

# Of Handcuffs and Signals: Investment Treaties and Capital Flows to Developing Countries

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*This article examines the potential association of investment treaties with the quantity and cost of capital flows to developing countries. Whereas previous research on the effect of bilateral investment treaties (BIT) on capital flows has focused almost exclusively on direct foreign investment (DFI), this article examines total flows of all types. It also asks a question ignored by previous studies: Do investment treaties affect the cost that a developing country must pay for the capital it receives? Instead of viewing investment treaties as just international legal instruments prescribing rights and duties, the article also examines their role as information to international capital markets. Relying on insights from the economics of information and signaling theory, it argues that investment treaties influence capital flows through the signals they send to international capital markets. Accordingly, it creates a model of a "Strong BIT Signal Country" and proceeds to identify twenty-six countries that fit the model, while identifying for comparative purposes fifteen countries deemed to be "Weak Signal BIT Countries." An analysis of capital flows to both groups of countries finds that the Strong Signal BIT Countries experienced significant increased capital inflows following the completion of their BIT negotiation program and also reveals that they outperformed the Weak Signal BIT countries in this respect. Using data on sovereign credit ratings and World Bank governance indicators on the rule of law, the author also finds that several countries experienced an improvement in both indicators following the conclusion of their BIT programs, leading to the inference that such improvement might also be associated with a reduction in a country's risk premium and therefore a decline in its cost of capital.*

## I. INTRODUCTION: ASKING DIFFERENT QUESTIONS

Investment treaties, now estimated at more than 3300,<sup>2</sup> have constituted one of the world's most active areas of international law making during the last fifty years. Although countries continue to employ such treaties in their efforts to foster international capital flows and trade, the continued use of this international legal device has generated considerable controversy over its utility and cost to developing countries.<sup>3</sup> This article hopes to contribute

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2. JESWALD W. SALACUSE, *THE LAW OF INVESTMENT TREATIES* 3 (2d ed. 2015). As of the end of 2014, the United Nations Conference on Trade and Development (UNCTAD) estimated that the total number of international investment agreements (IIAs) was 3271, consisting of 2926 BITs and 435 "other IIAs." UNCTAD, *World Investment Report* 109 (2015).

3. See, e.g., M. Sornarajah, *An International Investment Court: Panacea or Purgatory*, No. 180. COLUMBIA FDI PERSPECTIVES 1 (Aug. 15, 2016), <http://ccsi.columbia.edu/files/2013/10/No-180-Sornarajah-FI-NAL.pdf> ("The central issue is whether investment treaties should exist at all."); see also, *infra* notes 17–22.

to that debate by exploring two different but related questions about investment treaties: 1) Are investment treaties associated with an increase in the flow of capital of *all* forms (not just direct foreign investment) to host countries that have concluded them? and 2) Are investment treaties associated with a reduction in the cost of capital that host countries must pay for the capital they receive? At the outset, it should be underscored that numerous factors, in addition to treaties, may influence both the quantity of capital flows as well as their costs and that it is extremely difficult, if not impossible, to isolate the impact of any one factor. This article will therefore limit itself to determining whether there is merely an association or correlation between investment treaties on the one hand and the quantity and cost of capital flows on the other in hopes that it might encourage other scholars to probe more deeply into answering the two questions that have yet to be addressed fully.

To address the two questions, Part II of the article first reviews the nature, purposes, and possible effects of investment treaties, taking into account earlier related studies. Because investment treaties generally seek to have an impact on the totality of international capital flows, not simply direct foreign investment, Part III will discuss the composition of international capital flows and how investment treaties apply to the flows' constituent parts. Part IV then undertakes a functional analysis of the ways in which investment treaties influence the investment process and financial decision making, drawing particularly on the economics of information and signaling theory. On the basis of that analysis, it advances a theoretical four-element model on ways that developing countries may employ investment treaties to optimize inward capital flows. Parts V and VI report on a research study examining twenty-six countries that have actually applied the four-element model and compare their results with a group of states that have used treaties only to a minimal extent. Part V focuses on the quantity of capital flows while Part VI seeks to determine the relation of investment treaties to the cost of capital. Finally, Part VII summarizes the results of the research, advances some general conclusions, and proposes questions for further study.

