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Working Group on the Relationship between Trade and Investment

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SCOPE AND DEFINITION

I. INTRODUCTION

1. The November 2001 Doha Ministerial Declaration (WT/MIN(01)/DEC/W/1) clearly focuses the work of the Working Group (WG) in the period until the Fifth Session of the Ministerial Conference on clarification of the various elements of a future multilateral investment framework.

2. Of the elements in question, this paper explores "scope and definition", examining a number of related points. Scope and definition are key clarification issues in that they will affect the shape of the entire framework, and as such, they will require ongoing discussion at this and future WG meetings.

3. Regarding the theme of scope and definitions, a number of submissions have been presented in the past meetings of the WG, and they should serve as a useful reference[1].

II. SCOPE

4. In terms of scope, this paper concentrates on the relation between the possible investment framework and GATS. As GATS provides disciplines for services related investment, discussion on the relation between the two disciplines will be an essential part of considering the scope of an investment framework.

A. SCOPE OF GATS

5. GATS applies to "measures by Members affecting trade in services" (Article 1.1). However, it excludes those measures related to protecting public morals, maintaining public order, protecting life or health, and protecting security interests (Articles 14 and 14 bis). (These exclusions should be borne in mind when considering exemptions to investment rules.)

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[1] WT/WGTI/W/43 ("Definition of Investment" – Japan), W/49 ("Definition of Investment" – Korea), W/60 ("Definition of Investment" – Costa Rica), W/61 ("Definition of Foreign Investment" – IMF), W/76 ("Issues raised and points made on the definition of investment" – WTO Secretariat), W/80 ("Definition of Investment" – Australia), W92 ("Definition of 'Investment' in the WTO Rules on Investment" – Japan).

6. For the purposes of GATS, trade in services is defined as the supply of a service in one of the following modes:

(a) from the territory of one Member into the territory of any other Member;

(b) in the territory of one Member to the service consumer of any other Member;

(c) by a service supplier in the territory of one Member, through commercial presence in the territory of any other Member;

(d) by a service supplier of one Member, through the presence of natural persons of a Member in the territory of any other Member.

7. These modes are presented in diagram form in Annex 1. The third mode, namely the supply of services through commercial presence, applies to direct investment in the services area, such as a bank's establishment of a branch. GATS can therefore be said to include disciplines related to direct investment in services.

8. Clearly, then, direct investment in services is already included within the scope of the WTO Agreement. At the same time, no comprehensive agreement exists for direct investment in areas outside services, and given the enormous impact which direct investment has on trade in manufacturing, the lack of rules in this regard creates a striking imbalance in the WTO Agreement.

B. DISTINCTION BETWEEN GOODS AND SERVICES

9. In 1998, the share of the direct investment flow absorbed by manufacturing sectors and services sectors was 44.0% and 38.9% respectively on a world basis, 37.5% and 42.9% in the case of developed countries, and 66.8% and 25.0% in the case of developing countries[2]. The scale of direct investment in manufacturing is therefore much the same as for services, with the manufacturing ratio particularly large in developing countries (see Annex 2). Given the reality of such large-scale economic transactions, the Doha Ministerial Declaration recognized the "case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border direct investment, particularly foreign direct investment, that will contribute to the expansion of trade" (Paragraph 20).

10. With regard to extending the scope of an investment framework as far as direct investment in services is concerned, we need further careful consideration. Even in the case that investment in services sectors is excluded, it may prove unexpectedly difficult to categorize individual investment activities as belonging to either manufacturing or services. In fact, even the 1998 UNCTAD statistics on FDI inflow by industry (Annex 2) indicate that 8.4% of world investment (1.6% for developing countries, 10.3% for developed countries) belongs to industries which cannot be specified. However, if a possible agreement on investment follows the precedent of many international investment agreements and sets the provision regarding investment as the establishment, acquisition, holding, or operation, etc. of investment assets (companies, stocks, real estate, etc.) by investors, it naturally covers direct investment in the services sector and there is a strong likelihood of duplication with GATS on economic activities through commercial presence.

11. Where an investment framework is created, we could well find the same case subject to both GATS and the new investment framework. The WG should give consideration to whether a preference/subordination clause should be designed in relation to GATS and the investment framework, or whether panels should be left to resolve any problems that occur.

[2] "World Investment Report" (UNCTAD, 1999).

C. INDUSTRY CLASSIFICATIONS

12. Given that the future investment framework could adopt a "positive list" approach (included among the elements for clarification in the Doha Ministerial Declaration), the WG needs to conduct some sort of consideration of industry classifications. It is desirable that the deliberation on the scope of a possible investment framework should proceed through this work.

