs) incorporating provisions on investment protection, or they may prefer stand-alone bilateral investment treaties (BITs). Either way, the trend is toward more IIAs and higher-standard IIAs. Even China, which has been historically reluctant to enter into high-standard IIAs, has sought high-level protection in its latest BITs.

If governments build an IIA network, it will be used. Well-advised Asian investors will use their rights under IIAs as leverage in negotiating with governments. Well-advised investors will also plan their investments in advance to maximise their IIA rights and hedge against risk.

Asian investors have also shown they are willing and able to use IIAs to enforce their rights when necessary. Japanese and other investors have taken cases to investment arbitration and won – in some cases obtaining hundreds of millions of dollars, such as in the *Saluka* case discussed below. And 2007 saw the first investment claim ever brought by a Chinese investor, under the China-Peru BIT.

For investment protection, Asia is the next frontier. But more importantly, for Asian investors, treaty-based investment protection can provide a risk hedge that can pay for itself in enhanced bargaining leverage in difficult times.

Asia has become a major source of foreign direct investment

Asian investors have been increasingly looking abroad for opportunities. The growth in the outflow of FDI from Asia has been substantial in recent years. According to data reported by the United Nations Conference on Trade and Development (UNCTAD), in 2007 annual FDI outflow from countries in Asia exceeded US$200 billion for the first time ever, surging from US$168 billion in 2006 to US$224 billion.[2] The 2007 outbound FDI reached US$73.5 billion for Japan, US$22 billion for mainland China, US$15 billion for Korea, US$14 billion for India, US$12 billion for Singapore and US$11 billion for Malaysia.[3] Not surprisingly, cumulative total FDI from Asia also set a new record in 2007, reaching US$2.2 trillion.[4]

As an example, Japan's outward FDI is large and growing. Its 2007 FDI flow of US$73.5 billion, the largest in Asia, increased 46 per cent over the year before, and Japan's total FDI stock reached a record US$543 billion by the end of 2007.[5] Japan's role as a source of outward FDI has outstripped its role as an export superpower. Since 2004, the net income from Japanese outward FDI has been larger than Japan's trade surplus. Sales by Japanese-owned manufacturing companies abroad reached ¥80 trillion (US$830 billion) in 2006, equal to about 18 per cent of total sales.[6]

This development reflects underlying economic trends. The production chain of Japanese industry has shifted to incorporate offshore manufacturing in East Asia and elsewhere, impelled by labour shortages in Japan. As Japan has few energy or mineral resources, Japanese companies have attempted to assure security of energy and resource supplies by upstream investment abroad. Because Japan's population is declining, service industries such as construction must expand abroad in order to grow; because delivery of these services involves presence in the customer's market, exports of these services also necessarily involve FDI.

China too is a rapidly growing FDI source, with outward flows from mainland China of US$22 billion in 2007, almost double the level of 2005[7] – a remarkable development, considering China's history as a capital-importing economy.[8] The Chinese government has taken important steps to encourage outbound FDI. A recent study of China's approach to FDI found that 'the Chinese government's approval process for [outbound FDI] has been streamlined and decentralized in order to promote foreign investments by Chinese enterprises' and '[t]he Chinese government has also introduced several incentives to promote Chinese [outbound FDI] in specific areas'.[9] And indeed, the outflow of FDI from China has been growing more rapidly than FDI inflow, suggesting that while China may still be a net capital-importing country, the export of capital is growing in importance, and China's importance as a capital exporter is growing along with it.[10] Hong Kong's outbound FDI flow (much of which may consist indirectly of outflows from mainland China) exceeded US$53 billion in 2007 alone,[11] and by the end of 2007, Hong Kong's total FDI abroad exceeded US$1 trillion for the first time.[12]

Smaller Asian countries are also important as FDI sources. UNCTAD reports that '[f]or the first time in 2007, outflows from Malaysia and the Philippines exceeded inflows of FDI'.[13] Malaysian and Philippine companies 'are investing overseas to acquire or build brand names, access markets, technologies, and natural resources and strengthen value chains'.[14]

Foreign direct investment from Asia is being actively sought by developed and developing countries alike. UNCTAD's 2008 World Investment Report noted that investment promotion agencies from developed countries have begun establishing offices in countries such as China, Singapore and India to attract

FDI, and, in fact, 'India is now among the top investors in the United Kingdom'.[15]

