

## **Chapter 1.2**

### **The History, Economics, and Politics of FDI**

by Frank Emmert

#### **A. INTRODUCTION**

The importance of investment law and ISDS for contemporary (international) legal professionals stems from two connected factors, the significance of foreign direct investment (FDI), and the availability of effective remedies for ill-treated investors.

An introduction into the available remedies was provided in Chapter 1.1. We will be discussing the details of these remedies and how they work in practice throughout this book. The present Chapter will provide a brief introduction to the significance of FDI, mainly from an economic perspective.

FDI should be understood as the acquisition and continued ownership of economic assets by foreigners, i.e. natural or legal persons from one country buying and owning companies and other assets in another country. By contrast to international business transactions like export-import trade, i.e. international sales transactions, FDI has a longer time horizon. In Chapter 1.1, we discussed how this makes the foreign investors more vulnerable to unforeseen and unforeseeable changes in the political and legal environment in the host country. Changes in the economic environment, for example the entry of a new competitor or an unforeseen decline in consumer interest, are generally considered part of the inevitable risk facing each entrepreneur. Changes in the political and legal environment can be different and may not be considered part of the inevitable risk against which there is no insurance or remedy. For example, a political decision to expropriate all or certain foreign investors should not be part of this inevitable risk facing every foreign investor. The problem how to draw the line between changes for which a remedy should be provided and changes that may negatively affect an investor but should not entitle to compensation is another consistent theme of this book.

Historically, FDI used to follow trade. Countries and markets around the world are endowed with different absolute, relative, and comparative advantages. This creates powerful incentives to trade between these countries and markets. If the advantages and disadvantages of different countries and markets are durable, for example the immense oil reserves of Saudi Arabia that far exceed local needs, or the centuries of experience giving Switzerland unmatched skills and reputation in fine watchmaking, traders may find it useful to establish a local presence in the foreign market, either to facilitate the acquisition or the sale of the goods and services they have been trading so far only in one-off transactions. Thus, Swiss watchmakers may want to open a distribution center in China to gain easier and wider access to the huge Chinese market. And an American manufacturer of oil extraction equipment may want to create a presence in Saudi Arabia to better serve the clients it already has in that important market.

More recently, we have also seen the inverse time line, i.e. trade following investment. For example, a European manufacturer of kitchen appliances may have had no significant trade in appliances or parts going to or coming from Vietnam. Nevertheless, because of advantages like

low wages and skilled workers found in Vietnam, the manufacturer builds a factory there and now ships, i.e. trades, its lower cost appliances from Vietnam back to Europe to sell to its traditional clients there.

Since both scenarios hinge on absolute, relative, and comparative advantages, we will take a closer look at these now. A brief exploration of more or less competitive markets and how competition- or antitrust law can help, will be included. Subsequently, we will analyze recent flows of FDI and total accumulated FDI stock around the world to gain some insights into the economic significance of FDI, as well as who owns what and where.

## **B. ABSOLUTE, RELATIVE, AND COMPARATIVE ADVANTAGES AS MOTORS OF TRADE AND FDI**

In this sub-chapter, we will review two texts published earlier. The first text explains the concepts of absolute, relative and comparative advantages and disadvantages. The benefits of trade and investment are easy to understand if one country has an absolute advantage, for example Saudi Arabia with an abundance of oil, and another country has an absolute disadvantage, for example Germany without any oil. Similarly, the benefits of trade and investment are easy to understand if one country has a relative disadvantage, for example Iceland where bananas can only grow in climate controlled green houses, while another country has a relative advantage, for example Costa Rica, where bananas can grow almost anywhere like weeds. The benefits of trade and investment are harder to understand if one country seems to be better at producing all goods and services under consideration. For such cases, the concept of comparative advantage and disadvantage will be explained with the help of the so-called **5000 Bicycles Model**.

With the help of the first text, we will learn that there are many good reasons for literally all countries to participate in trade and investment. Countries cutting themselves off trade and investment or managing their trade and investment relations poorly will inevitably suffer economic loss, at least at the macroeconomic level. These societies will overall be poorer and fall behind others in development. Unfortunately, it is still possible for some individuals in these societies to benefit at the expense of the rest of the country. An important problem in this respect is addressed in the second text dealing with competition in the market, and competition- or antitrust law to protect it. Based on the second text, we will understand that countries should pursue trade and investment in inverse proportion to the competitiveness of their markets. This means that countries with less competitive markets, which is often the case of smaller countries where many product and service markets are dominated by just a few or even a single provider or manufacturer, should be all the more interested in trade and investment to increase competition in their markets. If these kind of countries are neither pursuing robust antitrust enforcement, nor opening of market access for trade and investment, it is often because the dominant economic players are able to influence the political process in ways that protects their monopoly or dominance at the expense of society as a whole.

### **Frank Emmert: The History and Motors of International Commerce<sup>1</sup>**

While many histories of world trade tend to start out somewhere in the 15<sup>th</sup> century,<sup>2</sup> the history of trade actually goes back as far as the earliest human settlements. Due to differences in climate, soil, flora and fauna, and other natural factors and resources, each localized group of humans typically had or was able to produce [**\*9**] only certain types of food, clothing, tools, etc. By **barter trading** with other groups who had other resources and goods, each group could overcome, at least to an extent, its own limitations of resources and hence increase its wealth as expressed in chance of survival and quality of life.<sup>3</sup>

This image of early human societies already introduces the first two of the three most important motors of international commerce: absolute advantage/disadvantage and relative advantage/disadvantage. We may speak of an **absolute advantage and disadvantage** if a society or country has plenty of a given resource or good, while another society or country has none of it at all. For example, Saudi Arabia has a lot more oil than it can consume on its own in a very long time frame, while Germany has virtually no oil at all. Therefore, if Germany needs petroleum for transportation or production or any other purposes, it has to import. Conversely, if Saudi Arabia wants to make use of its abundance, it has to export. Bringing the two together in a trade relationship should benefit both of them.