## II. THE NATURE, PURPOSES, AND POSSIBLE EFFECTS OF INVESTMENT TREATIES

### A. *In General*

Often referred to as "international investment agreements" (IIAs), investment treaties are essentially instruments of international law by which states (1) make commitments to other states on how they will treat investors and investments from those other states, and (2) agree to some mechanism for enforcement of those commitments. Rather than leave matters of enforcement to the contracting states alone, most investment treaties grant foreign

investors the right to bring an action before an international arbitration tribunal against an offending state to obtain monetary compensation for injuries caused by the offending state's alleged failure to meet its treaty obligations. Granting a foreign private party the ability to sue a sovereign state for acts it ostensibly took in the public interest is historically a revolutionary remedy in international law that now seems largely taken for granted.<sup>4</sup>

Investment treaties consist principally of three types: (1) bilateral investment treaties, commonly known as "BITs", (2) bilateral economic agreements with investment provisions, often referred to as "free trade agreements," and (3) other investment-related agreements involving more than two states which may deal with investment alone, such as the ASEAN Comprehensive Investment Agreement,<sup>5</sup> or with both trade and investment, such as the North American Free Trade Agreement<sup>6</sup> and the Energy Charter Treaty.<sup>7</sup>

The steadily growing number of the world's investment treaties, coupled with the rapid rise in investor-state arbitrations, many of which have led to monetary awards in the hundreds of millions of dollars against developing country governments,<sup>8</sup> has raised concerns about whether developing countries that make such agreements have derived benefits from them worth the costs that they entail. The potential costs of investment treaties for a devel-

4. See *BG Grp. v. Argentina*, 134 S. Ct 1198, 1220 (2014) (Roberts, CJ., dissenting) (quoting JESWALD W. SALACUSE, *THE LAW OF INVESTMENT TREATIES* 137 (1st ed. 2010)).

5. ASEAN Comprehensive Investment Agreement, Feb. 26, 2009, <http://agreement.asean.org/media/download/20140119035519.pdf>.

6. North American Free Trade Agreement, Can.-Mex.-U.S., Dec. 17, 1992, 32 I.L.M. 289 (1993). <https://www.nafta-sec-alena.org/Home/Legal-Texts/North-American-Free-Trade-Agreement>.

7. European Energy Charter Treaty, *opened for signature* Feb. 1, 1995, 34 I.L.M. 360, <http://www.ena.lt/pdfai/Treaty.pdf>.

8. See, e.g., *CME Czech Republic BV v. Czech Republic* (Neth. v. Czech.), UNCITRAL, Final Award, (Mar. 14, 2003), 9 ICSID Rep. 264 (2006) (awarding US \$270 million against Czech Republic); *Occidental Exploration & Production Co. v. Republic of Ecuador* (U.S. v. Ecuador), London Ct. Int'l Arb. Case No. UN3467, Final Award, 73 (July 1, 2004) (awarding US \$71 million against Ecuador); *Československá Obchodní Banka AS v. Slovak Republic*, ICSID Case No. ARB/97/4, Final Award, (Dec. 29, 2004), 9 ICSID Rep. 264 (2008) (awarding US \$824 million against Slovakia); *Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. The Argentine Republic*, ICSID Case No. ARB/19/03, Award, (April 9, 2015), (awarding US \$404.5 million against Argentina); *AWG Grp. Ltd. v. The Argentine Republic*, UNCITRAL, Award, (April 9, 2015), <http://www.italaw.com/sites/default/files/case-documents/italaw6304.pdf>. In the much publicized Yukos cases in 2014 more than US\$50 billion was awarded against Russia, which was almost certainly the largest investor-state arbitral award in history. See *Hulley Enters. Ltd. (Cyprus) v. The Russ. Fed'n*, PCA Case No. AA 226, Final Award, ¶ 1888 (July 18, 2014), <http://www.italaw.com/sites/default/files/case-documents/italaw3278.pdf>; *Yukos Universal Ltd. (Isle of Man) v. The Russ. Fed'n*, PCA Case No. AA 227, Final Award, ¶ 1888 (July 18, 2014) <http://www.italaw.com/sites/default/files/case-documents/italaw3279.pdf>; *Veteran Petroleum Ltd. (Cyprus) v. the Russ. Fed'n*, PCA Case No. AA 228, Final Award, ¶ 1888 (July 18, 2014), <http://www.italaw.com/sites/default/files/case-documents/italaw3280.pdf>. On April 20, 2016, the Hague District Court in the Netherlands, the country where the awards were rendered, set them aside on grounds that the tribunal lacked jurisdiction. The Claimants have appealed that decision to Hague Court of Appeal. See Daniella Strik et al., *Yukos Awards Set Aside by The Hague District Court*, KLUWER ARBITRATION BLOG, (Apr. 27, 2016), <http://kluwerarbitrationblog.com/2016/04/27/yukos-awards-set-aside-by-the-hague-district-court/>.

