

OECD INSIGHTS

EDITED BY PATRICK LOVE

DEBATE THE ISSUES: INVESTMENT

OECD Insights

Debate the Issues: Investment

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OECD Insights: Debate the Issues

OECD Insights are a series of reader-friendly books that use OECD analysis and data to introduce some of today's most pressing social and economic issues. They are written for the non-specialist reader, including interested laypeople, older high-school students and undergraduates. The books use straightforward language, avoid technical terms, and illustrate theory with real-world examples.

The *OECD Insights: Debate the Issues* series brings together a selection of articles from the OECD Insights blog (<http://oecdinsights.org/>) on major social and economic issues. Experts from inside the OECD and outside the Organisation present data, analysis and their personal views of the implications of these for our societies and policy making.

The collection on investment examines the state of investment in different regions of the world, the issues facing investment in particular sectors, the institutional frameworks that govern international financial flows, and the policy options that will allow investment to support better lives for all.

You can take part in the debate by sending us your comments on the articles on the Insights blog.

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Introduction

by

Ana Novik, Head of the Investment Division,
OECD Directorate for Financial and Enterprise Affairs

The 2015 meeting of the OECD Council at Ministerial Level explored the importance of investment in placing economies on sustainable growth paths while addressing inequalities, encouraging innovation, helping the transition towards low-carbon economies, and financing the UN's Sustainable Development Goals (SDGs). As Dutch Prime Minister Mark Rutte put it, "Our priorities are three "I"s: Investment, Investment and Investment!".

International investment is so important because it makes economic globalisation, and the growth and jobs it brings, possible. Investment provides the finance needed to build value chains that stretch across the planet. It facilitates the trade that allows goods and services to be moved to where they are needed.

International investment also helps domestic economies to grow too, both directly by giving local firms the means to expand in home and export markets, as well as indirectly through access to the investors' expertise, experience and networks.

The issue for governments is how to encourage international investment and to maximise the benefits. They have been successful in eliminating overt discrimination against foreign investors but it has become clear during the crisis that many structural impediments continue to hold investment back. Governments need to tackle these structural barriers so that investment can flow towards the projects, firms and places that need it most.

Governments need to encourage longer-term productive investment in the firms and ideas that will be sources of growth, rather than in the short-term strategies that provided such a fertile breeding ground for the crisis.

Getting it right means finding the best balance between multiple, sometimes competing, economic goals, social needs, and political constraints and the interests of stakeholders ranging from huge multinational corporations to private citizens.

The following eclectic collection of articles from the OECD Insights blog brings together the personal views of authors from the OECD and outside the Organisation on the trends and challenges shaping international investment today. You'll find discussions and debates on the state of investment in different regions of the world, the issues facing investment in particular sectors, the institutional frameworks that govern international financial flows, and the policy options that will allow investment to support better lives for all.

We hope you find this collection informative and stimulating.

**The OECD's Business
and Finance Outlook looks
at the greatest puzzle
of today**

by

Adrian Blundell-Wignall, Director
OECD Directorate for Financial and Enterprise Affairs
Special Advisor to the Secretary-General on Financial Markets

The greatest puzzle today is that since the global crisis financial markets see so little risk, with asset prices rising everywhere in response to zero interest rates and quantitative easing, while companies that invest in the real economy appear see so much more risk. What can be happening? The puzzle is even more perplexing when we see policy makers lamenting the lack of investment in advanced countries at a time when the world economy shows all of the characteristics of excess capacity: low inflation and falling general price levels in some advanced countries for the first time since the gold standard and despite six years of the easiest global monetary policy stance in history.

Will financial markets be proved wrong so that asset prices will soon collapse? Or, alternatively, will business investment take off and carry growth and employment to more acceptable levels validating the market optimism? The *OECD Business and Finance Outlook* presents a reconciliation of these apparent contradictions based on the bringing together of new evidence about what is happening in some 10 000 of the world's biggest listed companies as they participate in global value chains across 75 countries and which represent a third of world GDP. The salient points are as follows.

There is plenty of investment globally but from an advanced country perspective it is happening in the wrong places, as global value chains have broken down the links between policies conducted by governments inside their own borders and what their large global companies actually do. Short-termism too is apparent, where investors prefer companies that carry out more buybacks and dividends compared to those that embark on long-term investment strategies. Advanced country companies appear to prefer outsourcing investment risk to emerging market countries in global value chains when they can.

From a developing country point of view, financial repression and exchange rate targeting are legitimate development strategies. Investment is enormous (running at double the rate per unit of sales in general industrial companies compared to those of advanced countries), but it is not well based on market signals and efficient value creation strategies. Instead, it is fostered by cross-border controls, the heavy presence of state-owned banks that

intermediate the “bottled-up” savings into investment, local content requirements and pervasive regulations and controls. Over-investment – characterised as a falling return on equity in relation to the high cost of equity that opens a negative value creation gap – is a feature of many emerging market companies which, at the same time, are borrowing too heavily.

Concern about employment and growth in advanced countries has seen central banks vainly trying to stimulate investment at home: for six years they have kept close to zero interest rates and successive attempts at quantitative easing have been launched in the US, the UK, Japan and Europe. These actions are pushing up the value of risk assets in the search for yield, as pension funds and insurance companies face very real insolvency possibilities (with liabilities rising and maturing bonds being replaced by low-returning securities). The competition to buy high-yield bonds is seeing covenant protections falling, and less liquid alternative products hedged with derivatives are once more on the rise.

Many of these new products are evolving in what has come to be known as the “shadow banking sector”: as banks themselves have become subject to greater regulatory controls financial innovation and structural changes in business models are once again adjusting to shake off the efforts of regulators. Broker-dealers intermediate between cash-rich money funds on the one hand, which need to borrow higher-risk securities to do better than a “zero” return, and cash-poor institutional investors on the other, that need cash to meet margin and collateral management calls that the new-generation higher-yield alternative products demand. Shadow banking is focused on the reuse of assets and collateral. With this comes a new set of risks for financial market policy makers to worry about: leverage, liquidity, maturity transformation, re-investment and other risks outside of traditional banking system.

The *Business and Finance Outlook* provides evidence on some of these trends.

Nor are global value chains that facilitate the shift in the centre of gravity of world economic activity towards emerging markets serving economic development in the manner that might be expected.

Sales-per-employee illustrate an astounding “catch-up” of emerging countries over the past decade. However, when company “value added” per employee is calculated, there is much less sign of any emerging market catch-up to advanced country productivity levels, in either infrastructure or general industrial companies.

Worse still, the “value added” productivity growth apparent catch-up prior to the crisis has not continued in subsequent years. This is no way in which to foster promises for ageing baby boomers, nor for the stable growth of employment for younger generations. The international financial and production systems will have to be reformed towards greater competition and openness if the world economy is to be put onto a more stable path.

Useful links

Original article: Adrian Blundell-Wignall, Director, OECD Directorate for Financial and Enterprise Affairs, Special Advisor to the Secretary-General on Financial Markets, “The OECD’s Business and Finance Outlook looks at the Greatest Puzzle of Today”, OECD Insights blog, <http://wp.me/p2v6oD-26r>.

OECD (2015), *OECD Business and Finance Outlook 2015*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264234291-en>.

**The Policy Framework
for Investment:
What it is, why it exists,
how it's been used
and what's new**

by

Stephen Thomsen, OECD Directorate for Financial and Enterprise Affairs

Of all the acronyms in existence, “PFI” has to be one of the most popular. For many people, it is the Private Finance Initiative but that is only one of at least 40 meanings of the PFI, including institutes devoted to everything from pet foods to pellet fuels. For us at the OECD and for the many emerging economies we have been working with, the PFI stands for the *Policy Framework for Investment*. Our PFI means exactly what it says: it is a policy framework to stimulate investment and to enhance the impact from that investment.

Most people would agree on the potential benefits of investment. It can bring increases in productive capacity and other assets, including intangible assets such as intellectual property – all of which can contribute to productivity increases. As Nobel-prize winning economist Professor Paul Krugman famously remarked, “Productivity isn’t everything but in the long run it is almost everything.”

But many of us would also agree that the benefits from investment can sometimes be disappointing, not only on efficiency grounds but even more importantly as to its development impact. Some investment can even be detrimental in social or environmental terms.

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising the economic and social returns. Quality matters as much as the quantity as far as investment is concerned. The PFI also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small.

So how does it work? The PFI looks at 12 different policy areas affecting investment: investment policy; investment promotion and facilitation; competition; trade; taxation; corporate governance; finance; infrastructure; policies to promote responsible business conduct and investment in support of green growth; and lastly broader issues of public governance. These areas affect the investment climate through various channels, influencing the risks, returns and costs faced by investors. But while the PFI looks at policies from an investor perspective, its aim is to maximise the

broader development impact from investment and not simply to raise corporate profitability.

The PFI is essentially a checklist which sets out the key elements in each policy area. The value added of the PFI is in bringing together the different policy strands and stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It doesn't provide ready-made reform agendas but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. It's a tool, not a magic wand.

The best way to understand the PFI is to see how it has been used. Over 25 countries have undertaken OECD Investment Policy Reviews using the PFI, most recently Myanmar. Several other reviews are in the pipeline. The PFI is a public good and hence it is possible for a country to undertake its own self-assessment, but in practice the combination of part self-assessment by an inter-ministerial task force and part external assessment by the OECD has proven to be a good formula. The PFI has also been used for capacity building and private sector development strategies by bilateral and multilateral donors. It has also been used as a basis for dialogue at a regional level, such as in Southeast Asia.

The PFI was originally developed in 2006 and has been updated in 2015 to reflect developments in the many policy areas mentioned above. Approaches to international investment agreements have evolved over the past decade. The OECD Guidelines for Multinational Enterprises have been substantially updated, partly to reflect the development of the UN Guiding Principles for Business and Human Rights. The OECD Principles of Corporate Governance and OECD Guidelines on Corporate Governance of State-Owned Enterprises are currently under review. The new PFI also places even more focus on small- and medium-sized enterprises and on the role played by global value chains. It has incorporated gender issues, a vital element of inclusive development, and now has a chapter on policies to channel investment in areas that promote green growth.

We have also taken advantage of the focus on the PFI to address issues of how to move from PFI assessments to actual

implementation of reforms on the ground. For this reason, the donor community has been strongly involved in the discussions surrounding the update. Experience at country level and consultations on the PFI update have led to greater co-operation between the OECD and the World Bank Group on investment climate reforms. In this way, the PFI can provide a platform for co-operation among international organisations, allowing them to provide more effective and complementary advice and support.

The update of the PFI has not been a purely technocratic exercise. The new PFI represents the collective wisdom of experts, policy makers, business people and other stakeholders. It has been presented in regional forums in Southeast Asia, Southern Africa and Latin America, as well as in Brussels and Washington D.C., led by a Task Force co-chaired by Finland and Myanmar. As a result of these inclusive consultations, the PFI strikes a balance between what investors want and the broader interests of society. The updated PFI was launched at the OECD's Ministerial Council Meeting in June 2015. So the next time you hear someone speak of the PFI, it might well be the Policy Framework for Investment.

Useful links

Original article: Stephen Thomsen, OECD Investment Division, "The Policy Framework for Investment: What it is, why it exists, how it's been used and what's new", OECD Insights blog, <http://wp.me/p2v6oD-24N>.

2015 Update of the Policy Framework for Investment, www.oecd.org/daf/inv/investment-policy/pfi-update.htm.

Do lower taxes encourage investment?

by

Pierre Poret,

Deputy Director, OECD Directorate for Finance and Enterprise Affairs

Conventional wisdom holds that countries with lower taxes attract higher levels of foreign direct investment (FDI). At first glance, this intuitive assumption seems to be supported by the evidence. Some tiny jurisdictions with low or no taxes on foreign investment do seem to attract more FDI than major economies, but “investment” is the wrong term for billions of dollars that flow in and out of these places as part of the strategies multinationals use to pay less tax.