By contrast, we may speak of a **relative advantage or disadvantage** if a society or country is able to produce a certain good but only at great cost and effort, while another society or country with different resources or skills can do it much more easily and cheaper. For example, it is certainly possible to grow bananas in Canada or Scandinavia, provided one is willing to grow them in a greenhouse with lots of heating energy – and indeed Iceland is doing exactly this because it has inexpensive geothermal energy in the form of volcanic hot springs – but it probably makes more sense to import the bananas from Central America or Africa, where they basically grow on their own. Thus, we may say that the Nordic countries have a relative disadvantage in producing tropical fruit, while the Tropical countries have a relative advantage. Again, bringing the two together in a trade relationship should benefit both of them.

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<sup>1</sup> See Frank Emmert, *International Business Transactions: Text, Cases, and Materials*, Carolina Academic Press 2<sup>nd</sup> ed. 2021, pp. 8-14 (some emphases added).

<sup>2</sup> The key event being the discovery of open ocean navigation by the Portuguese, and therefore the birth of systematic long-distance maritime trade; see, for example, Huggill, *World Trade Since 1431: Geography, Technology, and Capitalism*, Harrisonburg, 1993; McCusker (ed), *History of World Trade Since 1450*, 2005; Pomeranz & Topik, *The World That Trade Created - Society, Culture, and the World Economy 1400 to the Present*, 1999; for a more comprehensive approach, starting around 3,000 B.C., see Bernstein, *A Splendid Exchange - How Trade Shaped the World*, New York, 2008.

<sup>3</sup> For an analysis of the economies of primitive societies see Marshall Sahlins, *Stone Age Economics*, Routledge 1974. The idea that wealth should be measured by the access to a great many goods and services by average citizens was formulated by Adam Smith in his book *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776.

*Advantages and disadvantages are not only based on climatic factors and natural resources but can also be developed or squandered in the form of skills by human effort or the lack of it, as some individuals or groups become better at making certain things than other individuals or groups. For example, the Swiss have a relative advantage at selling expensive watches around the world after they have spent centuries at developing their watchmaking skills, as well as a reputation for uncompromising quality.*

*Absolute and relative advantages and disadvantages work nicely to fuel international business and trade, as long as each and every society can figure out a few things it is good at making, so that it can export some goods and services, and then use the export revenue to import those goods and services the society is not so good at making. To the extent advantages are lasting, they can provide the revenue for sustainable trade relationships. To the extent advantages are more fleeting, a society has to constantly **[\*10]** re-invent itself to find something else it is good at making if an earlier advantage is no longer valid. To give an example, Colombia has excellent climatic conditions and many years of experience in growing high quality coffee. Potentially, the country should be able to count on sustainable export revenue from this important commodity. However, political instability or the plant disease leaf rust could put at risk what essentially looked like a safe bet without an end date. Unfortunately, countries and societies rarely prepare for the fading away of their advantages while times are still good and resources flush. By the time change has become imminent, resources may already be scarce and adjustments correspondingly harder. Saudi Arabia may become a case on point when its oil riches run out.*

*Compared to absolute and relative advantages, the third motor of international commerce is a little harder to understand but quite probably even more important today. The concept of **comparative advantage and disadvantage** was first formulated by the British economist David Ricardo in 1817.<sup>4</sup> To illustrate the idea, we shall look at Country A and Country B and their respective production of cars and bicycles. We shall assume that both countries have to purchase the material and energy and other input factors on the international markets at the same prices. Therefore, the only production factor that will be different in the two countries is the cost of labor and we can disregard the rest:*

|                                    | Country A         | Country B       |
|------------------------------------|-------------------|-----------------|
| labor cost                         | US\$20 / hour     | US\$15 / hour   |
| productivity in bike manufacturing | 12.5 hours / bike | 20 hours / bike |
| productivity in car manufacturing  | 250 hours / car   | 500 hours / car |

<sup>4</sup> See Ricardo, *On the Principles of Political Economy and Taxation*, London, 1817. For an accessible introduction to the economics of international trade see William Baumol & Alan Blinder, *Microeconomics: Principles and Policy*, Cengage Learning, 13<sup>th</sup> ed 2016, Chapter 21, or William Baumol & Alan Blinder, *Macroeconomics: Principles and Policy*, Cengage Learning, 13<sup>th</sup> ed. 2015, Chapter 18; as well as Alan Stockman, *Introduction to Microeconomics*, The Dryden Press Harcourt Brace College Publishers, 1995, Chapter 23. For more detailed analysis see Paul Krugman, Maurice Obstfeld & Marc Melitz, *International Economics: Theory and Policy*, Pearson, 11<sup>th</sup> ed. 2017.

|                    |                 |                 |
|--------------------|-----------------|-----------------|
| unit cost of bikes | US\$250 / bike  | US\$300 / bike  |
| unit cost of cars  | US\$5,000 / car | US\$7,500 / car |

*Based on these numbers, it would seem that A and B cannot possibly have a profitable long-term trade relationship. Country A is better at making cars and bicycles, both products are more expensive when made by Country B. While Country B would probably like to import cars and bicycles from Country A to get their lower prices, such a one-sided trade relationship is unsustainable since B will soon run out of money if it only imports and cannot export.*

*However, what Ricardo explained for the first time is that every individual, every company, and even a national economy, always has to work with limited resources. [\*11] Even if I am better than my secretary not only at teaching but also at typing, does that mean that I should do my own typing? Probably not, because my day has only 24 hours and I should focus on the higher value activity or, in other words, I should focus on what I am comparatively better at, versus what I am comparatively less good at. In our two-country two-product model, this can be shown as follows:*

|                     |                            |                            |
|---------------------|----------------------------|----------------------------|
|                     | Country A                  | Country B                  |
| available resources | US\$10 mio for labor / day | US\$10 mio for labor / day |
| primary need        | 1,000 cars / day           | 1,000 cars / day           |

*We shall assume that each country has 10 mio \$ available resources to pay for labor in the combined manufacture of cars and bicycles per day. We shall further assume that one of the products is more important to the country than the other, i.e. that the needs for the one product – the cars – have to be satisfied before any leftover resources can be dedicated to making the other product, the bikes. If each country has 10 mio \$ available and needs 1'000 cars per day, the overall production looks like this:*

|                                                                           |                            |                           |
|---------------------------------------------------------------------------|----------------------------|---------------------------|
| Scenario 1: independent manufacturing without specialization and/or trade |                            |                           |
|                                                                           | Country A                  | Country B                 |
| cost of 1'000 cars                                                        | US\$5 mio                  | US\$7.5 mio               |
| available resources for bikes                                             | US\$5 mio                  | US\$2.5 mio               |
| total output                                                              | 1,000 cars<br>20,000 bikes | 1,000 cars<br>8,333 bikes |