13. The GATS experience should prove a valuable reference in approaching this work. A commitment schedule was created for GATS based on a service classification table (MTN.GNS/W/120) drawing on the United Nations' Central Product Classification (CPC)[3] system. The commitment schedule covers 155 types of services, with Members listing those service areas where they can guarantee fulfilment of national treatment and market access obligations. (Transparency and MFN treatment are as a rule considered obligatory for all service areas, with Members required to list up exemptions.) As with the GATS, a classification table could be created for the investment framework that deals with non-service (or manufacturing) areas, using this as the basis for a commitment schedule. Another option of using the Harmonized Commodity Description and Coding System (HS) deserves deliberation. In that case, taking into consideration that the products manufactured by companies vary, the use of a 4-figure or a 6-figure category is unrealistic because they are divided in too much detail, so that a 2-figure category or the category above, i.e. 21 Sections, would be the subject of consideration.

III. DEFINITION

A. BASIC APPROACH TO INVESTMENT CATEGORIES

14. International investment can be divided broadly into foreign direct investment (FDI) and portfolio investment. Basically, the bulk of FDI comprises investment aimed at building long-term economic relations in the host country, while, seemingly, most portfolio investment is considered to be speculative in nature and conducted with the primary goal of investment profit. International investment has, however, become more diversified in recent years, blurring the distinction between these two types. We will return to this issue later.

15. The International Monetary Fund (IMF) defines direct investment as the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy[4]. The "lasting interest" implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise. Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated. The direct investment capital actually transacted through direct investment activities is capital provided by a direct investor to a direct investment enterprise or received by a direct investor from a direct investment enterprise. The components of direct investment capital transactions are equity capital, reinvested earnings, and other capital associated with various intercompany debt transactions.

16. Portfolio investment includes, in addition to equity securities and debt securities in the form of bonds and notes, money market instruments and financial derivatives such as options. Excluded are any of the aforementioned instruments included in the categories of direct investment and reserve

[3] International classification standard for goods. Designed to embrace in principle all goods which can be traded, including not only the goods and services produced through economic activities, but also tangible assets such as land, and intangible assets such as real estate.

[4] Communication from the IMF entitled "Definition of Foreign Investment" (WT/WGTI/W/61).

assets. To put it simply, cross-border investment in securities is investment with the intention of profit-making rather than management control, and this is not categorized as direct investment.

17. Direct investment is typified by green-field investment, whereby a completely-financed commercial presence is established in another country (typically plants in the case of manufacturing, branches in the case of services), or cross-border mergers and acquisition. In this regard, the IMF definition stipulates that where the ratio of stockholdings by the foreign investor is 10% or over, it shall be included in the category of direct investment (the same definition as applied under Japan's Foreign Exchange and Foreign Trade Law). When the investment ratio is less than 10%, the investment is deemed to be portfolio investment. The relation between portfolio and direct investment is presented in diagram form in Annex 3.

B. Direct Investment as Defined in Investment Agreements

18. Existing investment agreements offer a range of definitions according to the purpose of the agreement. As explained by Japan in an earlier paper[5], these definitions can be divided into three broad categories. The first category is "enterprise-based", which focuses on the enterprise, whereby investment is defined only as direct investment in the context of the relationship with an enterprise. The second category is "asset-based", which uses asset standards, and is a wide-ranging definition that includes both portfolio and real estate investment[6]. There is room for variation in this category, however, such as the treatment of short-term capital regulations or exclusion of the movement of capital based on speculative financial transactions. The third type of definition allows for optional investment criteria, with the particular criteria determined according to goals and provisions. The definition may be called "selective asset based", which changes according to the respective specific obligations incurred under investment rules. For example, one investment arrangement applies a narrow definition in the case of investment liberalization, and a broad definition for investment protection.

19. Amidst this multitude of approaches to defining investment, Japan considers the use of the enterprise-based approach limited to direct investment as the most appropriate starting point of the discussion on the definition for investment in a multilateral investment framework. Japan's reasoning is as follows.

1. Significance of long-term economic relations

20. The investment covered by a multilateral framework should be restricted to investment intended to build long-term economic relations with the host country. As is noted in Paragraph 20 of the Doha Ministerial Declaration, the multilateral framework should address that investment which contributes to the expansion of trade, and, ultimately, to the economic development of the host country. It is clear that direct investment meets these conditions. It is equally clear that it would not be appropriate to create a legal framework within the WTO concerning short-term investment of a speculative nature.

21. Disciplines on short-term capital movement are in any case outside the WTO's mandate. This particular issue is being discussed by financial experts in, for example, the Financial Stability Forum, in the context of stabilizing and strengthening the international financial system[7].