A new methodology for calculating FDI has been developed at the OECD to provide a clearer and fuller picture of FDI flows. Long time series of these new-generation FDI statistics are not yet available. In the meantime, we analysed the financial statements of around 10 000 multinationals for the 2015 *OECD Business and Finance Outlook* to model the relationships between their capital spending, rates of return, and tax holidays and exemptions, among other factors of investment. We found that tax holidays and exemptions do matter in investment decisions, but they are not the only factor and not necessarily the most important.

At the same time, governments around the world have become increasingly concerned with “double non-taxation”, i.e. companies not paying tax in either the country where they make their profits or the country where their headquarters are. Double non-taxation is one of the targets of the OECD/G20 project to counter tax base erosion and profit shifting (BEPS). Over 120 countries have participated in the project in recognition of the fact that a country trying to tackle BEPS on its own would probably lose out to more generous rivals. With the recent release of the final BEPS package, and the ongoing work on exchange of tax information, governments are well equipped to meet this challenge. However, governments also have three additional means at their disposal to prevent tax abuses without undermining investment.

Public governance of tax incentives according to internationally-agreed best practices.

The new tax chapter of the *OECD Policy Framework for Investment (PFI)*, used by dozens of countries and regions such as the South African Development Community and the Association of

Southeast Asian Nations, provides multilaterally-agreed guidance to help countries avoid potential abuses of tax incentives and resist undue pressure to offer tax incentives. The PFI calls for incentives to be granted only following a proper legislative process. The PFI also provides guidance on the implementation and administration of tax policy regarding investment, for instance on making sure different levels of government are working together, addressing capacity constraints in tax offices, establishing criteria for analysing the costs and benefits of incentives, and providing for “sunset clauses” that say how long the agreement stays in force. This ultimately works in favour of the broader business community concerned with public sector transparency and a level playing field. As this issue is of particular relevance for developing countries, the OECD, in collaboration with the IMF and World Bank, has also developed a report on *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*.

Clarifying the degree of exposure of tax measures to investor claims under investment treaties.

Many governments see investment treaties as a way to increase the investor confidence and long-term trust needed to encourage investment. However, there is concern that some investors and law firms are claiming that sovereign states who change tax regimes to phase out excessive advantages, or who enforce tax laws more energetically, are violating investment treaties and should pay compensation. Most investment treaties currently apply to tax measures, but to differing degrees. Some of these treaties – especially more recent ones – contain mechanisms that give the state parties the power to make joint determinations on individual tax measures, but these are still the exception: only 3.6% of the 2 060 treaties in a sample the OECD analysed contain a clause of this kind related to tax measures. Other investment treaties limit the types of claims that can be brought against tax measures and permit, for example, only claims for expropriation.

Clarifying the scope of application of investment treaties to tax measures can help provide a more certain policy landscape for governments and investors.

Under the legally binding *OECD Code of Liberalisation of Capital Movements*, certain tax measures can amount to a restriction to the free flow of capital and can fall within the scope of the Code. But the Code gives governments adequate policy space – for example, taxes that are not identically applied to residents and non-residents but are levied in accordance with widely accepted principles of international tax law, are not considered as a discriminatory restriction under the Code.

Violations of tax laws by investors may also be relevant to the application of investment treaties. This is because illegality of the initial investment is increasingly expressly recognised as a bar to treaty coverage and, for instance, the recently-negotiated Comprehensive Trade and Economic Agreement between the EU and Canada would limit the definition of investments to those made “in accordance with law”.

Communicating collectively to companies the expectation that they should obey not only the letter but also the spirit of tax law.

The OECD Guidelines for Multinational Enterprises (the Guidelines), a set of recommendations to companies by OECD and non-OECD governments, call on enterprises to comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate and not to seek or accept exemptions outside the statutory or regulatory framework related to taxation. Complying with the spirit of the law means discerning and following the intention of the legislature. Tax compliance also entails co-operation with tax authorities to provide them with the information they require to ensure an effective and equitable application of the tax laws. The Guidelines’ recommendation that enterprises should also treat tax governance and tax compliance as important elements of their oversight and broader risk management systems is reinforced by the recently revised *Principles of Corporate Governance*. Governments should increase their efforts to raise public awareness of the tax chapter of the Guidelines in support of their broader agenda to modernise and cooperate on tax policies.

Trade and FDI drive economic globalisation and help stimulate the growth of national economies. Fair and efficient tax systems are

central to sharing the fruits of that growth equitably among nations and citizens. The challenge for governments is to put in place policies that attract investment and enable them to collect their fair share of taxes.

Useful links

Original article: Pierre Poret, Deputy Director, OECD Directorate for Finance and Enterprise Affairs, “Do lower taxes encourage investment?”, OECD Insights blog, <http://wp.me/p2v6oD-2j4>.

IMF, OECD, UN and World Bank (2015), *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*, www.oecd.org/tax/tax-global/work-on-tax-incentives.htm

OECD work on international investment, www.oecd.org/daf/inv/.

Rethinking due diligence practices in the apparel supply chain

by

Jennifer Schappert, OECD Directorate for Financial and Enterprise Affairs

In 2013, the Rana Plaza building in Bangladesh's capital Dhaka collapsed, killing over 1 100 people and injuring another 2 500. The dead and injured were garment workers, ordered to go back to work even though shops and a bank in the same building had closed immediately the day before when cracks appeared. The garment factories were indirectly supplying international retailers, highlighting the debate on whether multinational enterprises (MNEs) can make the apparel supply chain safe and healthy. Ensuing recommendations to MNEs have often focused on MNEs strengthening existing compliance mechanisms with individual suppliers. However, to transform the sector, we need to question whether the current approach to supply chain due diligence is the right one to begin with.

In the absence of strong regulatory frameworks in many producing countries, the traditional approach to compliance is for enterprises themselves to take on the role of monitoring and assessing each supplier against international standards, developing corrective action plans, and then using their leverage (for example through the incentive of future contracts) to influence suppliers to mitigate risks. It sounds fine in theory, but in practice the system breaks down.

The OECD Guidelines for Multinational Enterprises advocate an approach where the nature and the extent of due diligence correspond to risk. However, the short-term nature of contracts between MNEs and their suppliers and the sheer size and complexity of apparel supply chains means that MNEs often struggle to know where to prioritise risk assessment and mitigation. Within this context an enterprise's compliance system becomes reduced to ongoing assessments of (almost) all suppliers across all risk areas. This leaves few resources for tailoring risk assessments, identifying root causes of risks, and effectively managing risks when adverse impacts are identified.

Effective monitoring of individual suppliers is further complicated by the well-documented shortcomings of social audits, such as: factory visits announced well in advance; fraud; inconsistent quality across audits and auditors; lack of alignment with international standards; audit duplication and resulting

fatigue; and the limited scope of social audits which seek to identify adverse impacts but rarely root causes. Efforts to improve the system, for example through long-term contracts and close collaboration with suppliers, have led to better results in certain cases and should be encouraged. However, this alone will not transform the sector because improvements are isolated to a few strategic suppliers and may fail to adequately address risks which cannot be tackled at the individual supplier level.

A multi-stakeholder project underway at the OECD is questioning current due diligence practices in the apparel supply chain on matters covered by the Guidelines (human rights, employment and industrial relations, environment and bribery) and, among other questions, asking whether trade unions and other representative worker organisations could play a role in helping MNEs take a risk-based approach to due diligence.

Historically, unions and other worker organisations have helped government regulators direct inspections towards high-risk workplaces. For example, in the United States, trade unions helped regulators direct occupational safety and health inspections towards high-risk workplaces by requesting inspections as risks arose. This enabled limited government resources to appropriately target the most risky workplaces. By contributing to inspections, trade unions also ensured that inspections targeted the most salient risks at each individual workplace.

Within the apparel supply chain, workers' representatives could act as an on-the-ground monitoring mechanism to trigger third-party inspections by multi-stakeholder initiatives. Such a process would potentially reduce the duplication of broad social audits and facilitate the targeting of technical assessments to specific risks. By contributing to the assessments, workers would likewise help to improve the quality and conformity of assessments and provide important context in identifying root causes of adverse impacts and corresponding solutions. Furthermore, unions and worker organisations have a role to play in promoting the long-term sustainability of solutions by increasing worker awareness of their rights, offering assistance in the actual exercise of individual rights,

and protecting the rights of individual workers through collective bargaining.

The focus of an enterprise's due diligence would then shift from the seemingly impossible task of monitoring suppliers for all risks to focusing on targeted assessments and risk remediation. The primary role of the MNE would be: to actively promote freedom of association amongst suppliers; create or participate in a system by which workers can request inspections; support timely and targeted technical assessments at the site level when requested or when operating in high-risk contexts (e.g. building integrity); and contribute to the mitigation of risks by addressing root causes (where feasible) in collaboration with suppliers, trade unions, and other buyers.

Freedom of association therefore becomes the enabler of risk-based due diligence across an entire supply chain. In countries where legal or political constraints prohibit or limit this fundamental right, the sector should use its leverage broadly, in collaboration with trade unions, government and international organisations, to influence government to reform the regulatory framework and its implementation in producing countries.

This broader approach to due diligence applies to other salient risks in the sector, low wages for example, that cannot be effectively addressed at the individual supplier level. The Bangladesh Accord on Fire and Building Safety and the Alliance for Bangladesh Worker Safety are demonstrating how a paradigm shift is feasible.

To date, supply chain due diligence in the apparel sector has predominantly focused on direct suppliers. However, according to the Guidelines, it should be applied across the full length of the supply chain. Effective due diligence of risks linked to upstream production should build on the lessons of the last 20 years: an individual and bilateral approach to due diligence will not transform the sector. Due diligence is the responsibility of all enterprises in the sector. It should therefore be carried out by enterprises operating at each segment of the supply chain and be mutually reinforcing.

Based on the findings of the multi-stakeholder project, the OECD will develop practical guidance to support the development of a common understanding of risk-based due diligence in the apparel and footwear sector supply chain.

Useful links

Original article: Jennifer Schappert, OECD Investment Division, “Rethinking due diligence practices in the apparel supply chain”, OECD Insights blog, <http://wp.me/p2v6oD-23B>.

Institute for Human Rights and Business (2015), *Remembering Rana Plaza*, www.ihrb.org/remembering-rana-plaza.html.

Responsible supply chains in the textile and garment sector, <http://mneguidelines.oecd.org/responsible-supply-chains-textile-garment-sector.htm>.

**Legislation on responsible
business conduct must
reinforce the wheel,
not reinvent it**

by

Roel Nieuwenkamp, Chair of the OECD Working Party on Responsible
Business Conduct

Supply chains spanning dozens of countries are now a feature of businesses large and small. However, global regulatory frameworks have largely not kept pace with these trends. Rule of law remains weak in many developing countries and significant uncertainty and enforcement issues continue to exist in transnational litigation and arbitration. Some international instruments, such as the Guidelines for Multinational Enterprises (the Guidelines) and the UN Guiding Principles for Human Rights and Business (UNGPs) have been important tools for filling these regulatory gaps. For example, the Guidelines establish an expectation that businesses behave responsibly throughout their supply chains, not just within their direct operations, extending to activity in potentially institutionally weak contexts where international standards and domestic laws may not be adequately enforced.

Recently domestic law has also begun to follow suit by introducing legally binding obligations. Section 1502 of the US Dodd-Frank Act provides that companies must report on whether they source certain minerals (tin, tantalum, tungsten and gold) from conflict areas. The OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas, which was adopted as an OECD Recommendation in 2011, was the first instrument to define responsibilities in this context and is explicitly referenced in section 1502. Currently the EU is considering introducing similar obligations in a proposal aimed at regulating the import of conflict minerals into the EU.