*In Scenario 1, each country satisfies its own needs and there is no trade in cars or bicycles between the two. We can see a total output – both countries combined – of 2,000 cars and 28,333 bicycles.*

*Next, we will assume that the two countries combine their resources and that each one specializes on one product, some of which it trades with the other country in exchange for the other product:*

| Scenario 2: international cooperation with specialization and trade: A makes cars and B makes bicycles, joint resources US\$20 mio |            |               |
|------------------------------------------------------------------------------------------------------------------------------------|------------|---------------|
|                                                                                                                                    | Country A  | Country B     |
| resources needed to make 2'000 cars                                                                                                | US\$10 mio |               |
| funds available for bikes                                                                                                          |            | US\$10 mio    |
| output                                                                                                                             | 2,000 cars | 33,333 bikes  |
| surplus / deficit                                                                                                                  |            | + 5,000 bikes |

**[\*12]** Scenario 2 shows very nicely an unchanged total output of 2,000 cars, to satisfy the primary needs of both countries. However, with the same amount of total resources we can now produce 33,333 bikes, which translates into a net gain of 5,000 bicycles per day or whatever unit of time we apply. The reader should appreciate that these additional 5,000 bicycles are solely the result of specialization and trade and essentially free. If the trade relationship can be implemented in this way, both countries can share the surplus 5,000 bicycles and both countries will be more wealthy as a result.<sup>5</sup>

Of course, the **transition** from the first scenario to the second scenario is not free, since the car industry has to shut down in B and it is unlikely that all workers who used to make cars in B can now find equally good employment in the expanding bicycle industry in B, and vice versa in A. However, the transition is a one-time event, while the added surplus occurs every day and potentially forever. Thus, some of the early surplus could be used to support re-location, re-training, or early retirement of the workers who lose their jobs in the transition. Whether this is happening or whether the surplus will largely be pocketed by the shareholders of the expanding industries, is a question of social and tax policies in the respective countries.

Furthermore, the surplus of 5,000 bicycles per day will be diminished not only during a limited transition period but continuously by the costs involved with the **trading transactions** themselves. International transport costs will have to come out of the 5,000 bicycles because they did not occur when all production was domestic. Similarly, customs duties and the cost imposed by non-tariff barriers, such as different product standards or bureaucratic red-tape, will also reduce the benefits to be shared between the different participating countries. By contrast to the **transition costs**, these **transaction costs** occur on a continuing basis and with each and every transaction. If we want to maximize the gains from an open and globalized economy it is, therefore, imperative that we minimize the transaction costs and prevent them from eating up the bulk of the 5,000 bicycles.

<sup>5</sup> The model with just two countries and two products is highly simplified, of course. However, if we would use 200 countries and tens of thousands of products and services that can be traded, the model would only become more complicated but not substantially different. For further reading see, for example, Krugman/Obstfeld/Melitz, *International Economics: Theory and Practice*, 11<sup>th</sup> ed., Boston et al., 2018, in particular Chapter 3. Readers who are not afraid of numbers and mathematical equations are invited to read up on the Heckscher-Ohlin theory of trade, New Trade Theory, as well as the Ricardo-Sraffa Trade Theory.

*Readers should consider different options for customs and trade laws aimed at keeping the transaction costs under control without compromising product safety, environmental standards, and other bona fide interests of society. [... \*13]*

*Just for fun, we shall also look at what would happen if the two countries would specialize “the other way around”, i.e. if B would end up making the cars and A would be making the bicycles:*

| 3 <sup>rd</sup> scenario: B makes cars and A makes bicycles, joint resources US\$20 mio |               |            |
|-----------------------------------------------------------------------------------------|---------------|------------|
|                                                                                         | Country A     | Country B  |
| resources needed to make 2'000 cars                                                     |               | US\$15 mio |
| funds available for bikes                                                               | US\$5 mio     |            |
| output                                                                                  | 20,000 bikes  | 2,000 cars |
| surplus / deficit                                                                       | - 8,333 bikes |            |

*As can be seen, we still get 2,000 cars because we have to satisfy the primary needs of both countries, but now we only get a total of 20,000 bikes, that is 8,333 less than if both countries would be working independently and there would be no trade between them. The question is, therefore, how can we make sure that countries understand their comparative advantages and disadvantages and don't try to specialize in the wrong products. The answer to this question depends on who makes the decisions about the allocation of limited resources. In our example, this is the question which industries should be shrinking or closing while others are growing and expanding. In open economies, decisions of this kind are taken by the market. Conversely, in state controlled economies, decisions of this kind are taken by bureaucrats somewhere in the state administration. For example, in the COMECON, the Council for Mutual Economic Assistance, which was the regional integration system used by the Soviet Union to impose its centralized model of state communism on its satellite states, the decisions which of the many factories in the automotive sector across the vast Soviet empire would be making the small cars, the medium sized cars, the large cars, the trucks, the buses, etc. were all taken at the Communist Party headquarters in Moscow.<sup>6</sup> We know from history that the market economy model of the West prevailed over the communist economic model of the East but it is useful to understand why this is so. Moreover, as we see Washington and other political centers increasingly beleaguered by lobbyists and other special interests, we need to remember that a country does not have to adopt a communist system to succumb to inefficient allocation of resources.*

*An obvious difference between decision making in a state controlled economy and a market economy is the degree of centralization. In a perfect market economy, an infinite number of individually small sellers meet with an infinite number of individually small buyers to negotiate production*

<sup>6</sup> For further analysis see János Kornai, *The Socialist System: The Political Economy of Communism*, Princeton University Press 1992; and Alec Nove, *An Economic History of the USSR: 1917-1991*, Penguin Books, 3<sup>rd</sup> ed. 1993.