oping country lie not only in the monetary expense of defending itself in a lengthy investor-state arbitration and paying any awards rendered against it but also in the constraints that investment treaty provisions may impose on policies and actions that a government may consider necessary to adopt in the public interest. For example, if a country has concluded a treaty promising investors “fair and equitable treatment,” will a government that subsequently enacts legislation curtailing the ability of tobacco companies to advertise their products violate the treaty and therefore be liable in damages if it requires treaty-protected foreign investors in the tobacco sector to abide by such restrictive legislation?<sup>9</sup> Questions such as this one may be seen as having a chilling effect on the regulatory process in countries that are parties to investment treaties.

A principal purpose of investment treaties and the main reason that developing countries sign them is to promote investment. Thus, the title of virtually all bilateral investment treaties states that it is a “treaty for the promotion. . . of investment”<sup>10</sup> or a “treaty for the . . . encouragement of investment,”<sup>11</sup> and their preambles usually repeat and elaborate on this stated purpose.<sup>12</sup> A second stated objective of investment treaties, as proclaimed by their titles and preambles, is to “protect investment.” They achieve this goal by promising investors of other contracting states protections from a list of governmental actions, including expropriation, unreasonable discrimination, denial of fair and equitable treatment, unjustified interference with monetary transfers, and the failure to provide full protection and security to covered investments, among others. If signatory states fail to meet their treaty obligations, investment treaties enable injured investors to sue signatory states for damages before an international arbitration tribunal. Although most treaties do not state specifically that signatory states are obligated to pay monetary damages for treaty injuries, arbitral tribunals, relying on treaty authorizations to apply customary international law to settle investor-state disputes, have held that if a contracting state fails

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9. Philip Morris Asia Ltd. v. The Commonwealth of Austl., PCA Case No. 2012-12, Award on Jurisdiction and Admissibility, ¶ 400 (Dec. 17, 2015).

10. See, e.g., Agreement for the Promotion and Protection of Investments, UK-N. Ir.-Alb., March 30, 1994, 2385 U.N.T.S. 203; Accord entre le Gouvernement de la République française et le Gouvernement de la République du Sénégal sur la promotion et la protection réciproques des investissements, July 26, 2007.

11. See, e.g., Treaty concerning the Reciprocal Encouragement and Protection of Investment, U.S.-Arm. Sept. 23, 1992, <http://www.state.gov/documents/organization/43477.pdf>; Treaty concerning the Encouragement and Reciprocal Protection of Investments, Ger.-Pol., Nov. 10, 1989, 29 I.L.M. 334 (1990).