Another example in the extractives sector where non-binding initiatives have acted as the harbinger for binding law is revenue transparency. The Extractive Industry Transparency Initiative (EITI), founded in 2003 was one of the first efforts to encourage government and private sector reporting on revenue streams of extractive operations as a strategy for battling corruption. Section 1504 of Dodd-Frank, passed in 2010, requires that companies registered with the Securities and Exchange Commission (SEC) must publicly report how much they pay governments for access to oil, gas and minerals. The EU has since mandated similar obligations through Accounting and Transparency Directives -Norway and South Korea have expressed interest in doing the same.

After a Swiss motion proposing mandatory human rights and environmental due diligence for Swiss corporations was narrowly voted down in the Swiss Parliament, the Swiss Coalition for Corporate Justice announced that it will collect signatures for a popular initiative on the proposal. If they gather 100 000 signatures in 18 months, the measure will be put to a binding public referendum.

The 2015 UK Modern Slavery Act provides that commercial organisations must prepare a slavery and human trafficking statement annually detailing, among other matters, their due diligence processes in relation to slavery and human trafficking in their operations and supply chains.

The broadest scheme remains a French legislative proposal to mandate supply chain due diligence in accordance with the Guidelines. Companies with 5 000 employees or more domestically or 10 000 employees or more internationally would be responsible for developing and publishing due diligence plans for human rights, and environmental and social risks. Failure to do so could result in fines of up to EUR 10 million. If such a law is passed in France, it could generate spill-over effects within the EU. The rapporteur for this proposal, Dominique Potier, has indicated that he will push the European Commission to develop an EU directive along similar lines.

The move from soft to hard law is a concern for many businesses. However, when it concerns the more severe issues of responsible business conduct, the jump between the two is not that high. Many companies already have due diligence systems in place. This means that the playing field for the more progressive companies will be levelled. That was one of the reasons why many British businesses supported the Modern Slavery Act. In addition, the UN Guiding Principle 23(c) already provides specific guidance on how companies should manage the risks of the most severe impacts; it says that businesses should “Treat the risk of causing or contributing to gross human rights abuses as a legal compliance issue wherever they operate”.

Another concern that businesses may have is that all these proposals will create a mess of different hard and soft standards. A

proliferation of obligations (national, regional and international) has the potential to generate regulatory disarray and create challenges for businesses in navigating their obligations. Uniformity and clarity around obligations and expectations will be important for establishing a level playing field for business. A large imbalance or contradictions in obligations regarding due diligence or reporting across jurisdictions may unfairly penalise companies operating in multiple jurisdictions or subject to more onerous standards. In ensuring that standards are aligned, administrative burdens for business will be eased and competitive risks will be mitigated. Additionally, such laws must be drafted carefully in order to be practical and fairly enforceable. Presently the language included in both the French legislation and UK law is highly general and therefore the obligations under the law remain somewhat abstract.

In order to ensure that such regulation is realistic, reasonable and effective, the regulations and guidance that will accompany these laws should be developed on the basis of carefully drafted non-binding standards, such as the UNGPs and the Guidelines. They will also need multi-stakeholder input. In the context of the OECD, all due diligence guides interpreting the expectations of the Guidelines are developed in consultation with industry, government, civil society and worker organisations. This process has ensured that recommendations included in the guidance are endorsed by businesses, the ultimate users of the guidance, and that they are ambitious yet reasonable. Additionally, the role of non-binding instruments, as well as the organisations that crafted and implemented them should not be overlooked. The UN and OECD will be important sources of guidance on these issues.

Legislative proposals related to existing international instruments should not seek to reinvent the wheel, but to reinforce it. Existing instruments that are widely recognised and proven to be effective and reasonable should represent a foundation for their legally-binding counterparts.

Useful links

Original article: Roel Nieuwenkamp, Chair of the OECD Working Party on Responsible Business Conduct, “Legislation on responsible business conduct must reinforce the wheel, not reinvent it”, OECD Insights blog, <http://wp.me/p2v6oD-22T>.

OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Afflicted and High-Risk Areas, <http://mneguidelines.oecd.org/mining.htm>.

2015 Global Forum on Responsible Business Conduct, <http://mneguidelines.oecd.org/globalforumonresponsiblebusinessconduct/>.

OECD Guidelines for Multinational Enterprises, <http://mneguidelines.oecd.org/>.

UN Guiding Principles for Human Rights and Business, <http://business-humanrights.org/en/un-guiding-principles>.

When businesses are bad, who you gonna call?

by

Carly Avery, OECD Directorate for Financial and Enterprise Affairs

Most businesses are good. They pay their taxes, they create employment, they abide by the laws, and they generally contribute to the societies in which they operate. But unfortunately, this isn't always the case. And when businesses behave badly, the human consequences can be devastating: factories collapse killing thousands; workers, often children, are treated like slaves; rivers, lakes, and even seas are rendered lifeless, and entire species are threatened.

In order to deal with cases of bad business behaviour such as these, we need a multilateral system where victims of this type of treatment could complain, and the person receiving the complaint would analyse it, see if it's valid, alert all the parties involved, and sit down with them to help fix the situation. No, this isn't some Disney film scenario with a dashing knight in shining armour swooping in to save the day. In fact, this is something that already exists: the National Contact Points (NCPs) for the OECD Guidelines for Multinational Enterprises.

The Guidelines are the leading international standard for responsible business conduct for multinational enterprises wherever they operate in the world. They cover all areas of business ethics, including human rights, labour issues, environmental protection, anti-bribery, taxation, and science and technology. They operate on the expectation that businesses should not only do good, but that they should also do no harm. The Guidelines were first adopted in 1976 and today 46 governments have signed up.

With the Guidelines you can raise your hand and say "Hey, stop doing that to my fish!" and someone, an NCP, can do something about it. NCPs are the mechanism that reinforces how the Guidelines are applied. They are units that have been set up by every government adhering to the Guidelines and are there to help parties find a solution for issues arising from any alleged non-observance of the recommendations found in the Guidelines. This isn't a legal process so NCPs focus on problem solving – they offer good offices and facilitate access to consensual and non-adversarial procedures (e.g. conciliation or mediation).

So, everything is fine then, right? Well, not quite. Here's a statistic for you: multinationals from countries that adhere to the Guidelines have USD 22.6 trillion invested around the world. The NCPs received 35 new cases in 2014. That means that there was one case for every USD 645 billion of foreign direct investment in 2014. That's either a lot of very responsible multinationals or we're missing something.

The natural conclusion is that not all instances of bad business conduct are being alerted to NCPs. Why? Simply put, NCPs aren't visible enough. If President Obama can cite the Guidelines in terms of the US anticorruption agenda and yet "NCP" in the UK is better known as an acronym for UK National Car Parks, there's a mismatch.

Governments need to up the stakes. If they gave more funding to this vital mechanism, NCPs could be more visible and live up to their potential. G7 governments agree. In their 2015 statement they committed to strengthening "mechanisms for providing access to remedies, including the National Contact Points..." and encouraged the OECD "to promote peer reviews and peer learning on the functioning and performance of NCPs" while ensuring that their own NCPs "are effective and lead by example".

Here are some of the problems increased funding could help fix:

- Staffing issues: In 2014 only 15 of the 46 NCPs had an allocated budget and this impacts staffing. Few NCPs have staff solely devoted to the responsibilities of the NCP.
- Communications deficit: Currently only 57% of NCPs have or are working on developing a structured promotional plan.
- Lack of transparency: NCPs are encouraged to report publicly on their activities but only 40% have put at least one annual report online over the past three years according to the 2014 Annual Report on the Guidelines.
- NCPs would be better equipped to handle the complaints they receive. With better communications they can promote Guidelines more widely, and with greater transparency they can build the vital element of trust.

If NCPs had more clout, companies would work even harder to protect and develop their reputations by pre-empting any complaints about the ways they operate. This in turn would contribute to growth that benefits individuals, and communities, as well as global aspirations such as the Sustainable Development Goals.

What's the OECD doing in all of this? Since the most recent update of the Guidelines in 2011, the OECD has increased its work with NCPs to strengthen the grievance mechanism process to ensure that it delivers results. This includes peer-reviews and targeted communications support. The Chair of the OECD Working Party on Responsible Business Conduct has even launched a competition to find a better name for "NCPs".

As I said at the outset, bad business conduct exists, but we also have NCPs working hard to manage the complaints they receive, despite imperfections. And sometimes the NCPs get their Disney moment, like when the UK NCP provided mediation to help the WWF and Soco talk to each other and avoid drilling in Virunga National Park, a UNESCO world heritage site. Concrete change has to start somewhere, and the NCPs are part of the change for enforcing responsible business conduct happening around us right now.

Useful links

Original article: Carly Avery, OECD Investment Division, "When businesses are bad, who you gonna call?", OECD Insights blog, <http://wp.me/p2v6oD-2ba>.

Responsible Business Conduct Matters, <http://mneguidelines.oecd.org/responsible-business-conduct-matters.htm>.

Guidelines on Specific Instances, <http://mneguidelines.oecd.org/specificinstances.htm>.

The OECD Database of Specific Instances, <http://mneguidelines.oecd.org/database/instances/>.

Don't supply chains: Responsible business conduct in agriculture

by

Patrick Love, OECD Public Affairs and Communications Directorate

Two questions today: which fictional character helped bring down a colonial empire and gave his name to a food label? If you're Dutch, you probably know the answer, if not, I'll save you an Internet search by telling you: Max Havelaar, eponymous protagonist of Multatuli's *Max Havelaar, of de koffi-veilingen der Nederlandsche Handel-Maatschappij*, translated into English as *Max Havelaar: Or the Coffee Auctions of the Dutch Trading Company*. In the middle of the nineteenth century, the Dutch government ordered farmers in its East Indies, modern-day Indonesia, to grow quotas of export crops rather than food. The Dutch also reformed the tax system, creating a public-private partnership that allowed tax commissioners to keep a share of what they collected. The result was the misery and starvation the book denounces. *Max Havelaar* helped change attitudes to colonial exploitation in the Netherlands and was even described as "The book that killed colonialism" by Indonesian novelist Pramoedya Ananta Toer in the *New York Times Magazine*.

The name Max Havelaar was adopted by the Dutch Fairtrade organisation and other European members of their network. The movement describes itself as "an alternative approach to conventional trade and is based on a partnership between producers and consumers. When farmers can sell on Fairtrade terms, it provides them with a better deal and improved terms of trade". The movement has its critics. For instance in an article on Fairtrade coffee in the *Stanford Social Innovation Review*, Colleen Haight argues that "strict certification requirements are resulting in uneven economic advantages for coffee growers and lower quality coffee for consumers" and that while some small farmers may benefit, farm workers may not.

Which brings us to the second question: what's that got to do with the OECD? We asked for comments on the draft FAO-OECD Guidance for Responsible Agricultural Supply Chains from government, business and civil society representatives, international organisations, and the general public by 20 February 2015. I'd like to say that winning entries received a guinea, but they didn't. We did however publish a compilation on this web page from the OECD division in charge of the Guidelines for Multinational Enterprises (MNEs) <http://mneguidelines.oecd.org/fao-oecd-guidance-consultation.htm>.

The world's population is increasing and, human biology being what it is, so is the demand for food. Agriculture is expected to attract more investment, especially in developing countries, and human nature being what it is, some rascals may be tempted not to trade fairly. Or as the call for comments puts it: "Enterprises operating along agricultural supply chains may be confronted with ethical dilemmas and face challenges in observing internationally agreed principles of responsible business conduct, notably in countries with weak governance and insecure land rights."

Apart from the OECD MNE Guidelines, the guidance considers half a dozen other sets of standards and principles from the FAO, UN, and International Labour Organization among others, designed to encourage "responsible business conduct". Intended users include everybody from farmers to financiers, in fact the whole supply chain from seed sellers to grocers. The guidance as it stands today was developed by an Advisory Group with members from OECD and non-OECD countries, institutional investors, agri-food companies, farmers' organisations, and civil society organisations.