and prices. None of the sellers/producers or buyers/consumers are large enough to dominate the market and dictate [\*14] the prices. All of them are “price takers” and the market is the “price maker.” By contrast, in a state controlled economy, there is only one decision-maker, which is the government, and it controls both production and prices. In both economies, the challenge is to make smart decisions about who should produce what in which way and who gets to buy it at what price, i.e. the optimal allocation of limited resources for greatest overall benefit. At least from a theoretical perspective, it is not immediately obvious why a large number of individually small sellers and buyers should be inherently better at making these decisions than the government. After all, with its superior resources and knowledge, the government will outmatch each of the small producers and consumers, at least individually. Furthermore, the players in the market economy are in the game for their personal benefit more than anything, while the bureaucrats in the government should be disinterested on the personal level and pursue only the common good. Thus, the planned economy should have the advantage. Finally, the idea of a perfect market economy is largely theoretical while in practice many geographic and product markets are characterized by just a handful of powerful economic and/or political players or even outright monopoly, which means that the crucial decisions are controlled by very few decision-makers, similar to the state economy, except that they are openly pursuing their personal benefit and nobody is there to protect the smaller players and promote the common good. How can it be explained, therefore, that the communist model of state controlled economy failed so spectacularly wherever it was systematically employed?

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**Frank Emmert: The Argument for Robust Competition Supervision  
in Developing and Transition Economies<sup>7</sup>**

**1. THE ECONOMICS OF COMPETITION**

*It has been said that there is no end to human greed. Pretty much everything else in the world, in particular those things that we consider positive and/or desirable, are in short supply. When something is in short supply, it means that there is not enough of it available to satisfy everyone who would like to have it. We may be able to produce more of one thing but only at the expense of another thing. For example, we may be able to satisfy more people who desire clean air by closing a factory that causes pollution or by forcing it to install expensive filter equipment. However, both of these measures, while increasing the supply of one thing, clean air, decrease the supply of one or more other things, in this case some or all of the jobs in the factory and some or all of the goods it is producing. One of the most important problems facing human societies, therefore, is the need to make decisions about how much to produce of everything and how to distribute the limited production among the many who want to have a share of it. This is called the problem of allocation of limited resources.*

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<sup>7</sup> Published in Journal of Governance and Regulation 2016, Vol. 5, No. 3, pp. 67-89.



*Economists<sup>[8]</sup> have long argued, and 20<sup>th</sup> century history has ultimately proven, that market [\*68] economies are more efficient than non-market economies at making these decisions.<sup>[9]</sup> In a non-market economy, decisions about allocation of scarce resources (capital, labor, goods, etc.) are either made by the state or by a small number of private actors. If these decisions are made by the state, we speak of a planned economy, sometimes also called a socialist or communist economy. If the decisions are made by a small number of private actors, they have to be in a position of monopoly or dominance or they have to collude in the form of cartels in order to have impact. By contrast, the allocation of scarce resources in a market economy is based on large numbers of*

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<sup>8</sup> Many lawyers – and at least some of my readers – very quickly get uncomfortable with any form of economic analysis, in particular if it includes charts, let alone numbers. All too often, the very reason why we went to law school in the first place is that it seemed the furthest from anything that could require mathematics. The reality is not quite like that, however. Whether in tax law, when we have to understand the financial implications of different ways of structuring a corporation or international business transaction, or in the calculation of damages in tort law, a good lawyer will always think about the economic implications of his or her advice for the client. This is all the more true in competition law, where economic analysis has become very important for the way regulatory authorities and courts will analyze conduct or practices of corporations potentially restricting competition [E. Cavanagh, *Antitrust Law and Economic Theory: Finding a Balance*, Loyola University Chicago Law Journal 2013, Vol. 45 No. 1, pp. 123-171]. As Morgan has pointed out, “whether or not one personally likes the implications toward which economic analysis points, a lawyer needs to understand the analysis in order to assess what the purpose and effect of a practice might be, whether the practice is likely to be challenged, and if so, how most courts today will react to it.” See [Morgan, T.D., *Cases and Materials on Modern Antitrust Law and Its Origins*, Thomson/West, St. Paul MN, 3rd ed. 2005, at p. 5]. Fortunately, there are a number of relatively accessible books for lawyers seeking to understand economic analysis of law and more particularly competition law. These include [D.W. Barnes & L.A. Stout, *Economic Foundations of Regulation and Antitrust Law*, West Publishing, St. Paul MN, 1992; Simon Bishop & Mike Walker, *The Economics of EC Competition Law: Concepts, Application and Measurement*, Sweet & Maxwell, London UK 2010; T. Calvani & J. Siegfried, *Economic Analysis and Antitrust Law*, Little Brown & Co., Boston MA, 1988; E. Gellhorn, W.E. Kovacic & S. Calkins, *Antitrust Law and Economics in a Nutshell*, West Academic Publishing, St. Paul MN, 5<sup>th</sup> ed. 2004; D. Hildebrand, *The Role of Economic Analysis in the EC Competition Rules*, Kluwer Law International, Alphen aan den Rijn NL, 3<sup>rd</sup> ed. 2009; K.N. Hylton, *Antitrust Law and Economics*, Edward Elgar Publishing, Cheltenham UK, 2<sup>nd</sup> ed. 2010; as well as E.T. Sullivan & J.L. Harrison, *Understanding Antitrust and Its Economic Implications*, LexisNexis, New York NY, 6<sup>th</sup> ed. 2014].

<sup>9</sup> The goal would be to come as close as possible to the so-called “Pareto-optimal allocation of goods and resources.” See [Dennis C. Mueller, *Public Choice III*, Cambridge University Press, Cambridge, U.K., 3<sup>rd</sup> ed. 2003]. A Pareto-optimum is achieved when all production factors, such as resources and other goods, know-how, labor, and capital, are allocated in such a way that any re-allocation making at least one person better off would also leave at least one person worse off.

It should be noted, however, that Pareto-optimal allocation considers only the overall benefits to society. There may be many variations of Pareto-optimal allocation, each one benefitting *society equally but individuals differently*. For example, a certain level of employment at a factory may be the Pareto-optimum. Employing *more* workers would reduce overall efficiency. However, employing *different* workers could well be the same from society’s point of view while making a huge difference for those who now have jobs and those who do no longer.