12. See, e.g., Treaty concerning the Reciprocal Encouragement and Protection of Investments, Preamble, U.S.-Egypt, June 27, 1992, [http://www.wipo.int/wipolex/en/other\\_treaties/text.jsp?file\\_id=243534](http://www.wipo.int/wipolex/en/other_treaties/text.jsp?file_id=243534) (“Recognizing that agreement on a general framework for the encouragement and nondiscriminatory treatment of investments will stimulate the flow of productive capital and technology and thereby provide for a more effective use of capital and technical resources for development needs, further promoting economic stability and durable peace. . .”).

to respect its treaty commitments, it must pay monetary compensation to the investor.<sup>13</sup>

Such provisions are aimed at protecting investors from “political risk,” which may be defined as the probability of negative governmental action or inaction impairing benefits that an investor legitimately expects to derive from an investment.<sup>14</sup> The dual promotional and protective objectives of investment treaties are linked conceptually in that it is by granting such enforceable protections under international law that signatories to the treaties seek to reduce potential investors’ perceptions of political risk in their territories and thereby encourage them to invest. Investment treaties are based on the recognition that in making decisions investors are influenced by two fundamental factors: risk and return; consequently, an investor’s goal in undertaking any investment is to maximize investment returns and minimize investment risks.<sup>15</sup> Thus, all other things being equal, governmental actions that reduce investor risk encourage investment while governmental actions that heighten investment risk discourage investment. Although their texts are not identical, investment treaties as a group demonstrate a remarkable similarity in terminology, structure, legal concepts, and approach, a factor that allows them to be viewed together as constituting “an international regime for investment.”<sup>16</sup>

Developing countries see the primary benefit of investment treaties as the acquisition of new and needed investment in their territories. It is the prospect of such benefit that leads states, particularly developing countries, to conclude investment treaties with other states. For the past several years, scholars have worked to determine whether developing countries have actually derived benefits from the treaties they have signed. They have sought to arrive at a conclusion on this issue by undertaking studies that ask a fundamental question: Do investment treaties, in particular bilateral investment treaties (BITs), actually promote direct foreign investment?

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13. For a discussion of the legal basis for awarding monetary compensation as a result of investment treaty violations, see Salacuse, *supra* note 2, at 436–45.

14. The World Bank Group’s Multilateral Investment Guarantee Agency (MIGA) offers the following definition of political risk:

Political risks are associated with government actions which deny or restrict the right of an investor/owner (i) to use or benefit from his/her assets; or (ii) which reduce the value of the firm. Political risks include war, revolutions, government seizure of property and actions to restrict the movement of profits or other revenues from within a country.

See MULTILATERAL INVESTMENT GUARANTEE AGENCY, *Glossary of Terms Used in the Political Risk Insurance Industry*, [https://www.miga.org/documents/Glossary\\_of\\_Terms\\_Used\\_in\\_the\\_Political\\_Risk\\_Insurance\\_Industry.pdf](https://www.miga.org/documents/Glossary_of_Terms_Used_in_the_Political_Risk_Insurance_Industry.pdf).

15. For a discussion of the role of risk and return in investment decision making, as well as the role that law and legal mechanism may play in that process, see JESWALD W. SALACUSE, *THE THREE LAWS OF INTERNATIONAL INVESTMENT: NATIONAL, CONTRACTUAL, AND INTERNATIONAL FRAMEWORKS FOR FOREIGN CAPITAL* 19–22, 24–34 (2013).

16. See generally JESWALD W. SALACUSE, *The Emerging International Regime for Investment*, 51 HARV. INT’L L. J. 427 (2010).

The answers to this question have not been uniform. Various studies have concluded 1) that investment treaties do not in fact result in increased investment flows,<sup>17</sup> 2) that only some encourage FDI flows,<sup>18</sup> 3) that they attract substantial amounts of foreign investment from both protected and unprotected investors,<sup>19</sup> 4) that they increase FDI between countries with tense political relations more than between friendly countries,<sup>20</sup> 5) that they have a very limited impact on economic liberalization,<sup>21</sup> and 6) that they may actually lead to reductions in governance quality.<sup>22</sup> On balance, although the evidence is not conclusive, one may say that the more recent of these studies tend to show a positive correlation between a country's concluding bilateral investment treaties and an increase in direct foreign investment received by that country.