The aim is not to create new standards, but to help enterprises respect standards that already exist "by referring to them in order to undertake risk-based due diligence". Some unfamiliar language/jargon/special terminology is inevitable in a document like this, but the authors of the guidance have taken care to explain it all. "Due diligence" here refers to the process through which "enterprises can identify, assess, mitigate, prevent, and account for how they address, the actual and potential adverse impacts of their activities" (and those of their business partners).

The draft proposes a five-step framework for risk-based due diligence, covering management systems, identifying risks, responding to them, auditing due diligence, and reporting on due diligence. Some of the concrete proposals will provoke little or no discussion I imagine, such as "respect human rights". On the other hand, "promote the security of employment" is likely to see a frank and open exchange of views. (The 2013 *OECD Employment Outlook* has a chapter on enhancing flexibility in labour markets.)

The human rights and labour sections could apply to any sector of the economy, as could most of the proposals on governance (we're against corruption) and innovation (we're for appropriate technologies), but there are a number of proposals targeting agriculture in particular, for example “promoting good agricultural practices, including to maintain or improve soil fertility and avoid soil erosion”. Again, some of the draft focusing on agriculture is uncontroversial (respect legitimate rights over natural resources), but I can't imagine owners of factory farms agreeing to grant animals “the freedom to express normal patterns of behaviour”.

I'm sure you'll find plenty to agree or disagree with, so let us know and we'll rid the agricultural supply chain of, as Multatuli would say, all the “miserable spawn of dirty covetousness and blasphemous hypocrisy”.

Useful links

Original article: Patrick Love, OECD Public Affairs and Communications Directorate, “Don't supply chains: Responsible business conduct in agriculture”, OECD Insights blog, <http://wp.me/p2v6oD-1Yx>.

Haight, C. (2011), “The Problem with Fair Trade Coffee”, *Stanford Social Innovation Review*, Vol. 9/3, http://ssir.org/articles/entry/the_problem_with_fair_trade_coffee.

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The OECD Cleangovbiz Initiative: <http://www.oecd.org/cleangovbiz/>.

International investment in Europe: A canary in the coal mine?

by

Michael Gestrin, OECD Directorate for Financial and Enterprise Affairs

At the start of the 2007 crisis, global foreign direct investment (FDI) stocks actually declined, and even today, global flows of FDI are still 40% below their pre-crisis peak. Generally, OECD countries were the sources of the biggest declines while many emerging economies experienced increases in FDI flows. Europe has been one of the worst affected regions. EU inflows are down 75% and outflows are down 80% from their pre-crisis levels.

Inflows into the EU are currently around USD 200 billion, down from USD 800 billion at the peak of the global FDI cycle in 2007. Outflows are also currently around USD 200 billion, down from USD 1.2 trillion in 2007. For the rest of the world, a global economy “without” the EU is doing quite well. In this global economy, inflows recovered strongly starting in 2010 and reached new record heights in 2011, at just over USD 1.2 trillion. With respect to outflows, the FDI crisis was limited to a one-year decline of 20% in 2009. Although world-minus-EU outflows have not grown over the past three years, they have been at record levels.

Part of the strong performance of the world-minus-EU can be explained by the growing importance of the emerging markets, in particular China, as sources and recipients of FDI. In 2012, emerging markets received over 50% of global FDI flows for the first time, and China is now consistently among the world’s top three sources of FDI.

The crisis initially gave rise to a significant gap between the non-EU-OECD countries and the rest of world with respect to both inflows and outflows, just as it did for the EU. A big difference, however, is that for the non-EU-OECD countries the gap closed after only two years. While the EU and the world-minus-EU group have been going in different directions ever since the start of the crisis, the non-EU-OECD group and its rest-of-world counterpart appear to have returned to a similar cycle after parting ways for a much shorter period during 2008-9.

Comparing the EU and non-EU-OECD shares of world inflows and outflows highlights the extent to which the positions of these two groups have reversed in recent years. At the turn of this century the EU accounted for over 50% of global inflows and 70% of global outflows. By 2013 both shares were down to 20%. Conversely, the

non-EUOECD countries have seen their shares of global FDI inflows and outflows recover to pre-crisis levels. This group overtook the EU in 2010 in terms of its share of both inflows and outflows, thus reversing the historical relationship.

Why? The greatest declines in inward FDI in the EU have been from within Europe itself. Before the crisis around 70-80% of the region's inward FDI consisted of intra-EU investment. Today only 30% of inward FDI is intra-EU. This sharp decline in the share of FDI that EU countries receive from their EU neighbours also helps to explain the decline in outward EU FDI.

The decline in the share of intra-EU in total EU inward FDI would seem to suggest a lack of confidence on the part of EU investors in their own regional market. One tempting explanation for this is that these declines have been concentrated in a sub-set of EU countries that have experienced particularly difficult economic conditions (such as Greece, Ireland, Portugal, and Spain) during the crisis.

This has not been the case. The FDI crisis in Europe has been broad-based, with the bulk of the declines in FDI flows concentrated in the largest economies. France, Germany, and the UK accounted for 50% of the USD 600 billion decline in FDI inflows between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for only USD 14 billion, or 2%, of the inflow decline. With respect to outflows, France, Germany, and the UK accounted for 59% of the USD 1 trillion decline between 2007 and 2013. Over the same period, Greece, Ireland, Portugal, and Spain accounted for 12% of this decline.

Part of the explanation for the decline in investment in Europe is linked to an increasing share of international divestment relative to international mergers and acquisitions (M&A). While pre-crisis levels averaged around 35%, they reached almost 60% in 2010-11 and now stand at around 50%. In other words, for every dollar invested, 50 cents is divested. Consequently, net international M&A investment in Europe is currently at its lowest levels in a decade, at around USD 100 billion.

The clear “leader” in this regard is the consumer products segment, with a divestment/investment ratio of 148%. This means that for every dollar invested in consumer products over the past six years, around one and a half dollars was divested. This is an example of investment de-globalisation. Domestic and international M&A in Europe have generally followed the same pattern: both are on track to reach their lowest levels in a decade. Conditions that are holding back international investment in Europe would seem to be discouraging domestic investment as well.

From a policy perspective, the challenges of breaking out of this regional investment slump are daunting but urgent. A useful starting point is the recognition that a supportive environment for productive international investment needs to reflect the evolving needs of international investors. Such a supportive environment has three dimensions.

First, investors generally favour predictable, open, transparent, rules-based regulatory environments, much along the lines put forward by the OECD’s *Policy Framework for Investment*. Where impediments to investment have not been addressed by governments this often has more to do with implementation challenges rather than disagreement over principles. For example, it is widely accepted that excessive “red tape” is an obstacle to investment but in many countries this is still often cited by business as being one of the most important impediments to doing business. In Europe, many such impediments represent relatively easy opportunities for improving the regional investment climate.

The second dimension concerns important changes in the structures and patterns of global investment flows as well as in the way MNEs are organising their international operations. This is reflected in investment de-globalisation and “vertical disintegration” which has seen MNEs become more focused on their core lines of business over time and more reliant upon international contractual relationships for organising their global value chains.

Finally, Europe would seem to be confronting a competitiveness puzzle in which declining competitiveness is discouraging investment, and declining investment is in turn undermining

competitiveness. A few years ago, OECD Secretary General Angel Gurría outlined six policy recommendations for getting Europe back on a sustainable growth path that also hold for investment:

1. Further develop the Single Market.
2. Ease excessive product market regulation.
3. Invest more in R&D and step up innovation.
4. Make sure that education and training institutions deliver highly sought after skills.
5. Increase the number of workers participating in labour markets and make markets more inclusive to address social inequalities.
6. Reform the tax system, including by reducing the tax wedges on labour.

Useful links

Original article: Michael Gestrin, OECD Investment Division, “International investment in Europe: A canary in the coal mine?”, OECD Insights blog, <http://wp.me/p2v6oD-1Ua>.

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OECD work on Foreign Direct Investment (FDI) Statistics, www.oecd.org/investment/statistics.htm.

**In my view:
The OECD must take charge
of promoting long-term
investment in developing
country infrastructure**

by

Sony Kapoor, Managing Director
Re-Define International Think Tank

The world of investment faces two major problems. Problem one is the scarcity – in large swathes of the developing world – of capital in general, and of money for infrastructure investments in particular. Poor infrastructure holds back development, reduces growth potential and imposes additional costs, in particular for the poor who lack access to energy, water, sanitation, and transport. Problem two is the sclerotic, even negative rate of return on listed bonds and equities in many OECD economies. The concentration of the portfolios of many long-term investors in such listed securities also exposes them to high levels of systemic – often hidden – risk.

Most long-term investors would readily buy up chunks of portfolios of infrastructure assets in non-OECD countries to benefit from the significantly higher rate of return over the long term, and to diversify their investments. At the same time, developing economies, where neither governments nor private domestic markets have the capacity and depth to fill the long-term funding gap, are hungry for such capital.

So what's stopping these investments?

Financial risks in developing countries are well known and often assumed to be much higher than in OECD economies. Also, investing in infrastructure means that investors will find it hard to pull their money out on short notice, and therefore such investments pose liquidity risks.

Despite these easy answers, however, there are three significant caveats:

- First, the events of the past few years have demonstrated that on average, political risk and policy uncertainty in developing countries as a whole have fallen, especially in the emerging economies.
- Second, OECD economies are also exposed to serious risk factors, such as high levels of indebtedness and demographic decline. As the financial crisis demonstrated, they are also likely to face other “hidden” systemic risks not captured by commonly used risk models and measures.

- ▶ Third, the kind of risks that dominate in developing countries, such as liquidity risks, may not be real risks for long-term investors (e.g. insurers or sovereign wealth funds). Given that the present portfolios of these investors are dominated by OECD-country investments, any new investments in the developing world may look more attractive and may actually offer a reduction of risk at the portfolio level.

So I ask again: Why aren't long-term investors investing in developing country infrastructure in a big way?

The biggest constraint is the absence of well-diversified portfolios of infrastructure projects and the fact that no single investor has the financial or operational capacity to develop these. Direct infrastructure investment, particularly in developing countries, is a resource-intensive process.

The G20, together with the OECD and other multilateral institutions such as the World Bank, can facilitate the development of a diversified project pipeline on the one hand, together with mechanisms to ease the participation of long-term investors on the other. This work will involve challenges of co-ordination, more than commitments of scarce public funds.

In my view, the OECD – which uniquely houses financial, development, infrastructure and environmental expertise under one roof – must take charge.

Useful links

Original article: Sony Kapoor, Managing Director, Re-Define International Think Tank, “In my view: The OECD must take charge of promoting long-term investment in developing country infrastructure”, OECD Insights blog, <http://wp.me/p2v6oD-1Pd>.

OECD work on financing for sustainable development, www.oecd.org/dac/financing-sustainable-development/.

OECD work on institutional investors and long-term investment, www.oecd.org/pensions/private-pensions/institutionalinvestorsandlong-terminvestment.htm.

The growing pains of investment treaties

by

Angel Gurría, OECD Secretary-General

International investment treaties are in the spotlight as articles in the *Financial Times* and *The Economist* show. An ad hoc investment arbitration tribunal recently awarded USD 50 billion to shareholders in Yukos. EU consultations on proposed investment provisions in the Trans-Atlantic Trade and Investment Partnership (TTIP) with the United States generated a record 150 000 comments. There is intense public interest in treaty challenges to the regulation of tobacco marketing, nuclear power and health care.

Some 3 000 investment treaties provide special rights for covered foreign investors to bring arbitration claims against governments. Principles of fair and equitable treatment included in many treaties are uncontroversial as general principles of good public governance. But the treaty procedures for interpreting and enforcing them in arbitration claims for damages are increasingly controversial.

A trickle of arbitration claims under these treaties has become a surging stream. Over 500 foreign investors have brought claims, mostly in the last few years. Investor claims regularly seek hundreds of millions or billions of dollars. High damages awards and high costs have attracted institutional investors who finance claims.

