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DO BILATERIAL INVESTMENT TREATIES AFFECT A COUNTRY'S CAPITAL FLOWS COMPOSITION?

by

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Overview

This article is important to policy makers in three respects. First, it highlights that bilateral investment treaties protect more than just foreign direct investment. This is good news to countries keen to attract capital flows in order to smooth consumption and investment. Second, despite their protection of the different types of capital flows, empirical evidence shows that bilateral investment treaties tilt the composition of capital flows in favor of FDI. Third, signing and ratifying bilateral investment treaties is a major FDI determinant that should not be underestimated.

Background

Bilateral investment treaties (BITs) have been widely used over the past three decades to attract foreign direct investment (FDI). BITs reduce political risk to foreign investors by establishing clear, simple, and enforceable rules for the protection of foreign investment from expropriation. They specify the circumstances under which expropriation takes place and the compensation standards, and design the necessary investment dispute settlement mechanisms between states and investors.

The influence of BITs has been examined in the FDI literature. Recent empirical studies found a significant positive impact of BITs on FDI. Egger and Pfaffermayr (2004) find a higher positive impact of ratified treaties reflecting the higher degree of commitment to protection of FDI. Tobin and Rose-Ackerman (2006) find positive impact of BITs on FDI, although their marginal impact diminishes in subsequent periods, and that better political environments complement the role of BITs in attracting FDI.

While BITs are known for protecting FDI mainly, the protection domain of foreign investment may extend beyond FDI. In the 2012 U.S. Model Bilateral Investment Treaty, for example, foreign investment includes portfolio equity, private non-guaranteed debt, public and publicly guaranteed debt, in addition to FDI.

This raises an important question of whether the protection of treaties of the other types of capital flows encourages them akin to FDI flows. Mina (2015) empirically examines the influence of BITs on the different types of capital flows – FDI, private debt, public debt and portfolio equity – to 85 middle and low income countries for the period 1984-2011. Results show that BITs increase the volume of FDI flows, reduce private debt flows, and tilt the composition of capital flows in favor of FDI.

Implications for Policy Makers

This article should bring to the attention of policy makers three important points. First, bilateral investment treaties protect more than just FDI. Second, despite their protection of different types of capital flows, empirical findings show that BITs tilt the composition of capital flows in favor of FDI. Third, signing and ratifying bilateral investment treaties is a major location determinant of FDI.

References

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