Despite the differing conclusions of scholars and the doubts expressed by certain international institutions and nongovernmental organizations on the benefits to be derived from investment treaties, countries continue to negotiate them.<sup>23</sup> Moreover, investment treaty making has recently evolved to a new level as countries undertake to negotiate mega-regional investment treaties, such as the recently completed Trans-Pacific Partnership Agreement (TPP) involving the United States and eleven other countries in the

17. See, e.g., Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit . . . and They Could Bite*, 18–23 (WBG, Working Paper No. 3121, 2003).

18. See Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L. J. 67, 104–08 (2005) (concluding, with regard to U.S. bilateral investment treaties (BITs), that there is a strong correlation between the existence of a U.S. BIT with a developing country and increased capital flows to the developing country concerned but indicating that the evidence is much less strong with respect to BITs concluded between developing countries and other OECD countries). See also Yoram Z. Haftel, *Ratification Counts: US Investment Treaties and FDI Flows into Developing Countries*, 17 REV. INT'L POL. ECON. 348, 359–65 (2010).

19. See Andrew Kerner, *Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties*, 53 INT'L STUD. Q. 73, 90–96 (2009); see also, Tim Büthe & Helen V. Milner, *The Politics of Direct Foreign Investment into Developing Countries: Increasing FDI Through International Trade Agreements?*, 52 AM. J. POL. SCI. 741, 747–49 (2008); Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 WORLD DEV. 1567, 1575–82 (2005) (finding strong evidence that developing countries that sign BITs enjoy massive increases in FDI and also claiming that this result is very robust because of changes in model specification, estimation technique, and sample size). But see Jason Yackee, *Do BITs Really Work? Revisiting the Empirical Link between Investment Treaties and Foreign Direct Investment*, U. WIS. L. SCH. LEGAL STUD. RES. PAPER SERIES, Paper No. 1054 (2007) (critiquing Neumayer and Spess). “After a series of relatively small but ‘very justifiable changes’ in methodology and model specification, [Yackee finds that] the apparently positive relationship between BITs and FDI largely or even entirely faded from statistical significance.” *Id.* at 1.

20. See Rodolphe Desbordes & Vincent Vicard, *Foreign Direct Investment and Bilateral Investment Treaties: An International Political Perspective*, 37 J. COMP. ECON. 372, 379 (2009).

21. See Kenneth J. Vandevlede, *Investment Liberalization and Economic Development: The Role of Bilateral Investment Treaties* 36 COLUM. J. TRANSNAT'L L., 501, 524–25 (1998).

22. See Tom Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance* 25 INT'L REV. L. & ECON. 107, 118–22 (2005).

23. See, e.g., UNCTAD estimates that in 2014 alone the countries of the world concluded 18 bilateral investment treaties and 13 other international investment agreements. UNCTAD, *World Investment Report* 106 (2015).

Pacific basin.<sup>24</sup> In addition, six other mega-regional negotiations, in various stages of completion, are currently under way: (1) the Canada–EU Comprehensive Economic and Trade Agreement (CETA); (2) the Tripartite Agreement among the Common Market for Eastern and Central Africa (COMESA), the East African Community (EAC), and the Southern African Development Community (SDAC); (3) the EU–Japan Free Trade Agreement; (4) the “Pacer Plus” negotiations among Australia, New Zealand, and the Pacific Islands Forum developing countries; (5) the Regional Comprehensive Economic Partnership (RCEP) involving the ASEAN countries, Australia, Japan, China, India, Korea, and New Zealand; and (6) the EU–United States Transatlantic Trade and Investment Partnership (TTIP).<sup>25</sup> As of March 1, 2016, only two texts had emerged from these negotiations: the TPP<sup>26</sup> and the CETA,<sup>27</sup> both of which have to undergo processes of ratification that are likely to be contentious. The TPP’s Chapter 9 on investment follows the patterns of previous investment treaties by specifying the legal treatment owed to protected investors by the twelve signatory states and providing for international investor-state arbitration, independent of national legal systems, in cases in which investors believe a state has violated their treaty rights.<sup>28</sup> While CETA also provides for the usual guarantees of investor treatment found in many treaties, it purports to break with traditional investor-state arbitration by creating a permanent investment court or tribunal that will be under the control of the contracting states.<sup>29</sup>