The recent surge in outward investment from Asia has been particularly directed toward developing countries. FDI flows to southern Africa grew more than fivefold in 2007,[16] and much of this growth was a result of increased FDI from Asia, and from China in particular.[17] UNCTAD reports that '[i]n 2007, the Export-Import Bank of China financed over 300 projects in the [African] region, constituting almost 40% of the Bank's loan book'.[18] While China's outbound FDI was formerly focused on developed countries,[19] developing countries in Africa, Asia and Latin America now receive the vast majority of outbound FDI flow from China.[20] Japan recently announced the creation of 'a facility within the Japan Bank for International Cooperation… for investment (ie, equity investment, guarantees and local financing) in Africa of [US]$2.5 billion over the next five years', an amount that is equal to 'twice the total FDI flows from Japan to Africa during the past five years'.[21]

While there is no doubt that global markets are experiencing a period of extreme volatility, predictions for outbound FDI from Asian countries remain positive. UNCTAD predicts that '[p]rospects for outbound FDI are encouraging because of the strong drive of Asian corporations to internationalize, as well as significant M&As expected to be completed in 2008'.[22] The economic fundamentals impelling foreign investment, noted above in the case of Japan, also apply in China, Korea, Malaysia and other middle-income Asian countries, all of which are experiencing to some extent increasing lifespans, declining birthrates, and high savings rates. All of these factors add up to an increasing need for pension funds and other sovereign wealth funds to invest abroad, so that these countries can diversify risk and obtain the best return on capital.

Given the recent surge in outward investment and its expected sustainability, Asian countries are likely to continue to expand their investments abroad. It is critical that Asian countries with strong outbound FDI ensure their investors are appropriately protected by strong international investment agreements that guard their investments and reduce risk.

Why well-advised investors use international investment agreements to reduce foreign investment risk

Governments worldwide are building an ever-broadening network of IIAs – which now includes over 2,600 BITs and many EPAs and FTAs with investment chapters. Almost all countries in the world (179 of 195) are party to at least one investment agreement.[23]

Governments have created this network to promote and protect foreign investment. These agreements respond to investors' requests, and provide a valuable tool to attract desirable inward FDI. Investing abroad inevitably carries increased political and economic risks, particularly when an investment involves large sunk costs or a long-term commitment of capital. As outward FDI from Asia turns increasingly toward developing countries with less stable legal and judicial frameworks, the risks associated with foreign investment increase. And in an era of capital shortage, investment destinations will compete to obtain the most desirable investment projects.

IIAs serve the interests of capital-exporting and capital-importing governments, as well as foreign investors. The investor gains legal protection that reduces business risk and increases certainty; its government gains protection for the investor; and the host state government gains the employment and technology benefits of the investment.

From an investor's standpoint, IIAs have desirable benefits, flowing from the specific legal guarantees. Modern IIAs provide protection against arbitrary and discriminatory acts by the host government. They can also guarantee valuable commercial freedoms, such as the freedom to transfer funds and repatriate profits. These agreements also permit the investor to bring claims against the state directly to a neutral arbitration tribunal, which can award monetary compensation for treaty violations that have harmed the investor.[24]

One typical IIA legal provision prohibits host countries from expropriating foreign investment without compensation. This guarantee against expropriation is not limited to seizures of physical property, or forced divestures of assets or equity. It can cover any government measure that deprives an investor of the economic value of its investment. Since IIAs define 'investment' broadly, IIAs can provide a remedy when, for example, a government arbitrarily revokes a licence or a concession contract, or takes away the investor's intellectual property rights.

IIAs also often guarantee investors 'fair and equitable treatment' for their investments. Tribunals have interpreted this standard to require that states provide due process to the investor through courts or administrative tribunals, act transparently and free from ambiguity, refrain from unreasonable or arbitrary regulatory actions, and protect investors' 'legitimate expectations', including assurances made to an investor regarding its investment. And IIAs often guarantee 'full protection and security' for investments, requiring host governments to take reasonable action to protect foreign investments from theft or harm.

IIAs can also protect investors and their investments against government discrimination in favour of similarly situated domestic investors (national treatment) or foreign investors from a different country (most-favoured-nation treatment). These guarantees bar the host government from targeting foreign investors for unfavourable treatment.