Providing investors with recourse against governments is valuable. Governments can and do expropriate investors or discriminate against them. Domestic judicial and administrative systems provide investors with one option for protecting themselves. The threat of international arbitration gives substantial additional leverage to foreign investors in their dealings with host governments, especially when domestic systems are weak.

At the same time, there is mounting criticism. Arbitration cases can involve challenges to the actions of national parliaments and supreme courts. As Chief Justice Roberts of the US Supreme Court wrote earlier this year, “by acquiescing to [investment] arbitration, a state permits private adjudicators to review its public policies and effectively annul the authoritative acts of its legislature, executive, and judiciary”. In a similar vein, Chief Justice French of the High Court of Australia recently noted that the judiciary in his country had not yet made any “collective input” to the design of investment

arbitration and that it was time to start “catching up”. This broadening interest in the system will enrich the debate on the future of investment treaties.

Governments and business leaders are also seeking to reform treaties so as to ensure that they help attract investment, not litigation. Some major countries, such as South Africa, Indonesia and India, are terminating, reconsidering or updating what they perceive to be outdated treaties that excessively curtail their “policy space” and entail unacceptable legal risks. Germany opposes the inclusion of investment arbitration in TTIP. The B20 grouping of world business leaders recently called on the G20 to address investment treaties.

International organisations such as the OECD can help governments and others to shape the future of investment treaties. I propose the following agenda for joint action to reform and strengthen the investment treaty system.

Resolve investor claims in public. The frequently secretive nature of investment arbitration under many treaties heightens public concerns. The treaties of NAFTA countries and some other countries have instituted transparent procedures. But nearly 80% of investment treaties create procedures that fall well short of international standards for public sector transparency. This is a major weakness. In July, UNCITRAL (the United Nations Commission on International Trade Law) approved a multilateral convention on transparency. Governments can now easily make all investor claims public. Over a century ago, Lord Atkinson emphasised that a public trial is “the best security for the pure, impartial, and efficient administration of justice, the best means of winning for it public confidence and respect”. Governments – with the support of major investors – should rapidly take action to ensure that investment arbitration adopts high standards of transparency.

Boost public confidence in investment arbitration. Governments have borrowed the ad hoc commercial arbitration system for their investment treaties. But this borrowing is increasingly questioned. Sundaresh Menon, as Attorney-General of Singapore, has observed that “entrepreneurial” arbitrators are subject to troubling economic

incentives when making decisions on investor state cases. Advanced domestic systems for settling disputes between investors and governments go to great lengths to avoid the appearance of economic interests influencing decisions. Investment arbitration needs to do the same.

Do not distort competition. The concept of national treatment is a core component of investment and trade agreements. It promotes valuable competition on a level playing field. Investment treaties should not turn this idea on its head, giving privileges to foreign companies that are not available to domestic companies. Governments should protect competition and domestic investment by, for example, ensuring that treaty standards of protection do not exceed those provided to investors under the domestic legal systems of advanced economies. Some case law interpretations of vague investment treaty provisions go beyond these standards, and are unrelated to protectionism, bias against foreign investors or expropriation. Governments that allow for such interpretations should either make public a persuasive policy rationale for these exceptional protections for only certain investors, or take action to preclude such interpretations of their treaties.

Eliminate incentives to create multi-tiered corporate structures. By allowing a wide range of claims by direct and indirect shareholders of a company injured by a government, most investment treaties encourage multi-tiered corporate structures. Each shareholder can be a potential claimant. Indeed, many treaties encourage even a domestic investor to create foreign subsidiaries – it can then claim treaty benefits as a “foreign” investor.

If complex structures were cost-free, perhaps it wouldn't matter. But they aren't. Complex structures increase the cost of insolvencies and mergers. They also interfere with the fight against bribery, tax fraud and money laundering because they can obscure the beneficial owner of the investment. Governments should promptly eliminate investment treaty incentives to create multi-tiered corporate structures.

We need international capital flows to support long-term growth through a better international allocation of saving and

investment. But the investment treaty system needs to be reformed to ensure that the rights of citizens, governments, enterprises and investors are respected in a mutually beneficial way.

Useful links

Original article: Angel Gurría, OECD Secretary-General, “The growing pains of investment treaties”, OECD Insights blog, <http://wp.me/p2v6oD-1Rj>.

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OECD work on international investment law, www.oecd.org/daf/inv/investment-policy/oecdworkoninternationalinvestmentlaw.htm.

The transatlantic trade deal must work for the people, or it won't work at all

by

Bernadette Ségol, General Secretary
European Trade Union Confederation (ETUC) and
Richard Trumka, President
AFL-CIO and of the OECD's Trade Union Advisory Committee (TUAC)

In 2013, the United States and the European Union began talks on the Trans-Atlantic Trade and Investment Partnership (TTIP). The AFL-CIO and the European Trade Union Confederation (ETUC) believe that increasing trade ties could be beneficial for both American and European workers, but only if TTIP promotes a people-centered approach which considers the interests of the public and not just those of corporations. As with all other economic relationships, the rules of the TTIP will matter because TTIP is about much more than just trade. Its rules will make the difference between a Trans-Atlantic New Deal, which envisions an important role for democratic decision making, and a Trans-Atlantic corporate hegemony that privatizes the gains of trade while socialising the losses. Increasing trade between the US and the EU can only help create quality job growth with shared prosperity on both sides of the Atlantic if the project is approached and concluded in an open, democratic, and participatory fashion and with these goals in mind.

Unions believe that TTIP could represent a “gold standard” agreement that improves living and working conditions on both sides of the Atlantic and ensures that standards are not lowered. However, the risk of the current model of trade and economic integration agreements to democratic decision making cannot be overstated. The US has already lost state-to-state challenges to its anti-smoking, meat labelling, and tuna labelling policies, and even now, European multinationals are using the investor-to-state system to challenge decisions to phase out nuclear energy and raise minimum wages. Simply put, these policies are part of a government’s most basic responsibility to promote the general welfare of its people.

Trade and investment rules that not only allow but promote such challenges undermine support for trade even as they reduce the ability of governments to be more responsive to their publics than they are to well-heeled global corporations. This is no accident. Global corporations have long wanted to “overcome regulatory sovereignty”. See, for example: *Trade on the Forefront: US Chamber President Chats with USTR* (<http://archive.freeenterprise.com/international/trade-forefront-us-chamber-president-chats-ustr>) and *NAFTA Origins: The Architects Of Free Trade Really Did Want A Corporate*

World Government (www.popularresistance.org/nafta-origins-the-architects-of-free-trade-really-did-want-a-corporate-world-government/).

We envision a set of rules that respect democracy, ensure state sovereignty, protect fundamental labour, economic, social and cultural rights and address climate change and other environmental challenges. In a people and planet-centred agreement, the negotiators should consider: how will this decision create jobs, promote decent work, enhance social protection, protect public health, raise wages, improve living standards, ensure good environmental stewardship and enshrine sustainable, inclusive growth? If negotiators are not pursuing these goals, the negotiations should be suspended.

Rules on the protection of workers should not in any way be regarded as trade barriers. The TTIP should not undermine provisions for the protection of workers set down in laws, regulations or collective agreements, nor collective trade union rights such as freedom of association, the right to collective bargaining and the right to take industrial action. The TTIP must ensure that all parties adopt, maintain, and enforce the eight core conventions of the International Labour Organization for all workers, as well as the Decent Work Agenda, and that those minimum standards set a starting point for regular improvements that are built into the architecture of the agreement. The US and EU should also explore adopting trans-Atlantic mechanisms in line with EU instruments to provide for: information, consultation, and participation of workers in trans-national corporations; stronger protections for workplace safety and health; and requirements to ensure “temporary” workers receive equal treatment with regard to pay, overtime, breaks, rest periods, night work, holidays and the like. In other words, the TTIP should not just raise standards for those whose standards currently do not measure up, it should create a system for continuous improvement.

This must include advancing democracy in the workplace. Only when workers are free to organise, associate, peacefully assemble, collectively bargain with their employers and strike when necessary can they provide a vital balance to the economic and political influence held by global corporations.

The TTIP must be aligned with – and never work at cross purposes to —international— agreements to protect the environment, including commitments to slow catastrophic climate change. As part of its rules, the TTIP must advance a sustainable balance between human activity and the planet. Rules must not encroach or dilute national and subnational efforts to define and enforce environmental rules, measures and policies deemed necessary to fulfil obligations to citizens, the international community and future generations. Rules must respect the right of parties to prohibit corporations from capturing gains through predatory extraction, unsustainable resource utilisation, and “dumping” of pollutants and refuse.

The TTIP must have at its core state-to-state commitments and modes of conflict resolution; it must reject all provisions that allow corporations, banks, hedge funds and other private investors to circumvent normal legislative, regulatory and judicial processes, including investor-to-state dispute settlement (ISDS). State-to-state commitments and enforcement mechanisms reinforce the notion that the agreement is between sovereign nations, for the benefit of their citizens. It also recognises the right of different states to make different choices about how to best promote the general welfare. A hold-over from the discredited era of market fundamentalism, ISDS is used by private actors to constrain the choices democratic societies can make about how best to protect the public interest. It gives the government's duty to secure the general welfare the same status as private interest in profit – undermining public trust and placing governments in the position of having to pay a ransom to protect the public interest. At the same time, investors must assume their responsibilities, and it is imperative that respect for instruments such as the OECD Guidelines for Multinational Enterprises be fully be integrated in TTIP. We also ask that Contact Points meet the highest standards and those in EU countries be better coordinated.

Only when American and European workers can meaningfully participate in the development and design of the TTIP will they be confident that it is being created for their benefit, rather than as a secret deal that will amplify the influence of global corporate actors and diminish the voice of the people. Secret trade deals may have

been appropriate when they were limited to tariffs and quotas, but given the broad array of issues covered under “trade” agreements – including healthcare, intellectual property, labour, environment, information technology, financial services, public services, agriculture, food safety, anti-trust, privacy, procurement, and supply chains – secrecy can no longer be defended. The proper place to debate and reach agreement on these domestic policy issues is in the public forum – if an idea cannot stand the light of day, it must not be pursued.

The AFL-CIO and the ETUC are united in a commitment to ensure that the TTIP represents a global new deal that would create high quality jobs, protect worker rights and the environment and benefit workers on both sides of the Atlantic. A new trade model that puts people first can create a high standard for not only the US and the EU, but for global trade. Workers deserve a deal that delivers improved living and working conditions on both sides of the Atlantic.

Useful links

Original article: Bernadette Ségol, General Secretary, European Trade Union Confederation and Richard Trumka, President, AFL-CIO and TUAC, “The transatlantic trade deal must work for the people, or it won’t work at all”, OECD Insights blog, <http://wp.me/p2v6oD-1Mt>.

OECD work on the benefits of trade liberalisation,
www.oecd.org/trade/benefitlib/.

**Aiming high:
The values-driven
economic potential
of a successful TTIP deal**

by

Karel De Gucht, Former EU Trade Commissioner

In 2013, Presidents Barroso and Obama launched negotiations for a Trans-Atlantic Trade and Investment Partnership, or TTIP. A deep and comprehensive free trade deal in generic terms, but much more than that from political, commercial, and civil perspectives. We have now held five formal negotiating rounds, and it's time to re-state the importance of this deal not only to us in Europe and the US, but for people around the world.

The overall figures are impressive. The EU and the US trade goods and services worth around EUR 2 billion every day, and together we make up one third of global trade. Independent assessment indicates that both sides could gain significantly in terms of GDP growth over ten years (EUR 120 billion in the EU, EUR 90 billion in the US) – and equally so does the rest of the world (EUR 100 billion). Such opportunity for growth is not something to leave by the wayside in a time of hesitant economic recovery.

But these macro figures don't tell the whole story. The EU and the US have much more in common than our trade relationship. We share values: on democracy, on human rights and freedoms, and on a global rules-based trading system. Each of us enjoys a vibrant civil society and business sector, and broad political debate over things that matter. TTIP's potential to deliver results depends very much on our ability as negotiators to meet the interests of all our stakeholders.