### B. *The Limitations of Previous Inquiries*

Although the many studies exploring the effect of bilateral investment treaties on direct foreign investment have yielded important information and insights, most, if not all, suffer from two important limitations. First, the basic question that virtually all address—Do BITS encourage direct foreign investment?—is too narrow. Second, they fail to address an important question that vitally concerns both investors and host country governments: Do investment treaties affect the cost of capital that recipient countries must pay? The significance of both limitations needs explanation.

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24. See Trans-Pacific Partnership Agreement, Annex I, Feb. 4, 2016 (signed, not ratified), <https://ustr.gov/tpp/>. Along with the U.S., the other countries involved in the TPP are Australia, Canada, Japan, Malaysia, Mexico, Peru, Vietnam, Chile, Brunei, Singapore, and New Zealand. *Id.*

25. UNCTAD, *World Investment Report* 119 (2014).

26. See Trans-Pacific Partnership Agreement, *supra* note 24.

27. See Comprehensive Economic and Trade Agreement (CETA), *opened for signature* Sept. 26, 2014, [http://trade.ec.europa.eu/doclib/docs/2014/september/tradoc\\_152806.pdf](http://trade.ec.europa.eu/doclib/docs/2014/september/tradoc_152806.pdf).

28. See Trans-Pacific Partnership Agreement, *supra* note 24.

29. See European Commission Press Release 16/3101, CETA Statement by the European Commissioner for Trade and Canada’s Minister of International Trade (Sept. 18, 2016).

### 1. *The Narrowness of the Question*

As normally defined, the term “direct foreign investment” is a form of investment by which a resident of one country obtains an equity ownership position in an enterprise in another country resulting in a 10 percent or more voting interest.<sup>30</sup> International capital flows, however, consist of two other components important to a country’s development: 1) loans and other forms of debt financing and 2) portfolio investment.<sup>31</sup> Virtually all investment treaties promote and protect a broad category of investments, including not only direct foreign investment, but also portfolio equity investment, all sorts of debt securities and arrangements, and numerous contractual and technology transactions.<sup>32</sup> Treaties often achieve this result by employing a formula in which the term ‘investment’ is defined as ‘every kind of asset’ and is followed by a *non-exhaustive* list of asset categories that usually includes: (1) movable and immovable property and any related property rights; (2) various types of interests in companies or any other form of participation in a company, business enterprise, or joint venture; (3) claims to money and claims under a contract having a financial value; (4) intellectual property rights; and (5) business concessions.<sup>33</sup> The reason scholars and

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30. The IMF defines direct investment as follows:

[A] direct investment enterprise is defined in this Manual as an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise). Direct investment enterprises comprise those entities that are subsidiaries (a nonresident investor owns more than 50 percent), associates (an investor owns 50 percent or less) and branches (wholly or jointly owned unincorporated enterprises) either directly or indirectly owned by the direct investor. Subsidiaries in this connotation also may be identified as majority owned affiliates. Foreign-controlled enterprises include subsidiaries and branches, but associates may be included or excluded by individual countries according to their qualitative assessments of foreign control. Also, a public enterprise may in some instances be a direct investment enterprise, as defined in this paragraph.

IMF, *BALANCE OF PAYMENTS MANUAL*, ¶ 362 (1993).