Finally, IIAs often give foreign investors the right to transfer funds freely, both into and out of the host country, without delay. These provisions typically protect both additional inflows of financial resources, and repatriation of profits, interest or proceeds from liquidation.

IIAs also provide powerful dispute resolution mechanisms. The signature of a modern IIA constitutes an advance agreement to allow foreign investors to resolve disputes with the host government through binding international arbitration. An IIA may allow investors to choose between multiple fora, such as arbitration at the World Bank-affiliated International Centre for Settlement of Investment Disputes (ICSID), or before an ad hoc arbitral tribunal organised under the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules.

IIAs thus provide important procedural rights in addition to substantive protections against government mistreatment, lowering the risks of investing abroad.

Asian governments are broadening and strengthening their international investment agreements to protect investors

Asian governments are actively enhancing their IIA networks. UNCTAD reports that Asian countries concluded 29 of the 44 new BITs in 2007, describing the effort as the 'most intensive treaty-making activity' in 2007, and as confirmation of the 'sustained high level of commitment from policymakers in this region for closer economic integration and investment protection and liberalization'.[25]

China negotiated five new BITs in 2007 and, at the end of 2007, had the second highest number of BITs in the world (120). In the past five years, China has shifted focus toward treaty-making with developing countries; the majority of China's new BITs in the past five years were with African countries. China is also engaged in an ambitious negotiating programme for BITs, or FTAs with investment provisions, with Russia, Japan, Australia and Korea. China has also upgraded and strengthened 15 of its earlier BITs. The new Chinese BITs, such as China's 2004 BIT with the Netherlands or its amended BIT with Germany, eliminate some of the reservations and gaps that severely reduced the value of older Chinese BITs. The China-Canada BIT, currently under negotiation, even features environmental considerations.[26]

China's increasing focus on outward investment has brought with it a shift in policy toward stronger substantive and procedural investment protections in BITs.[27] Though still a developing country and a net capital importer, when negotiating BITs China has increasingly taken the position of a capital-exporting country, pushing for strong protections for its investors.[28] The China-New Zealand FTA, which entered into force on 1 October 2008, includes strong substantive protections for investments and provides for investor-state arbitration.[29] China's new FTA with Singapore, signed on 23 October 2008, reportedly also includes an investment chapter.[30]

Japan too has gone through a major shift in policy toward negotiation of IIAs. With the increasing difficulties in making headway in WTO negotiations, in 2002 Japan launched a series of EPAs liberalising trade in goods and services, and including strong investment protection provisions covering both manufacturing and services investment. Like NAFTA, almost all of Japan's EPAs are negotiated on the principle of liberalising all areas of investment except for those in a negotiated 'negative list'. This formula effectively opens markets for new investment by providing pre-establishment national treatment for investors.

Japan is engaged in an ambitious negotiating programme for EPAs and BITs, targeted at the destinations for Japanese overseas investment, countries with natural resources, regional investment gateways or others targeted by business. Since 2002, Japan has concluded EPAs containing investment protections with Singapore, Mexico, Malaysia, the Philippines, Chile, Thailand, Brunei, Indonesia and Switzerland; also, BITs with Korea, Vietnam, Cambodia, Laos and Uzbekistan. India and Japan have announced plans to complete FTA negotiations by the end of 2008. Japan is also negotiating with Saudi Arabia, Peru and the Gulf Cooperation Council, and negotiating a Japan-Korea-China BIT to replace the existing Japan-China BIT.

As Korea, India, Malaysia and other countries in Asia become sources for foreign investment by major international investors, they too are turning toward strengthening BIT and FTA/EPA networks. The prospects favour ever wider use of IIA protections by investors of these and other Asian countries.

Maximising the potential of international investment agreements as a risk-management, problem-solving tool

Since the modernisation of Asia's IIA network is fairly recent, business can be expected to take time to appreciate the new possibilities opened by the new-model EPAs and BITs of Asia. Asian investors that have sustained damage from IIA violations by governments can use their rights to obtain compensation through arbitration before an independent tribunal. Yet even if an investor is reluctant to seek arbitration due to the potential for business disruption, it is useful for that investor to know its treaty rights and use them to bargain effectively with a host state government. Investors can also plan investments in order to maximise their IIA rights in the event that problems occur some time in the future.