*decisions made by large numbers of buyers and sellers, who meet in the marketplace every day to negotiate deals, each of which individually does not significantly influence the overall economy.*<sup>[10]</sup>

*The problem with all of these decisions – market economy or not – is that the decision-makers do not necessarily pursue the public good, that they have limited information, and that the parameters in the market place change all the time. Thus, from a point of view of economic efficiency, we can say that the problem is that a certain number of decisions will inevitably be wrong. Either those decisions will promote private benefit at the expense of public good, or they will try to promote the public good but fail to do so in the best possible way because of insufficient factual information or insufficient understanding of the optimal solution for the respective problem. Insufficient understanding may be an objective problem of predicting the future or a subjective problem of not understanding the present. For the purposes of this article, both types of decisions shall be defined as mistakes, namely those that promote short term and/or limited private gain over long term and/or larger public gain, and those that may pursue the best overall result but turn out to be inferior at doing that. Both types of mistakes cause overall loss to society.*

*In our globalizing world, national economies are no longer predominantly about the allocation of resources on the national level. They are also competing for resources on the global level, for example for profitable sales opportunities in foreign markets, for deals to buy natural or other resources abroad, and for decisions about foreign direct investment. At the same time, countries have become more interdependent, and decisions in one country may directly affect the availability and allocation of resources, hence ultimately the level of prosperity, in another country. This magnifies the impact of good or bad decisions and the importance of making as few mistakes as possible. To illustrate the point, compare the strategic decisions taken by Nissan and General Motors towards the first generation of electric automobile. While the Nissan Leaf runs entirely on electricity, which limits its range to the life of the battery, the Chevy Volt comes with a back-up engine running on gasoline so that it can operate beyond the life of its battery. However, the second engine in the Volt comes at the steep price of an additional \$8,000 on the sticker price. The next couple of years will show who made the better bet and either Nissan or General Motors will sell large numbers of automobiles not only in their respective domestic markets but potentially in many countries. Although it is possible that the one type of car may appeal to one type of user and the other to another and that both companies come out as winners, it is also possible that one of them will have sunk billions of dollars in development costs into a product that does not sell (enough) and*

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<sup>10</sup> Relatively small firms in competitive markets are also called *price takers* because they do not make the prices by restricting or increasing their output. Rather, the prices are made by the market, i.e. the aggregate of all buying and selling transactions by all buyers and sellers meeting in the marketplace. If one firm would reduce its output, it would not be able to sell less for more. Instead, it would just lose sales at the market price to another firm. Only if many firms would agree to lower their output and not to pick up customers turned away by their “competitors”, prices would go up. The latter, however, would be a cartel and not any more a competitive market. Very nearly every decent book on competition or antitrust law contains a discussion of price theory and competitive markets in its introductory chapters. For examples see note 42. Similar results can also be found in the public choice literature, for example in [Maxwell L. Stearns, *Public Choice and Public Law: Readings and Commentary*, LexisNexis, New York NY, 2003, at pp. 111-117].

*does not recover this investment. [...] Needless to say, even large automobile manufacturers with deep pockets can only afford so many of these kinds of mistakes.*

*It is important to understand that the problem of wrong decision-making is inherent in all economic activities, whether in a market economy or a non-market economy. As long as decisions are taken by humans, we will encounter selfish pursuit of short term private benefit at the expense of society, and we will encounter problems of incompetence and of [\*69] predicting future developments. One may even argue that a state actor should be less incompetent, on average, than a private actor and that governments should come up with fewer wrong decisions than companies or private investors, simply because of the larger information base and other resources available to the government. However, this may be countered by the problem of ownership. While private actors and investors are using their own money and usually have to bear the consequences of their wrong decisions themselves, civil servants in the government are usually insulated from the consequences of their decisions and thus less motivated to do their best at avoiding mistakes.<sup>[11]</sup> Whether one believes that private individuals and investors are generally better than government officials at making the kind of decisions we are talking about, is a question of ideology.<sup>[12]</sup> However, what is beyond doubt and ideology is the fact that both types of actors will make mistakes. Furthermore, while the future has always been uncertain, change comes ever more quickly today, which requires that decisions are adjusted all the time to match the needs of a changing environment and prevent a good decision from becoming a mistake. The crucial question, therefore, is how different economic models deal with their mistakes and how they deal with the change that is imposed on them.*

*The worst model at correcting its mistakes is the economy dominated by a small number of private individuals via monopoly, dominance, or cartels. Such an economy actually rewards mistakes as defined above. In the absence of constraints, the private individuals can and usually will pursue their personal self-interest at the expense of public good and will prosper while society as a whole has to pay the price. In the most extreme example of monopoly, the monopolist can and will charge super-competitive prices for its goods or services and become extremely rich. Each individual customer and society at large not only pay too much to satisfy their needs, but chances are that the absence of choice, hence competitive pressure, also results in inferior quality of the goods and services. Change, for example, in the form of technological progress, does not have to be accoun-*

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<sup>11</sup> This is one important reason why larger companies that are run by salaried CEOs rather than owners tend to tie the compensation of their leaders to the overall performance of the company via annual bonuses and longer term stock options. For in-depth analysis see [M. Jensen & K. Murphy, *CEO Incentives – It's Not How Much You Pay, But How*, Harvard Business Review, May-June 1990, No. 3, pp. 138-153].

<sup>12</sup> Until recently, the answer seemed pretty obvious. After all, the Soviet Union had proven unable to compete with the West and collapsed and even China had turned to market economy for its remarkable growth. However, the current financial crisis has somewhat discredited Western claims of superiority and indeed, those countries that have suffered less from the crisis seem to be the ones with more government intervention in markets. Nevertheless, there has yet to be a planned economy or an economy with heavy government intervention that reaches, let alone surpasses the level of general prosperity in the Western market economies of the EU and North America. In this context, it can also be instructive to compare different schools of antitrust analysis. See, for example, [Richard A. Posner, *The Chicago School of Antitrust Analysis*, University of Pennsylvania Law Review 1979, Vol. 127 No. 4, pp. 925-948].