That's why we are looking at three distinct areas: market access, regulatory cooperation and trade rules. Market access is a traditional element of trade negotiations. Tariffs between the European Union and the United States tend to be low in general but are still very high on certain important products, such as dairy and textiles. Even for products that have lower tariffs, such as chemicals, the volume of trade is so large that the tariffs add up to a significant extra tax on business.

Getting results on market access for our services industries is also important. Both the EU and the US have very strong services sectors, ranging from finance and commercial services, via the professions such as doctors and architects, to transport and environmental services. TTIP would help our world-class industries

to be able to establish themselves and work in the US without many of the restrictions that they face today. Furthermore, EU firms are highly competitive in many of the things that governments need to buy: for example energy services, rail transport equipment, aircraft, pharmaceuticals and textiles. TTIP could open up more public tendering by the US federal government and US states to EU bids, generating new contracts and jobs for European firms.

Market access isn't everything, however. From a global perspective, the regulatory and rules parts of TTIP are key. In the regulatory part of the negotiations, we are looking at how the EU and the US could cooperate better together in the future on new regulations, for example in breakthrough industries such as medical devices. We are also finding ways to align existing regulations, for example to stop unnecessary, unjustified duplication of tests, or to remove barriers to trade caused by two different ways of achieving the same result. These may seem unimportant by themselves, but taken together, reducing these trade obstacles would give a significant boost to trans-Atlantic trade. If the authorities of both sides work together from the early stages, we could avoid problems for businesses, share our limited resources and probably produce better outcomes.

As I have underlined many times, this is not about lowering regulatory standards. Where we agree with each other we will see what we can achieve together; where we don't, we will continue with our own approach.

Given the economic heft of the US and EU, any shared standards, policies or practices that we can agree in TTIP would almost certainly have spill-over effects on the rest of world trade. Producers in developing countries would not have to choose between US and EU market requirements – they would be able to start selling to the other side without incurring extra regulatory costs. The influence of strong US and EU standards would make it more worthwhile for other countries to develop their own policies based on the trans-Atlantic model. In areas such as trade in raw materials, high environmental and labour standards, the role of state-owned enterprises and the importance of intellectual property rights, a strong trans-Atlantic statement of intent would help steer

the multilateral debate in a positive direction for traders, workers and consumers worldwide.

This, then, is our ambition. A trade partnership that: opens our markets wide for goods, services and public procurement; that provides a framework for us to cooperate in the long term on regulatory issues affecting trade; and that sets high standards across a range of globally significant economic issues.

After five rounds, we are making good progress – but it won't be easy. Many of these things are deeply intertwined and we need to work hard to get the right results for our citizens. This is a complicated choreography to work with: with Member States and US states, EU and US regulators, EU and US legislatures, Trans-Atlantic business and civil society. That's a lot of voices to bring together. So a key element to success is making sure that we listen to the important concerns and interests of our stakeholders. This is what I have in mind when talking about the current EU consultation on investment protection, about the importance of safeguarding the EU's high standards of consumer and environmental protection, and about what TTIP could deliver for the global economy.

In this electoral year for the EU and the US, I want to highlight that it is Congress and the European Parliament – as well as the heads of 28 EU Member States that form the European Council – that will eventually need to examine, debate and approve the deal. The public debate about TTIP is very welcome in this context, and I look forward to continuing to take full part in it.

Useful links

Original article: Karel De Gucht, former EU Trade Commissioner, “Aiming high: The values-driven economic potential of a successful TTIP deal”, OECD Insights blog, <http://wp.me/p2v6oD-1Lt>.

OECD work on the benefits of trade liberalisation,
www.oecd.org/trade/benefitlib/.

Investment treaties: A renewed plea for multilateralism

by

Jan Wouters, Professor of International Law
Director of the Leuven Centre for Global Governance Studies
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We are living in interesting times for investment treaties, whether bilateral treaties or investment chapters in free trade agreements. Never before have they aroused such an interest from parliaments. People and politicians alike are concerned about their impact on international and domestic affairs. Their scope is expanding dramatically: just think of mega deals like the Trans-Pacific Partnership (TPP) or the Trans-Atlantic Trade and Investment Partnership (TTIP), and the rise of intra-regional investment agreements. Debates on investment agreements have intensified recently within the EU because of the European Commission's newly-acquired exclusive powers in this arena.

While competition for foreign investment is fierce, current levels of investment, both foreign and domestic, remain (too) low in many jurisdictions. The increased importance of global value chains (GVCs) and ever more integrated trade and investment flows call for (a renewed consideration of) more coherence between trade and investment policies. Today, governments adopting a regulatory measure (e.g. Australia's plain-packaging legislation for cigarettes) can face both WTO and investment treaty claims, often raising similar issues, but with sharply different adjudication mechanisms – ad hoc arbitration, WTO Dispute Settlement with a permanent Appellate Body – and diametrically opposed remedies – damages vs. non-pecuniary; and very high costs, especially in Investor-State Dispute Settlement

The growing debate requires attention from governments, in particular at the multilateral level. Increased coherence in the system would be beneficial to all countries, including those that have so far navigated it successfully. Governments currently may feel exposed to multiple claims, unlimited damages, and to uncertain or excessively broad interpretations of treaty obligations. If they consider that the treaties they are party to restrain them, rather than help them in attracting investment, they may drop out of the system altogether, instead of seeking reform. This would be unfortunate, because properly-designed treaties can play a constructive role in fostering investment.

Many treaties focus only on investor protection. In addition to being increasingly controversial, those provisions are too narrow for

today's needs, including ensuring sufficient productive investment, providing the infrastructure to support the development of GVCs and removing barriers to cross-border investment that hinder technology spill-overs. Good policies to support the liberalisation of investment are ever more needed. One also needs to consider investor-to-state dispute settlements carefully in order to respond to public concerns in many jurisdictions. Governments need to modernise, simplify and strive for coherence in investment treaty policy.

For all these reasons, we must revitalise the multilateral debate on investment treaties. A key role should be played in this respect by the G20, the OECD and other international organisations. All G20 governments have been invited to participate in the regular meetings of an OECD-hosted Roundtable that has focused on investment treaties since 2011. At the latest OECD conference on investment treaties in March 2015, major countries, including OECD members, China and India, expressed support for treaties but also for significant reform.

Where to start? We first need to find broad agreement on some core principles and some clearly-defined options for governments with differing interests. That could lead to more ambitious goals like discussions of a multilateral framework or model provisions in key areas. The G20 could give the lead by giving impetus, showing broad government interest, and commissioning work. Turkey has put investment at the centre of its G20 presidency. That is why the G20 and the OECD will be co-hosting a Global Forum on International Investment in connection with the G20 Trade Ministers meeting in Istanbul on 5 October. The trade and investment nexus, and investment treaties, will be key issues there. It is likely that China, in presiding the G20 next year, will similarly place particular emphasis on investment. This should be applauded.

Multilateral attention to improve investment treaties is long overdue. At the adjudicative level, the recent proposal by the European Commission to establish a permanent "Investment Court System" in the context of the TTIP negotiations is an interesting starting point for further discussion. The system, according to the proposal, should be based broadly on the WTO's Appellate Body,

with strict qualifications and ethical requirements and permanent remuneration for its members. It remains to be seen whether the US will go along with the proposal. In any event, it may serve as the starting point for reform of the heavily criticised current system of investor-state arbitration.

Useful links

Original article: Jan Wouters, Professor of International Law, Director of the Leuven Centre for Global Governance Studies, University of Leuven, “Investment Treaties: A Renewed Plea for Multilateralism”, OECD Insights blog, <http://wp.me/p2v6oD-2ek>.

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Capital controls in emerging markets: A good idea?

by

Adrian Blundell-Wignall,

Director OECD Directorate for Financial and Enterprise Affairs
Special Advisor to the OECD Secretary-General on Financial Markets

A few years ago the IMF produced some (cautious) comments and studies arguing that currency management and capital controls were OK in some circumstances. Many emerging market countries took this as an endorsement of their approach to policy which has not been limited to temporary crisis measures. The Figure below shows the national investment-saving correlations for the OECD countries over 1982-2010 and for a group of emerging countries (China, Brazil, India, South Africa, Mexico and South Korea) in the manner of Martin Feldstein and Charles Horioka.

In a 1980 paper, Feldstein and Horioka looked at two views of the relation between domestic saving and the degree of mobility of world capital. If capital is perfectly mobile, you would expect there to be little or no relation between the domestic investment in a country and the amount of savings generated in that country, since capital would flow freely to wherever the returns were highest. On the other hand, if the flow of long-term capital among countries is impeded by regulations or for other reasons, investors will be more likely to keep their money in their own country and increases in domestic saving will be reflected primarily in additional domestic investment. Feldstein and Horioka's analysis supported the second view more than the first.

Three decades later, the OECD economies have more-or-less achieved an open economy without capital controls (led in large part by Europe). But the emerging markets have a high correlation of national savings to investment (0.7), indicating a prolonged lack of openness.

The growing gap between the correlations for the OECD (highly open) and the emerging economies (impeded) is pointing to a fundamental imbalance in the world economy. Does it matter? The IMF study mentioned above showed that countries with stronger capital controls had a lesser fall in GDP in the post-crisis period. While the original authors were cautious in interpreting their results, this was not so for the users of those findings. This is all the more worrying given that the OECD exactly reproduced the IMF study and found that the results were not robust to a simple stability test. In other words, the OECD tests show that these results certainly

should not be used as a basis for claiming some form of general support for long-term use of capital controls.

The OECD also ran a simpler study using the IMF's own measures of capital controls, with both the IMF's original sample period and updating it. The OECD study found significant and contradictory results, which were much more consistent with an exchange rate targeting and "impossible trinity" interpretation of outcomes.

In the good years prior to the crisis, capital controls are indeed good supporters of growth. This is likely because combined with exchange rate management there is a foreign trade benefit, companies are not constrained for finance, and containing inflows reduces the build-up of money and credit following from exchange market intervention (and associated asset bubbles).

However, in the post-crisis period the exact opposite is found and the results are highly significant. Capital controls are negatively correlated with growth. The pressure on the exchange rate is down, not up, as foreign capital retreats, and international reserves are used up defending against a currency crisis (contracting money and credit). Companies are more constrained by cash flow and external finance considerations. Just at the time when foreign capital is needed, countries with the most controls suffer the greatest retreat of foreign funding. Investment and GDP growth suffer.

The full sample period (data from both before and after the crisis) shows significant negative effects of capital controls. That is, the overall net benefit appears negative compared to less capital controls.

These results have an intuitive appeal, consistent with economic theory. While it is early days, and some caution is required, the findings suggest that in the long-run dealing with the global investment-savings imbalances could be of benefit not only to developed countries, but also to the developing world itself.

Useful links

Original article: Adrian Blundell-Wignall, Director, OECD Directorate for Financial and Enterprise Affairs, Special Advisor to the Secretary-General on Financial Markets, “Capital Controls in Emerging Markets: A good idea?”, OECD Insights blog, <http://wp.me/p2v6oD-1Cz>.

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Making the most of international capital flows

by

Angel Gurría, OECD Secretary-General

International capital flows have increased dramatically in the past decades. Gross cross-border capital flows rose from about 5% of world GDP in the mid-1990s to historical highs of about 20% in 2007. This growth was around three times stronger than growth in world trade flows. The contraction caused by the crisis affected mainly international banking flows among advanced economies and subsequently spread to other countries and assets. Capital flows have rebounded since the spring of 2009, driven by portfolio investment from advanced to emerging-market economies and increasingly among emerging-market economies themselves.