This decade has already seen a number of examples of successful investment litigation by Asian investors. In 2004, the Malaysian company MTD Equity won a multimillion-dollar award against Chile for breach of the Chile-Malaysia BIT.[31] After receiving approval by one Chilean agency, MTD's project was blocked by another; a tribunal found that this sequence of actions by the Chilean government constituted unfair and inequitable treatment. In another case in 2004, a Singapore investor, Cemex Asia Holdings, brought a claim for US$400 million in damages under the 1987 ASEAN Agreement for the Promotion and Protection of Investments against the Indonesian government for blocking investment in an Indonesian firm.[32] This case was settled – as are many investment claims. The first registered investment arbitration request by a Chinese investor came in 2007; Tza Yap Shum claimed US$20 million in damages under the China-Peru BIT for an alleged expropriation.[33]

The most well-known example may be *Saluka v Czech Republic*,[34] brought in 2001. In June 2000, the Czech government seized a foreign-owned Czech bank and sold it to a competitor for 1 Czech koruna (US$0.04), after injecting cash into the foreign bank's domestically owned competitors. The bank was owned by Nomura of Japan through a Dutch special-purpose corporate vehicle, Saluka Investments BV. Saluka brought an investment claim against the Czech Republic in 2000; in 2006, an investment tribunal found that the government had violated its duty of fair and equitable treatment to foreign investors, and the parties agreed on a method to settle the amount of damages. The Czech Finance Ministry announced in June 2008 that it will pay Nomura compensation of US$263 million, including interest.

No investor will seek arbitration as a first choice; in our experience, many investors settle their cases successfully by negotiating with the host government. Knowing and using a company's IIA rights can provide very useful leverage to get a dispute settled and to get the settlement amount paid.

Investors can plan ahead and structure their investments to maximise IIA coverage. The *Saluka* case provides an example: because Nomura held its investment in the Czech bank through a subsidiary incorporated in the Netherlands, Nomura was able to use the Netherlands-Czech BIT and was able to recover damages even though there is no BIT between Japan and the Czech Republic. The modest cost of structuring an investment so that an investor can take advantage of the protections provided under an IIA can pay enormous dividends if difficulties occur down the road.

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Asia is now an important and growing source of FDI worldwide. Foreign investment provides Asian companies significant opportunities for diversification and business growth, but also increased risks, amplified by the market difficulties and volatility facing global investors today. IIAs provide important and robust protections. Investors should look closely at how they can effectively use these protections to manage risk and capitalise on investment opportunities in the years to come.