*ted for by the monopolist, unless the very monopoly comes under threat.<sup>[13]</sup> The situation is only marginally less extreme where an individual enterprise merely has a dominant position and not a full monopoly. The case where several enterprises could compete but rather collude in the form of a cartel may be the worst possible scenario because the monopolist at least benefits from economies of scale even if they are not passed on to the customers. The bottom line is in each of these cases that everybody pays a higher price for lower quality, and the economic loss of the many far outweighs the economic gains of the few.*

*The planned or state controlled economy is only marginally less bad at correcting its mistakes. While this economy does not actually reward the decision-makers for their mistakes, unless there is also corruption, it fails to adequately punish the mistakes. To the extent bureaucrats may be held accountable for wrong decisions, this gives them an incentive to hide those decisions, for example by deferring to committees or by suppressing data. It also gives them an incentive to avoid taking decisions in the first place, which makes governmental structures rigid and inflexible in the face of new data and/or external change. Simply speaking, planned economies will be slow to adopt decisions and even slower to correct them once they turn out to be inferior. The Soviet Union was full of examples.*

*This brings us to the market economy and the question why large numbers of individually small sellers negotiating with large numbers of individually small buyers should be inherently better at understanding how best to allocate resources in the present environment and how best to deal with change in the future. One could even argue that the very fact that none of the buyers or sellers is individually large naturally limits their ability to research and process today's data and to hire the most competent experts at predicting future trends. However, this would completely misunderstand the power of the market. Much like a match between a grandmaster of chess and a supercomputer, the invincible power of the market relies on its ability simply to try out every possible alternative. We may go as far as saying that the market, compared to the experts, is not very smart at all and makes lots of inferior choices. However, while the expert has to rely on his or her expertise to come up with the best possible solution, one move at a time, the market relies on an infinite number of trial and error moves to find the best possible solution. While individual buying and selling decisions in an open market place may not look very smart at all, the aggregate result of all buying and selling decisions in that market has proven superior to any other form or method of allocating scarce resources today and accounting for change tomorrow.*

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This discussion of competitive versus monopolistic or oligopolistic markets would be incomplete without a discussion of the definition of "market". A market is not just a certain geographic area like

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<sup>13</sup> A good example was the supply of end-user telephone equipment in Germany in the 1970s and early 1980s. Since Siemens was the sole – and therefore monopoly – provider licensed by the state telephone company, Germans had to deal with large mouse-grey rotary dial phones at high prices while sleek and colorful dial tone phones were already available in many more competitive markets at much lower prices. For background reading see [K. Morgan & D. Webber, *Divergent Paths: Political Strategies for Telecommunications in Britain, France and West Germany*, West European Politics 1986, Vol. 9 No. 4, pp. 56-74].

a country. First, a market is defined in product terms and includes only those goods or services that are interchangeable or substitutable. For example, in the automotive sector, all medium-sized and medium-priced family sedans would be interchangeable. A rational consumer would consider and compare Chevrolet, Ford, Honda, Nissan, Toyota and other options before picking her personal favorite based on quality and price. All of these cars are clearly part of the same **product market**. However, several others are at least substitutable. They may not obviously compete for the same customers but they are still in the same market. A rational consumer looking at a Chevy or a Honda may be swayed to buy a BMW or an Acura instead, if they have a special sales event. Or she may look at an Audi or a Cadillac, if she is surprised how expensive the new Fords are this year. Or she may decide that the cheaper Hyundai will be just fine, since it comes with a 100,000 mile bumper to bumper warranty. By contrast, a Ferrari or a Lamborghini is not in the same product market and does not compete for the same group of potential buyers. The same is true for larger pick-up trucks and delivery vans.

The second important criterion is geographic. After we have determined the relevant product market, we have to determine which buyers and sellers find themselves in the same **geographic market**. The latter is defined by its homogeneity. Regardless of political borders, only those producers and consumers will be part of a geographic market who can trade with each other easily. The geographic market for fresh bread may be as small as one village or just a few blocks in town because every consumer would only compare the quality and price of the five to ten bakers in this area and very nearly nobody would travel to the other side of town just to get fresh bread. By contrast, the geographic market for automobiles may be politically determined because it may be too much of a hassle for a buyer from Michigan to import and register a car purchased in nearby Canada or even in Indiana. Finally, for large passenger aircraft the relevant geographic market is the global market. Every single airline, whether they are based in New Zealand or New England, will be looking at every single manufacturer and compare their quality and prices before making a purchasing decision. After all, the products are literally designed to fly wherever we need them to.

Some analysts even include a temporal component in the market analysis.<sup>14</sup> The **temporal market** takes into consideration not just the sellers and buyers currently meeting in a given product and geographic market but also those who may join or drop out in the foreseeable future. On the one hand, temporal considerations are important if a market has already seen considerable consolidation and there is pressure on the remaining smaller competitors to follow the larger ones and merge as well to be able to compete in future. Further concentration can also be the result of one or more notoriously struggling competitors finally dropping out of the market, as was to be expected sooner or later. On the other hand, the power of dominant firms in a highly concentrated market is limited if there are several potential competitors already looking how they may overcome any barriers to market entry.

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<sup>14</sup> See, for example, Christopher Decker, *Time Matters: The Temporal Dimension of Antitrust*, *European Competition Law Review* 2020, Vol. 41, No. 6, pp. 273-282; and Anzhelika Gerasymenko & Svitlana Afendikova, *The Relevant Temporal Market Definition in Antitrust Analysis*, *Baltic Journal of Economic Studies* 2018, Vol. 4, No. 1, pp. 68-76.

The lesson to be taken from the analysis of absolute, relative, and comparative advantages is that trade and investment will expand choices and reduce prices, as long as they are well managed. Lower cost and lower prices alone should never be our priorities. Benefits to individual consumers and entire societies always depend on quality and price taken together. There are no benefits in cheap but unsafe or polluting products or services!

The lesson to be taken from the analysis of competition and markets is that the benefits of trade and investment will only be passed on to consumers and society as a whole if each of the respective markets is at least somewhat competitive. Suitable antitrust- or competition laws will be needed, combined with robust supervision mechanisms and authorities. However, laws and procedures alone cannot create additional choices and competitors. That's where trade and investment can help. By opening markets to trade and investment, countries can improve the competitive environment and reduce the power of domestic monopolies and oligopolies. This is one of the secrets of success of the European Union.