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[5] Communication from Japan entitled "Definition of 'Investment' in the WTO Rules on Investment" WT/WGTI/W/92.

[6] For example, a WG paper from Costa Rica (WT/WGTI/W/60) suggests that both direct and portfolio investment should be included in the investment definition, but that financial transactions for purely speculative purposes and capital movement in the form of loans with no relation to investment should be excluded.

[7] Made up of a number of international institutions, the Financial Stability Forum contains a working group on capital movement that has been conducting considerations from an expert standpoint, producing a report in April 2000

2. Statistical clarity

22. The IMF provides a clear definition of direct investment, and compiles statistics accordingly. If the definition of investment used in the multilateral investment framework were focused on direct investment, this would facilitate clarification of the scope of the investment to be covered by the framework. The inclusion of other international movements of capital is highly likely to create problems in terms of gathering data and maintaining credibility of statistics, and it could be difficult to ascertain the actual investment activities covered by the framework. To avoid creating unnecessary confusion over the actual scope of the framework, it would be safer to exclude all but direct investment.

C. FUTURE ISSUES

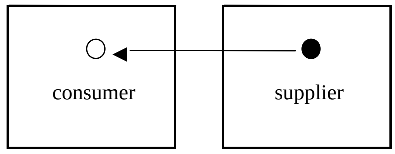
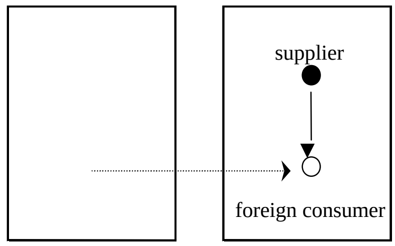
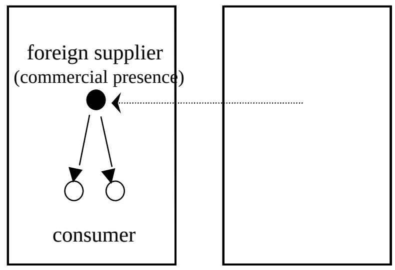
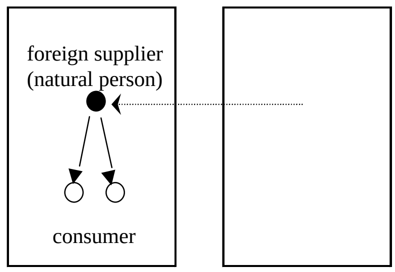
23. The treatment of portfolio investment of a long-term nature presents problems in terms of "long-term cross-border investment". More specifically, further consideration will probably be needed as to whether owning of equity interest at a low rate (of no more than 10%, according to the definition by IMF) but aimed at long-term economic relations in the host country should be excluded from the coverage. As noted above, if the definition by IMF is adopted, such investment would not be recognized as direct investment (see the "Foreign Portfolio Equity Investment" section of Annex 3). However, much portfolio equity investment in recent years involves active participation in management from a long-term perspective, and is not necessarily only investment of a speculative nature.

24. If the definition of a possible multilateral agreement on investment were to add long-term portfolio investment to direct investment as defined by the IMF, the actual scope of the said portfolio investment would need to be clearly delineated. Detailed considerations will be needed on questions such as the concrete definition of "long-term", and the possibility of dividing long-term portfolio equity investment into speculative investment and investment for the purpose of lasting interest, as well as dealing with the according statistical challenges.

(http://www.fsforum.org/Reports/RepCF.html). Finance Ministers also compiled a report entitled "Strengthening the International Financial Architecture" at the Kyushu-Okinawa Summit in July 2000.

Annex 1

Four modes of trade in services

Mode and Description	Example	Diagram
1 Cross-border supply Supply of a service from the territory of one Member into the territory of another Member < Border-crossing of a service>	Legal advices by telephone from a lawyer living abroad	
2 Consumption abroad Supply of a service in the territory of one Member to a service consumer of another Member < Border-crossing of a consumer>	Local consumption by a foreign tourist or businessperson, such as rental of electronic	
3 Commercial presence Supply of a service by a service supplier of one Member through commercial presence in the territory of another Member < Border-crossing of commercial presence>	Financial services provided by a local branch	
4 Presence of natural persons Supply of a service by a service supplier of one Member through the presence of natural persons of that Member in the territory of another Member < Border-crossing of suppliers>	Performances of a foreign artist	

< Symbols >
: supplier of a service
: consumer of a service
: supply of a service
: border-crossing of suppliers/consumers