Notes

1. UNCTAD, World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge (WIR 2008) – 'Major FDI Indicators'

Direct Investment Abroad (FDI Outward) Flow, http://stats.unctad.org/FDI ('UNCTAD 2008 FDI Outward Flow'). In this article, following the UNCTAD statistics, 'East Asia' refers to China, Hong Kong, Macao, Taiwan, North Korea, South Korea, Mongolia and Japan; 'South Asia' refers to Afghanistan, Bangladesh, Bhutan, India, Iran, Maldives, Nepal, Pakistan and Sri Lanka; 'South East Asia' refers to Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste and Vietnam; and 'Asia' includes all three of these regions.
2. UNCTAD 2008 FDI Outward Flow, supra note 1.
3. Id.
4. WIR 2008 – 'Major FDI Indicators' Direct Investment Abroad (FDI Outward) Stock, http://stats.unctad.org/FDI ('UNCTAD 2008 FDI Outward Stock').
5. UNCTAD 2008 FDI Outward Stock, supra note 4.
6. Japan Ministry of Economy, Trade, and Industry, 'Japan's Policies and Strategies on Bilateral Investment Treaties', available at www.rieti.go.jp/jp/events/08072501/pdf/3-1_E_Mita_t.pdf (last visited 27 October 2008).
7. UNCTAD 2008 FDI Outward Flow, supra note 1.
8. Id at p1.
9. See Axel Berger, 'China and the Global Governance of Foreign Direct Investment: The Emerging Liberal Bilateral Investment Treaty Approach', Discussion Paper, German Development Institute, 10/2008, at p17.
10. For further discussion of this relationship and its implications, see id at p14.
11. UNCTAD 2008 FDI Outward Flow, supra note 1.
12. UNCTAD 2008 FDI Outward Stock, supra note 4.
13. WIR 2008, available at www.unctad.org/Templates/webflyer.asp?docid=10502&intItemID=2068&lang=1, at p49 (citation omitted).
14. Id. at p49.
15. Id.
16. Id at p41.
17. Id.
18. Id at p44.
19. See Berger 2008, supra note 9, at p11.
20. Id.
21. WIR 2008, supra note 13, at pp44-45.
22. WIR 2008, supra note 13, at p46.
23. WIR 2008, supra note 13, at p14.
24. For example, *France Telecom v Lebanon*, in which the investor was awarded US$266 million for violations by Lebanon of the France–Lebanon BIT; *Azurix Corp v Argentina*, in which the investor was awarded US$165 million for violations by Argentina of the US–Argentina BIT; and *CMS Gas Transmission Company v Argentina*, in which the investor was awarded US$133 million for violations by Argentina of the US–Argentina BIT.
25. WIR 2008, supra note 13, at pp14-17.
26. WIR 2008, supra note 13, at p15.
27. See Berger 2008, supra note 9, at pp19-21.
28. See Berger 2008, supra note 9, at p21.
29. See New Zealand–China Free Trade Agreement Guide, available at http://chinafta.govt.nz.
30. See, eg, 'China, Singapore Sign Free Trade Pact', *China Daily*, 23 October 2008, available at www.chinadaily.com.cn/bizchina/2008-10/23/content_7135029.htm. The text of the China-Singapore FTA was not publicly available as of October 2008.
31. *MTD Equity Sdn Bhd and MTD Chile SA v Republic of Chile*, ICSID Case No. ARB/01/7, Award of 25 May 2004 (subsequent application for annulment denied, Decision on the Application for Annulment, 21 March 2007).
32. *Cemex Asia Holdings Ltd v Republic of Indonesia*, ICSID Case No. ARB/04/3; see also 'Cemex to End ICSID Claim Against Indonesia', 30 June 2006, *Global Arbitration Review*, available at www.globalarbitrationreview.com/news/article/3491/cemex-end-icsid-claim-against-indonesia/.
33. *Tza Yap Shum v Republic of Peru*, ICSID Case No. ARB/07/6; see also 'First Chinese Claimant Registered at ICSID', 16 March 2007, *Global Arbitration Review*, available at www.globalarbitrationreview.com/news/article/3739.
34. *Saluka Investments BV v Czech Republic* (UNCITRAL).

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Sidley Austin LLP's international arbitration practice is comprehensive and truly global in reach, with experience in arbitral fora ranging from London to Washington to Hong Kong. In addition to a full international commercial arbitration practice, Sidley is particularly known for its substantial practice in the high-profile field of investor-state (investment treaty) arbitration.

Sidley represents multinational companies as claimants, and sovereign governments as respondents, in disputes over government actions that allegedly injure foreign investments. Sidley lawyers also serve as arbitrators in investor-state cases, and Sidley has one of the largest dockets of any firm of ICSID and UNCITRAL cases.

In tandem with its investor-state arbitration practice, the international arbitration team advises Sidley's corporate clients on structuring multinational transactions to take advantage of the protections and arbitration options that investment treaties have to offer.

Sidley's investment treaty team includes lawyers who have served in government negotiating, and overseeing negotiations of and disputes under, bilateral and multilateral investment treaties. Sidley lawyers have served as arbitrators in investor-state disputes, have been appointed by governments to serve on standing rosters of arbitrators, and have taught courses and seminars in investment treaty arbitration.

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Stanimir Alexandrov is a partner at Sidley Austin, where he focuses his practice in the areas of international dispute resolution, including investor-state arbitration and international commercial arbitration, and resolution of trade disputes before the World Trade Organization (WTO). He has represented private parties and governments in arbitration before the International Centre for Settlement of Investment Disputes (ICSID), as well as in ICC, UNCITRAL, LCIA, and AAA international arbitrations. Mr Alexandrov has been appointed to ICSID's panel of arbitrators and panel of conciliators. He currently serves as an arbitrator in five cases under the arbitration rules of ICSID and LCIA. He has appeared as an expert witness in international arbitration on investment treaty interpretation.

Before engaging in private practice, Mr Alexandrov was vice minister of foreign affairs of Bulgaria. Prior to that, he served as deputy chief of mission of the Embassy of Bulgaria in Washington, DC, where he negotiated trade and investment agreements and worked with the World Bank and the IMF.

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