### **C. OVERALL FDI AND RECENT TRENDS – AN INTERPRETATION OF THE NUMBERS**

The United Nations Conference on Trade and Development (UNCTAD) has been collecting data about FDI flows between more than 200 economies for more than 40 years. Large scale international capital transfers characteristic for FDI are reported in the home country for tax purposes and may require various authorizations.<sup>15</sup> Similarly, the host country is usually informed of the capital inflow and may require authorization of the investment itself.<sup>16</sup> Since the 1970s, the U.S. and other OECD countries also have strict reporting requirements for banks for international money transfers exceeding US\$ 10,000.<sup>17</sup> For these reasons, contemporary FDI is relatively transparent and well documented.

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<sup>15</sup> See, for example, Jack Mintz & Alfons Weichenrieder, *The Indirect Side of Direct Investment: Multinational Company Finance and Taxation*, MIT Press 2010; Elie Roth & Claire Kennedy, *Canadian Outbound Investment: An Introduction*, Corp. Bus. Tax'n Monthly 2007, Vol. 8, No. 11, pp. 25-44.

<sup>16</sup> Typical requirements include "limitations on foreign ownership, screening or notification procedures, and management and operational restrictions." See Stephen Golub, *Measures of Restrictions on Inward Foreign Direct Investment for OECD Countries*, OECD Economics Department Working Papers No. 357, Paris 2003. National security considerations have always played a role. Another reason can be a preference for joint ventures with enhanced transfer of know-how compared to full foreign ownership. For analysis see, e.g., Bilgehan Karabay, *Foreign Direct Investment and Host Country Policies: A Rationale for Using Ownership Restrictions*, Journal of Development Economics 2010, Vol. 93, No. 2, pp. 218-225.

<sup>17</sup> In the U.S., the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, commonly known as the Bank Secrecy Act (BSA), was adopted in 1970 (31 U.S.C. 5311 et seq.). Based on Title II of the BSA, the U.S. Treasury Department adopted 31 CFR Part 103, nowadays 31 CFR Chapter X (<https://www.fincen.gov/resources/statutes-regulations/chapter-x>). The regulation established the Financial Crimes Enforcement Network (FinCEN), as part of the Treasury Department. Chapter X provides Know-Your-Customer (KYC) and Anti-Money Laundering (AML) obligations for banks and various money services businesses, including obligations to file Suspicious Activity Reports (SARs) if the purpose or recipient of larger financial transactions are unknown or potentially illegal.

One dataset collected by the OECD provides detailed information on the overall FDI stock, i.e. the overall foreign ownership in companies and other assets. The data is available for all economies taken together and for some 200 economies separately. The database shows that in 2021, foreign ownership (FDI stock) worldwide amounted to about US\$ 48 trillion.<sup>18</sup> For comparison, the overall size of the U.S. economy in 2021 was about US\$ 23 trillion. In other words, over time foreigners have built up ownership stakes in other countries amounting to twice the size of the entire U.S. economy.

The database also shows FDI stock by country. This makes it possible to see the home countries of investors and the host countries of investments. For the U.S., the data for FDI stock in 2020 looks as follows (top destinations only; the complete list is available from the OECD):

U.S. Owned FDI Stock in 2020<sup>19</sup>

|     |                                |                    |
|-----|--------------------------------|--------------------|
| #1  | United Kingdom                 | US\$ 890 billion   |
| #2  | Netherlands                    | US\$ 843 billion   |
| #3  | Luxembourg                     | US\$ 759 billion   |
| #4  | Canada                         | US\$ 422 billion   |
| #5  | Ireland                        | US\$ 390 billion   |
| #6  | Cayman Islands                 | US\$ 305 billion   |
| #7  | Bermuda                        | US\$ 274 billion   |
| #8  | Singapore                      | US\$ 270 billion   |
| #9  | Switzerland                    | US\$ 211 billion   |
| #10 | Australia                      | US\$ 163 billion   |
| #11 | Germany                        | US\$ 162 billion   |
| #12 | Japan                          | US\$ 131 billion   |
| #13 | China                          | US\$ 124 billion   |
|     | All of South America           | US\$ 141 billion   |
|     | All of Africa                  | US\$ 47.5 billion  |
|     | U.S. Owned FDI Stock Worldwide | US\$ 6,152 billion |

The table includes several relatively small economies with relatively large FDI stock held by U.S. investors. For example, the entire economy of the Cayman Islands, a country with a population of 65,000, was only US\$ 5.6 billion in 2020.<sup>20</sup> In theory, U.S. investors would be owning about 50 years of the entire economic activity in the Cayman Islands. The reality is quite different, of course, because the bulk of the money does not stay in these small economies. Most of it goes into holding companies which then invest in other companies in other countries. For example, the Netherlands, Luxembourg and Ireland are known to be friendly jurisdictions for investments going into the EU. “Friendly” jurisdictions have relatively low corporate tax levels, transparent laws and efficient

<sup>18</sup> See [https://www.oecd-ilibrary.org/finance-and-investment/oecd-international-direct-investment-statistics-2021\\_981db434-en](https://www.oecd-ilibrary.org/finance-and-investment/oecd-international-direct-investment-statistics-2021_981db434-en).

<sup>19</sup> *Id.*, pp. 328-336.

<sup>20</sup> See <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=KY>.

corporate filing and court procedures, employer-friendly labor laws, and treaty-based – thus guaranteed – access to larger markets where the real businesses are located or trading. Singapore delivers a similar service for investments directed into Asia. Switzerland, with a population of some 6.5 million, is the country with the largest number of bilateral investment treaties (128 BITs and 37 TIPs), has relatively low corporate tax levels, a highly efficient administration and court system, and one of the most sophisticated financial- and banking services sectors in the world. It is, therefore, generally a good place from where to make investments into the real economy almost anywhere in the world and a good role model to follow for other countries seeking a larger role in FDI.