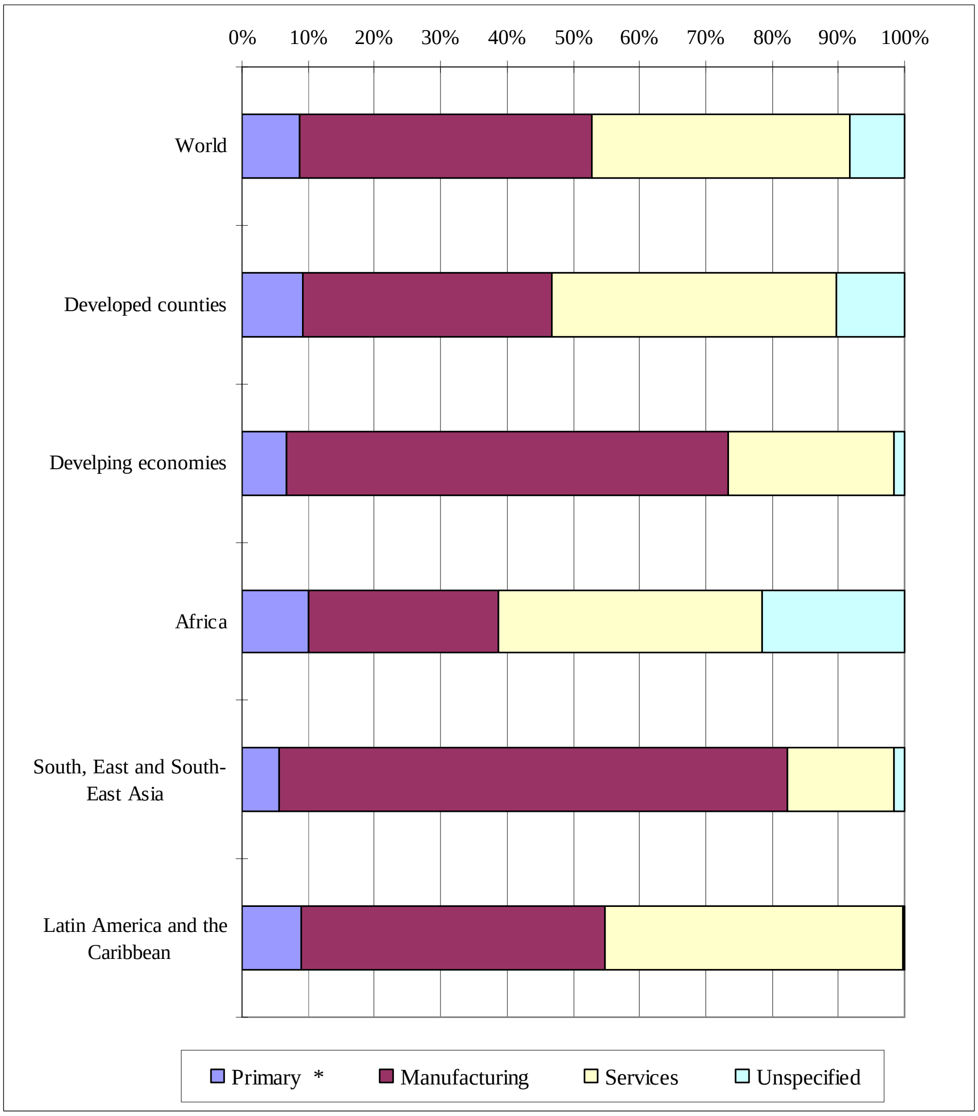
Annex 2

FDI inflows by industry (1998)

(Values in millions of US dollars)

	Primary*	Manufacturing	Services	Unspecified	All industries
World	10,364	52,776	46,653	10,044	119,837
Developed counties	8,577	34,974	39,999	9,620	93,170
Developing economies	1,787	17,802	6,654	424	26,668
Africa	65	183	254	137	639
South, East and South-East Asia	1,044	14,140	2,994	279	18,457
Latin America and the Caribbean	678	3,479	3,407	9	7,572

* Agriculture, hunting, forestry and fishing, mining, quarrying and petroleum and unspecified primary
(UNCTAD "World Investment Report"1999)



Annex 3

Relationship between Foreign Direct and Portfolio Investment
(based on the definition by the IMF)

<table>
<tr><td rowspan="2" colspan="2">Foreign Direct Investment</td><td>Greenfield Investment</td><td></td></tr>
<tr><td>Possession of 10% or more of the ordinary shares or voting power or the equivalent</td><td rowspan="2">)
) Cross-border
) M&A
)</td></tr>
<tr><td rowspan="2">Foreign Portfolio Investment</td><td>Foreign Portfolio Equity Investment</td><td>Possession of less than10 % of the ordinary shares or voting power or the equivalent</td></tr>
<tr><td></td><td>Equity securities and debt securities, including bonds and notes, money market instruments, and financial derivatives</td><td></td></tr>
</table>