31. Koralai Kirabaeva & Assaf Razin, *Composition of Capital Flows: A Survey 2* (Nat’l Bureau of Econ. Research, Working Paper No. 16492, 2010) (“Capital flows can be classified into the following types: foreign direct investment (FDI), foreign portfolio investment (FPI), and debt.”).

32. JESWALD W. SALACUSE, *THE LAW OF INVESTMENT TREATIES* 176–84 (2nd ed. 2015). *See also* U.N. CONF. ON TRADE AND DEV., *BILATERAL INVESTMENT TREATIES 1995–2006: TRENDS IN INVESTMENT RULEMAKING* 7–12, U.N. Sales No. E.06.II.D.16 (2007). In *Fedax N.V. v. Republic of Venezuela*, the ICSID tribunal stated: “A broad definition of investment . . . is not at all an exceptional situation. On the contrary, most contemporary bilateral treaties of this kind refer to ‘every kind of asset’ or to ‘all assets’ . . . .” *Fedax N.V. v. Republic of Venezuela*, ICSID Case No. ARB/96/3, Award on Jurisdiction ¶ 34–35 (Jul. 11, 1997), 37 ILM 1378 (1998). The tribunal also found that “[a] similar trend can be found in the context of major multilateral instruments.” *Id.*

33. Such an approach can be seen in the Germany–Bosnia and Herzegovina BIT, which states:

[T]he term “investment” comprises *every kind of asset, in particular*: (a) movable and immovable property as well as any other rights in rem, such as mortgages, liens and pledges; (b) shares of companies and other kinds of interest in companies; (c) claims to money which has been used to create an economic value or claims to any performance having an economic value; (d) intellectual property rights, in particular copyrights, patents, utility-model patents, industrial designs, trade-marks, trade-names, trade and business secrets, technical processes, know-how,



others have focused on direct foreign investment to the exclusion of other forms of finance is not completely clear but it may be because developing country governments consider direct foreign investment more valuable than other forms of capital, viewing it as essential to the creation and renewal of economic enterprises that offers direct benefits to their economies in the form of jobs, exports, increased productivity, the transfer of know-how and technology, and ultimately economic growth.<sup>34</sup> They see loans and portfolio investment flows as offering fewer benefits, and some international organizations seem to take a similar view.<sup>35</sup> Moreover, they also consider direct foreign investment as more stable and less prone to sudden liquidation and withdrawals than portfolio investment which they perceive as more volatile.<sup>36</sup>

To limit scholarly inquiry on the effect of treaties only to direct foreign investment is to exclude other types of foreign capital that may be equally valuable to the economic development of a country. Indeed, these other types of investment may be vital to the existence or the effectiveness of a direct foreign investment. It is a rare enterprise that is financed only with equity. Most foreign investment enterprises are financed with a mixture of debt, equity, and various forms of technology transfer transactions, often by independent investors who make their investment decisions based on their own estimates of project returns and risks. For example, nearly all infrastructure investments, while incorporating foreign direct equity investment, also necessitate large amounts of debt investment in the form of loans or bonds many times the size of the equity stake.<sup>37</sup> Normally, banks and other financial institutions make such loans on a “non-recourse” basis, which means that only the project vehicle itself, not the direct investors in the project, are

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and good will; (e) business concessions under public law, including concessions to search for, extract and exploit natural resources.

Treaty Concerning the Encouragement and Reciprocal Protection of Investments, Ger.-Bosn. & Herz. art. I(1), Oct. 18, 2001, U.N.T.S. 2501 (emphasis added).

34. See, e.g., U.N. CONF. ON TRADE AND DEV., *WORLD INVESTMENT REPORT 2000: CROSS BORDER MERGERS AND ACQUISITIONS AND DEVELOPMENT*, 196–206 U.N. Sales No. E.00.II.D.20 (2000).