In contrast to outgoing FDI from the U.S., FDI coming into the U.S. is somewhat differently structured (top countries of origin only; the complete list is available from the OECD):

Foreign-owned FDI stock in the U.S. in 2020<sup>21</sup>

|    |                                         |                    |
|----|-----------------------------------------|--------------------|
| #1 | Japan                                   | US\$ 679 billion   |
| #2 | Canada                                  | US\$ 569 billion   |
| #3 | Germany                                 | US\$ 564 billion   |
| #4 | United Kingdom                          | US\$ 481 billion   |
| #5 | France                                  | US\$ 314 billion   |
| #6 | Ireland                                 | US\$ 296 billion   |
| #7 | Netherlands                             | US\$ 236 billion   |
| #8 | Switzerland                             | US\$ 235 billion   |
| #9 | Australia                               | US\$ 101 billion   |
|    | All of South America                    | US\$ 61 billion    |
|    | All of Africa                           | US\$ 5.5 billion   |
|    | All Foreign Owned FDI Stock in the U.S. | US\$ 4,626 billion |

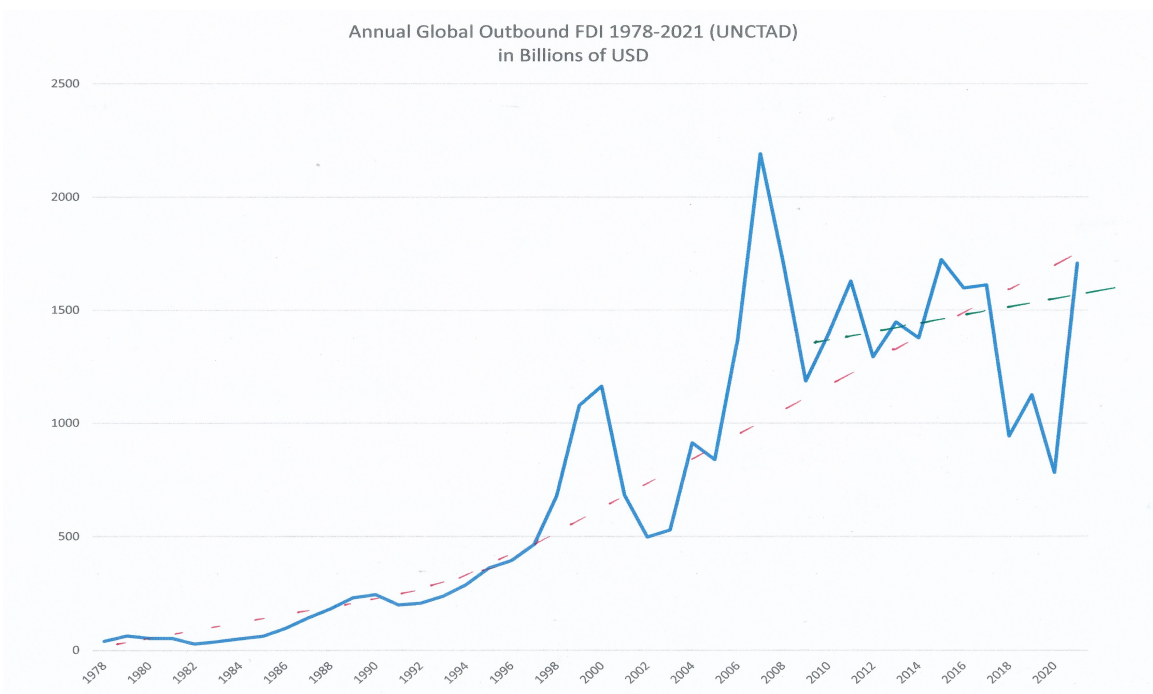
As we can see, foreign investors don't use offshore financial centers like the Cayman Islands to invest in the U.S. nearly as much as the other way around.

What we can also see is the fact that the large majority of FDI is flowing from developed nations into other developed nations. Indeed, the U.S. is the single largest recipient of FDI in the world and has been holding the top position for many years. In particular, the least developed countries in Africa, Central America, and Central Asia, are relatively insignificant when it comes to total FDI. Outside of extractive industries that have to go to where the mineral and other deposits are, and with the exception of labor intensive industries seeking cheap labor in relatively stable countries in East- and South East Asia, investors prefer the stability and predictability of developed Western economies for their foreign investments. We may safely assume that the data would be even more skewed toward developed nations if we did not have an entire network of bilateral and multilateral investment treaties and a sophisticated system of investor-state dispute settlement (ISDS) to make investments in less developed nations at least somewhat less risky.

<sup>21</sup> *Supra*, note 18, at pp. 328-336.



Finally, a look at the annual FDI flows from 1978 to 2021 provides additional, although somewhat tentative insights. First, we can see that annual FDI flows – the blue line – remained relatively moderate during the first decade covered in the chart. Annual FDI flows really took off in the late 1980s and virtually exploded between 1998 and 2008. This was initially fueled at least in part by the dot com bubble, triggering a race into opportunities around the globe. When the bubble burst in 2000/2001, FDI outflows took a step back as well. They swiftly recovered, however, and reached entirely new heights, until the housing bubble burst in 2008.



Since 2008, the data is somewhat inconclusive. On the one hand, a purely mathematical Gaussian extrapolation of the overall trend – the dotted red line – would seem to indicate steady upward growth, with a similar projection going forward. On the other hand, the succession of the 2001/02 and 2008 crises, and the 2019 Covid pandemic, could also point to a new normal with a much more shallow overall trend going forward – the dotted green line. Given the quick and strong recovery after the pandemic, both scenarios would at least seem possible.

While global trends may not tell much for specific countries or regions,<sup>22</sup> they do tell us that International Investment Law and ISDS has become a hugely important field and will only grow in importance going forward.

<sup>22</sup> Both the OECD and UNCTAD provide the data for specific countries and regions. For space reasons alone, that data is not discussed here right now.

## **D. CONCLUSIONS**

There are many good reasons why countries should seek and welcome FDI. A net inflow of capital strengthens the national currency in Forex markets, improves the balance of payments overall, and thereby also helps with the balance of trade. At least when well-managed, FDI provides much more than foreign money and also helps with job creation, human resource and capacity building, technology transfer, broadening of the domestic tax base, expansion of export opportunities, and many other benefits. As shown in this Chapter, well-managed FDI also helps with securing or restoring the competitiveness of markets. The emphasis, of course, is on “well-managed”. The challenge for managing well has to be met by the host countries first. However, it is also upon the arbitrators in ISDS cases who have to strike a balance between justified interests of investors to be protected against unreasonable or discriminatory treatment, and the justified interests of host countries to be able to adapt their laws and regulations in sensible ways to evolving environmental, climate, consumer, and social protection needs. All of these issues will be further developed in subsequent chapters of this book.