Financial globalisation, and the associated increase in the movement of capital across international borders, can be both a blessing and a challenge. As we argued in the 2011 *OECD Economic Outlook*, increasing international capital flows can support long-term income growth through a better international allocation of saving and investment, but they can also make macroeconomic management more difficult, because of the faster international transmission of shocks and the increased risks of overheating, credit and asset price boom-and-bust cycles and abrupt reversals in capital inflows. Volatility indeed is one of the hallmarks of capital flows.

Several countries, including in the OECD area, have dealt with the adverse effects of such volatility by taking measures to limit capital inflows. Others are considering doing so. At the same time, some emerging economies with restrictive regimes are opening up. These contrasting situations are a good enough reason in themselves to bring together experts and officials from the public and private sectors to exchange experiences, analyses and opinions.

But there's another reason for today's seminar too. In June this year, the OECD invited non-members to join our Codes of Liberalisation of Capital Movements and of Current Invisible Operations. These codes are an important tool to promote orderly liberalisation, learn from each other's experience, and ensure mutual accountability. While the two OECD Codes constitute legally binding rules, implementation involves "peer pressure" and dialogue exercised through policy reviews and country examinations.

Countries that adhere to the Codes are expected to fulfil three core principles. First, non-discrimination, meaning they grant the benefits of their liberalisation measures to all other adherents and do not discriminate against other adherents when applying any remaining restrictions.

Transparency is the second principle. Adherents must report up-to-date information on barriers to capital movements and trade in services that might affect the Codes' obligations and the interests of other adherents.

“Standstill” is the third principle. This means that adherents should avoid taking new restrictive measures or introducing more restrictive measures except in accordance with the Codes' provisions or established understandings regarding their application.

By adhering to the Codes, a country receives international support and recognition for its openness, and joins a community of countries that refrain from a “beggar-thy-neighbour” approach to capital flows. In other words, countries that adhere to the Codes will not try to improve their own situation by harming others.

An adherent also enjoys the liberalisation measures of other participants, regardless of its own degree of openness. It is protected against eventual unfair and discriminatory treatment of its investors established in other participating countries.

A more subjective, but equally important benefit is that the country reassures market participants that it does not intend to maintain controls broader or longer than necessary. This is crucial in today's economy where expectations and attitudes play such a significant role in financial markets and investment decisions.

There is obviously an issue of sovereignty in any discussion of openness (whether to capital flows or trade). I'd argue that the Codes help reinforce national influence because as an adherent, a country fully participates in shaping jurisprudence and improving the rules of the framework.

Moreover, the Codes recognise the right of countries to regulate markets and operations. The liberty to conduct transactions is subject to national regulations, as long as they do not introduce discriminatory treatment, in like circumstances, between residents and non-residents. Countries have the right to set prudential measures to protect users of financial services, ensure orderly markets, and maintain the integrity, safety and soundness of the financial system.

It's also worth emphasizing that while economies are increasingly interdependent and interconnected, they are not identical, and the Codes recognise this.

Countries can pursue liberalisation progressively over time, in line with their level of economic development. Emerging economies such as Chile, Korea and Mexico have adhered to the Codes. Some OECD countries used a special dispensation from their obligations under the Codes for countries in the process of development, while still enjoying the same rights as other adhering countries.

Last the Codes also provide countries with flexibility to cope with situations of short-term capital volatility including the introduction of controls on short-term capital operations and the reimposition of controls on other operations by invoking the Codes' "derogation" clause in situations of severe balance-of-payments difficulties or financial disturbance. This clause has been used 30 times since 1961, most recently in 2008 when Iceland introduced exchange controls and measures restricting capital movements in response to a severe banking and balance of payments crisis.

Hence the Codes are the only multilaterally-backed instruments promoting the freedom of cross-border capital movements and financial services while providing flexibility to cope with situations of economic and financial instability. They were also the first instruments created by the OECD when it was founded in 1961. For 50 years adhering countries have used the Codes to support reform, to co-operate to reap the full benefit of open markets and to avoid unnecessary harm from restrictive measures.

The OECD Council decided in June 2014 to open the Codes to adherence by all interested countries outside the OECD membership with equal rights as OECD countries. This is an important step in expanding international co-operation, maintaining deep liquid global capital markets, and making the most of international capital flows as a tool to finance growth and development. Time has also come to think about how the Codes should be improved to ensure we can continue to maximise the benefits from open capital markets while avoiding their downside effects and adapt the Codes' highly effective mixture of principle and pragmatism to the coming decades.

Useful links

Original article: Angel Gurría, OECD Secretary-General, "Making the most of international capital flows", OECD Insights blog, <http://wp.me/p2v6oD-1hl>.

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Overcoming barriers to international investment in clean energy

by

Geraldine Ang, OECD Environment Directorate

Most of us would agree that clean energy is a worthwhile goal, and the world has invested more than USD 2 trillion on renewable-energy plants in the past decade. In 2014, energy generators added more renewable capacity than even before. But are we doing enough? According to the IEA *World Energy Investment Outlook 2014*, cumulative investment in low-carbon energy supply and energy efficiency will need to reach USD 53 trillion by 2035 to keep global warming to 2°C. It sounds a lot, and it is, but it's only 10% more than the USD 48 trillion that would likely need to be invested in any case in the energy sector if the economy continues to expand and demand for power continues to grow as it has been doing in recent decades.

And the price difference with other types of energy is shrinking. Clean energy, especially electricity generation from renewable-energy sources, is increasingly competitive with new-built conventional power plants. It could therefore play a significant role in the transition to a low-carbon economy and help to meet broader economic and development goals. For example, the fact that electricity generation from renewables such as wind or solar power can exploit small distributed systems makes this form of energy suitable for areas not served by the large, centralised grids of traditional systems.

However, the deployment of low-carbon technologies is heavily influenced by government support, in particular in the solar- and wind-energy sectors. In the past decade, governments have provided substantial support to clean energy that has benefited both domestic and international investment. Globally, public support to clean energy amounted to USD 121 billion in 2013. At least 138 countries had implemented clean-energy support policies as of early 2014. Incentive schemes have contributed to enhancing clean energy investment worldwide, even if clean energy investment had to coexist with disincentives to investing in the sector, for example fossil-fuel subsidies, and the difficulties inherent in shifting away from fossil-fuels in the electricity sector, given the massive investments already made in traditional generation and the way electricity markets function.

Largely driven by government incentives, new investment in clean energy increased six-fold between 2004 and 2011, reaching USD 279 billion in 2011, before declining in 2012-13. Solar and wind energy have received the largest share of new investment – USD 114 billion and USD 80 billion respectively in 2013.

Prices of the equipment needed to generate clean energy, such as wind turbines and solar panels, have been falling, in part thanks to international trade and investment helping the solar photovoltaic (PV) and wind energy sectors to become more competitive. However, since the 2008 financial crisis, the perceived potential of the clean energy sector to act as a lever for growth and employment has led several OECD countries and emerging economies to design green industrial policies aimed at protecting domestic manufacturers, notably through local-content requirements (LCRs).

Local-content requirements typically require solar or wind power developers to source a specific share of jobs, components or costs locally to be eligible for policy support or public tenders. A forthcoming OECD report on *Overcoming Barriers to International Investment in Clean Energy* shows that as of September 2014, such requirements have been designed or implemented by at least 21 countries, including 16 OECD and emerging economies, mostly since 2009.

New, empirical evidence presented in the report shows that LCRs have hindered global international investment flows in solar PV and wind energy, reducing the potential benefits from international trade and investment mentioned above. This might be related to the fact that such policies increase the cost of intermediate inputs (the components needed to build the final products). This could lead to less competition in downstream segments of the value chain such as installation. Downstream activities are associated with more value creation than midstream manufacturing activities or upstream raw materials production and processing. The estimated detrimental effect of LCRs is slightly stronger when both domestic and international investments are considered. This indicates that LCRs do not have positive impacts on domestic investment flows.

In addition, according to results from a 2014 OECD Investor Survey of leading global manufacturers, project developers, and financiers in the solar-PV and wind-energy sectors on “Achieving a Level Playing Field for International Investment in Clean Energy”, LCRs stood out as the main policy impediment for international investors in solar PV and wind energy. It’s not surprising that a majority of international investors involved in downstream activities of the solar and wind-energy sectors selected LCRs as an impediment. More unexpectedly, a majority of international investors involved in upstream or midstream activities also identified LCRs as an impediment. This result suggests that LCRs can hinder international investment across the value chains.

As demonstrated in the OECD report, evidence-based analysis is needed to help policy makers design efficient clean-energy policies. Policy makers should reconsider measures in favour of domestic manufacturers for enhancing job and value creation in the clean energy sector if, as the OECD study suggests, the overall result is less investment and probably fewer opportunities for the very sector protectionism is supposed to help. Co-operation at a multilateral level is needed to address barriers to international trade and investment in clean energy.

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**Vital statistics:
Taking the real pulse of
foreign direct investment**

by

Maria Borgia, OECD Directorate for Financial and Enterprise Affairs

Let's start with a quiz. Which country is the second biggest direct investor in China? Who are the largest investors in India and Russia? You probably won't believe it, but the answers are (a) British Virgin Islands, (b) Mauritius and (c) Cyprus. It's not a sordid tale of hot money but rather a more mundane story of companies investing abroad through a holding company or affiliate located in a third country. They might be driven by the presence of a double taxation or bilateral investment treaty, or it might simply reflect corporate strategy to invest through an existing affiliate rather than by sending cash from the parent company.

Whatever the reason, it's all perfectly legal. But as a consequence, we sometimes know very little about who owns what. Those Cypriot investors in Russia are almost certainly owned by an investor in another country, sometimes even a Russian investor. As a result, national statistics on flows of foreign direct investment (FDI) tell us less and less about what we want to know. Who is investing in our country and where are our own companies investing? To know the truth about a country's FDI you need a comprehensive standard for measurement, which is why the OECD produced its standard: the *Benchmark Definition of Foreign Direct Investment, 4th Edition (BMD4)*.

BMD4 makes two key recommendations which address the problems posed by the complex ownership structures of MNEs. The first is to compile FDI statistics separately for resident special purpose entities (SPEs). But what are SPEs? The OECD defines them as "entities with no or few employees, little or no physical presence in the host economy and whose assets and liabilities represent investments in or from other countries and whose core business consists of group financing or holding activities". You may have seen images of them in TV reports about tax avoidance, when the camera shows a wall in a grubby building lined with mail boxes representing gigantic multinational firms. SPEs are often used to channel investments through several countries before reaching their final destinations. By separately compiling FDI statistics for SPEs, you can derive FDI into real businesses, giving countries a much better measure of the FDI into their country that is having a real impact on their economy. The second is to compile inward investment positions according to the ultimate investing country

(UIC) to identify the country of the investor that ultimately controls the investments in their country.

This boils down to less double counting and more meaningful FDI statistics.

By recommending that countries compile FDI statistics separately for resident SPEs, BMD4 eliminates a layer of complication due to the ownership structures of MNEs.

Our data show the percentage of the inward stock of FDI – that is the accumulated value of investment by foreigners in the economy – accounted for by resident SPEs for 13 OECD economies. SPEs are very significant in Luxembourg and the Netherlands, accounting for more than 80% of all inward investment. SPEs are also significant in Hungary, Austria, and Iceland, where they account for more than 40% of inward investment. SPEs play smaller, but still important, roles in investment for Spain, Portugal, Denmark, and Sweden. In contrast, SPEs are not significant in Korea, Chile, Poland, and Norway.

BMD4 also eliminates the lack of transparency regarding the country of the direct investor who ultimately controls the investment and, thus, bears the risks and reaps the rewards of it by recommending countries compile statistics by ultimate investing country (UIC) in addition to the standard presentation by immediate investing country.

The presentation by UIC can shed light on another important issue: round-tripping. Round-tripping is when funds that have been channelled abroad by resident investors are returned to the domestic economy in the form of direct investment. It is of interest to know how important round-tripping is to the total inward FDI in a country because it can be argued that round-tripping is not genuine FDI. The presentation by UIC identifies round-tripping by showing the amount of inward FDI controlled by investors in the reporting economy.

We can illustrate this by looking in more detail at France and Estonia and comparing the inward stock of FDI of the top ten ultimate investors to the amounts coming from the immediate investing country.

On the UIC basis, the United States is a much more important investor in France than it appears when presented by immediate partner country. Indeed, the inward stock of the United States increases from USD 79.6 billion to USD 142.1 billion. The inward investment stocks from Luxembourg and the Netherlands drop considerably, indicating that US companies may be using affiliates in these countries to handle business done in France. French investors are the 8th largest source of FDI into France. While this indicates there is some round-tripping, it accounts for less than 4% of the inward stock of FDI in France.

On the UIC basis, Estonia becomes its own second largest source of investment, indicating that round-tripping is more common than in France. Given that Sweden, Finland, the Netherlands, Russia, and Norway become less important as sources of investment when measured according to the ultimate investor, it appears that some of the round-tripping from Estonia is going through some or all of these countries. In contrast, the United States, Austria, Germany and Denmark are all more important sources of FDI in Estonia than the standard presentation indicates.

Does removing these layers of complexity matter? Yes. Every country has a strategy to attract investment and high quality statistics must be the empirical basis for any informed policy dialogue. Following the recommendations in BMD4 produces more meaningful FDI statistics that enable us to better understand who is really investing where internationally.

Useful links

Original article: Maria Borga, OECD Investment Division, “Vital statistics: Taking the real pulse of foreign direct investment”, *TO COME*.

OECD work on implementing new international standards for compiling FDI statistics, www.oecd.org/daf/inv/investment-policy/oecdimplementsnewinternationalstandardsforcompilingfdistatistics.htm.

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Investing in infrastructure

by

Patrick Love, OECD Public Affairs and Communications Directorate

William Topaz McGonagall is universally acknowledged as the worst poet who ever wrote in the English language, but that didn't stop him having an intuitive grasp of the economics of infrastructure investment. As he argued in "The Newport Railway" published to celebrate the Tay Bridge and the trains it carried to Dundee, "the thrifty housewives of Newport/To Dundee will often resort/Which will be to them profit and sport/By bringing cheap tea, bread, and jam/And also some of Lipton's ham/Which will make their hearts feel light and gay/And cause them to bless the opening day/Of the Newport Railway [...] And if the people of Dundee/Should feel inclined to have a spree/I am sure 'twill fill their hearts with glee/By crossing o'er to Newport/And there they can have excellent sport".

At the OECD, we're more into free verse than rhyming, so we talk about investing "to meet social needs and support more rapid economic growth". The social needs and benefits can be vast in developing countries in particular. Take sanitation for example. In many urban areas, infrastructure hasn't expanded as much as population, leaving millions of citizens with no access to piped water and modern sanitation, or forced to live near open sewers carrying household and industrial waste. Water-related diseases kill more than 3.4 million people every year, making this the leading cause of disease and death around the world according to the WHO.

According to the OECD's *Fostering Investment in Infrastructure*, it's going to cost a lot to keep the thrifty housewives across the globe happy over the next 15 years: USD 71 trillion, or about 3.5% of annual world GDP from 2007 to 2030 for transport, electricity, water, and telecommunications. The Newport railway was privately financed, as was practically all railway construction in Britain at the time, but in the 20th century, governments gradually took the leading role in infrastructure projects. In the 21st century, given the massive sums involved and the state of public finances after the crisis, the only way to get the trillions needed is to call on private funds.

There are several advantages to attracting private capital for governments, apart from the money. Knowledgeable investors bring skills and experience in designing, building and running projects. But will fund managers be willing to commit to investments with

long life cycles when their shareholders are demanding quick returns and high yields?

The opportunities are there, but the infrastructure sector presents specific risks to private investors, and since private participation in infrastructure delivery is relatively recent in many countries, governments do not necessarily have the experience and capacity needed to effectively manage these risks. *Fostering Investment in Infrastructure* brings together the lessons (both positive and negative) learned from the OECD's *Investment Policy Review* series, and lists the most useful policy takeaways for the various components of the investment environment, such as regulation or restrictions on foreign ownership, based on the actual experiences of a wide range of countries.

Some of the advice sounds like no more than common sense, but given the difficulties many infrastructure projects get into, it seems that many governments fail to take what the report calls a “holistic” view before signing deals. For example, the report warns governments to make sure that arbitration procedures are clear and coherent so that disputes that could be settled quickly don't end up as lengthy, costly cases before international tribunals.

Likewise, given that most infrastructures are built on or under land, you'd think it wasn't necessary to insist on having a “clear and well-implemented land policy”. Experience shows otherwise. For example, the US newspaper *The Oklahoman* describes how in its home state plans to develop wind farms met opposition from the oil and gas industry over access to the surface in the early 2000s, and that now, as development moves closer to suburban areas, there are calls for tighter regulation from property owners.

As the OECD report points out, investors are going to be unwilling to commit funds if they think policy regarding the basics is likely to change over the life-cycle of the project, and even less willing when policy changes within the term of a single administration.

Apart from the discussion on core conditions, there is a detailed look at investing in low-carbon infrastructure, such as wind farms. It

makes sense to look at this separately because the business model of the sector is so different from traditional energy production and distribution. For electricity generation for instance, highly centralised power stations serving a wide area are replaced by small-scale distributed generators that may only serve a single building. Feed-in tariffs are a popular means of encouraging low-carbon renewables – paying producers for extra energy they feed into the main grid via a Power Purchasing Agreement (PPA). But awarding PPA purely on a least-cost criterion can tip the balance away from renewables in favour of incumbent producers, as happened in Tanzania.

The lessons then are a mix of useful checklist and interesting insights. In a poem written not long after the one quoted above, our man McGonagall describes how if you get it wrong, you may not live to regret it: “the cry rang out all o’er the town/Good Heavens! the Tay Bridge is blown down”.

Useful links

Original article: Patrick Love, OECD Public Affairs and Communication Directorate, “Investing in infrastructure”, OECD Insights blog, <http://wp.me/p2v6oD-28T>.

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**We need global policy
coherence in trade
and investment
to boost growth**

by

Gabriela Ramos, OECD Chief of Staff and Sherpa to the G20

Mounting fears of another slowdown in the global economy call for bolder policy responses. Trade and investment are a case in point.

WTO forecasts suggest 2015 will be the fourth year running that global trade volumes grow less than 3%, barely at – or below – the rate of GDP growth. Before the crisis, trade was growing faster than GDP. In addition, global flows of foreign direct investment (FDI) remain 40% below pre-crisis levels. If we are to achieve the Sustainable Development Goals (SDGs) agreed in September 2015, and underpin broad-based improvements in living standards, we need to reignite these twin engines of growth and we need to do it for the ultimate goal of improving people’s prospects and wellbeing.

Trade and investment have always been intertwined in business, but they have never quite come together in policymaking. In a world of Global Value Chains (GVCs), characterised by the fragmentation of production processes across countries, the interdependencies between trade and FDI are sharper. Technological improvements, reductions in transport and communications costs, and regulatory developments allow firms to combine imports, FDI, movement of business personnel, and licenses to optimise their international business strategies.

The symbiosis between trade and investment is more complex than ever before. Multinational enterprises (MNEs) play a key role in this relationship, with their activities driving a large share of world trade. The decision of a firm to invest in a foreign country is influenced by the ease with which it can sell its products, but also by how easy it is to source inputs from its affiliates (intra-firm trade) or independent suppliers (extra-firm trade) abroad. Hence, trade barriers become indirect barriers to investment. In addition, “world factories” make emerging trade patterns more complex, as not only goods and services cross borders, but capital, people, technology, and data do too. Without a transparent framework, it is also difficult to upgrade and upscale responsible business conduct.

Services are an increasingly critical node in the relationship between trade and investment. The WTO’s General Agreement on Trade in Services (GATS) explicitly recognizes this by defining FDI in

services as one of the four ways in which services can be traded (mode 3, or “commercial presence”). This reflects how trade and investment interact with one another. Clearly, services will be central in any further efforts to liberalize investment and to improve the business environment. The OECD FDI Regulatory Restrictiveness Index shows that investment barriers are overwhelmingly in the services economy. Reforms in backbone services, notably digital services, transport, and logistics are key to unclogging GVCs. Domestic reforms to allow for more competition in the service sectors is also a source of growth and equality. Moreover, there is untapped potential in services value chains that could be realized if services markets were opened further. The OECD Services Trade Restrictiveness Index (STRI) provides a tool for identifying these barriers and measuring their costs, in order to prioritize and sequence reforms.

There is still no global set of rules governing investment and trade, however. Apart from GATS, two other WTO agreements – Agreement on Trade-Related Investment Measures (TRIMS) and Agreement on Subsidies and Countervailing Measures (SCM) – cover aspects of FDI, but they are not comprehensive. The OECD Codes are also a reference on capital flows, but does not address the link with the trade dynamics. The void has been filled with a complex network of nearly 3 000 bilateral investment treaties (BITs) of different quality and with different coverage... Investors and States need certainty. A uniform regime would help, providing a consistent interpretation of the rules that apply to investment flows, taking into account the interest of all stakeholders. We urgently need a clear, coherent and coordinated approach at multilateral level. Multiplying the number of BITs further muddies the water and moves us further away from the multilateral ideal. A better way forward may be to start consolidating and replacing BITs on the road to a comprehensive multilateral framework. We also need to take a hard look at investment dispute settlement mechanisms, transparently addressing stakeholders’ legitimate concerns.

Replace BITs with what? Regional Trade Agreements (RTAs) are already providing some closer policy linkages. Over 330 RTAs contain comprehensive investment chapters, reflecting more advanced thinking of how trade and FDI interact in the real economy. These

agreements also cover “deep integration” disciplines that are essential to investments, such as movement of capital, business persons, intellectual property rights, competition, state-owned enterprises, and anti-corruption. New generation RTAs are not perfect, but they are taking us several steps forward in addressing the services-trade-investment-technology nexus. Being regional, however, they are not applied uniformly at a global level, and create their own overlaps and incoherence. It would therefore be useful to create clearer rules for co-existence among RTAs and mega-regional blocs. Above all, it is important to foster information-sharing on emerging practices from these negotiations, so that good practices can be diffused more widely and uniformly, and provide a pathway for multilateral convergence. In this way, RTAs and mega-regionals can become the building blocks of an integrated and truly multilateral trade and investment regime.

We are at a critical juncture, both economically and politically. The global economy needs a helping hand for recovery from the global financial crisis and to give people the improvements they expect in their daily lives. At the same time, we have both an opportunity and obligation to upgrade the policy framework to meet the changing reality of how trade and investment are conducted across the world, to enhance policy coordination, and to ensure that both have a positive impact on people’s well-being. Mega-regional agreements like Trans-Atlantic Trade and Investment Partnership and Trans-Pacific Partnership are on track to deliver new frameworks over the coming months. These can be stepping stones towards the future of global trade and investment rules. As these mega-regional deals approach the finish line, the 10th WTO Ministerial in Nairobi in December is an opportunity to break the current impasse in the Doha Round. Finally, all of this is taking place as we enter a new “Post-2015” era with the new SDGs, where trade and investment are expected to do more of the heavy-lifting in global development.

Against this backdrop, the G20-OECD Global Forum on International Investment, held on 5 October 2015 in Istanbul, back-to-back with the meeting of G20 Trade Ministers, brought together the trade and investment policy communities – along with the business community – to reflect on the main axes of a pragmatic

strategy to enhance the international regime for investment, including through closer links with trade. The agenda cannot be delayed: trade and investment decisions must go hand-in-hand in policy, just as they do in global business.

Useful links

Original article: Gabriela Ramos, OECD Chief of Staff and Sherpa to the G20, “We need global policy coherence in trade and investment to boost growth”, OECD Insights blog, <http://wp.me/p2v6oD-2fi>.

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