35. The United Nations Conference on Trade and Development (UNCTAD), an international organization devoted primarily to the economic interests of the developing world, seems to reflect this view. For example, despite the generality of its title, UNCTAD’s *World Investment Report 2015*, an otherwise important source of information on investment in developing countries, focuses almost exclusively on direct foreign investment and seems to neglect entirely debt and portfolios capital flows. U.N. CONF. ON TRADE AND DEV., *WORLD INVESTMENT REPORT 2015: REFORMING INTERNATIONAL INVESTMENT GOVERNANCE*, U.N. Sales No. E.15.II.D.5 (2015).

36. Koralai Kirabaeva & Assaf Razin, *Composition of Capital Flows: A Survey* 8 (Nat’l Bureau Econ. Research, Working Paper No. 16492, 2010) at 8, <http://www.nber.org/papers/w16492>.

37. For instance, in 1995 the capital structure of the first phase of the Dabhol Power Company, then the largest foreign investment undertaken in India, amounted to US \$932 million, which consisted of US \$289 million in equity contributed by the three project partners and US \$643 million in debt provided by a variety of foreign and domestic banks and financial institutions. The debt-equity ratio of the Dabhol Power Company was therefore more than two to one. See JESWALD W. SALACUSE, *THE THREE LAWS OF INTERNATIONAL INVESTMENT: NATIONAL, CONTRACTUAL, AND INTERNATIONAL FRAMEWORKS FOR FOREIGN CAPITAL* 219–39 (1st ed. 2013). See also Richard P. Teisch & William A. Stoeber, *Enron in India: Lessons From a Renegotiation*, 35 *MID-ATLANTIC J. BUS.* 51 (1991).

legally obligated to repay the loans. Consequently, financial institutions must make a careful and independent evaluation of projected revenues and risk in order to price their loans properly. It is estimated that to meet infrastructure needs in energy, telecommunications, and roads, developing countries will need to increase their infrastructure spending by US \$1 trillion per year by 2020.<sup>38</sup> Since a three-to-one debt equity ratio is not an uncommon financial structure for infrastructure projects, an important portion of the US \$1 trillion needed, perhaps as much as \$750 billion annually, will of necessity have to come from foreign private sources in the form of debt for project finance. In addition, as countries develop stock markets, foreign portfolio capital flows can become important sources of finance for domestic enterprises.<sup>39</sup> Thus, it may well be that an investment treaty in certain situations and in particular countries may have a more positive influence on increasing debt and portfolio investment than direct equity investment. For these reasons, it is suggested that inquiries into the effect of investment treaties on investment flows should be broadened to address the following question: To what extent do investment treaties influence the quantity of capital, *of all types*, flowing to countries that conclude them?

## 2. *The Unasked Question: The Effect of Treaties on the Cost of Capital*

The acquisition of capital, whether in the form of debt or equity, always entails a cost, and that anticipated cost strongly influences investment decisions. The cost of capital profoundly affects expected returns to the investor and the price that the recipient will have to pay to obtain that capital. For investors, the cost of capital is the minimum acceptable rate of return for a capital investment. Investors usually avoid projects offering rates of return less than the cost of capital.<sup>40</sup> The determination of the cost of capital is influenced by numerous factors, including the estimated risk to the investor of committing capital to a specific purpose. Risk may be defined as the probability that expected returns from an investment will not be realized. The higher the risk to the investor the more the investor will demand in return as compensation for assuming that risk.<sup>41</sup> If one of the consequences of an investment treaty is to reduce the political risk to investors, that reduction in risk should, in theory, be reflected in a reduction in the cost of

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38. Amar Bhattacharya, Mattia Romani & Nicholas Stern, *Infrastructure for Development: Meeting the Challenge*, CTR. FOR CLIMATE CHANGE ECON. & POL'Y 10 (June 2012), <http://g24.org/wp-content/uploads/2016/01/Infrastructure-for-development.pdf>.

39. See, e.g., Chee-Keong Choong et al., *Private Capital Flows, Stock Market and Economic Growth in Developed and Developing Countries: A Comparative Analysis*, 22 JAPAN AND THE WORLD ECON. 107, 107-17 (2010); Geert Bekaert, Campbell R. Harvey & Christian Lundblad, *Does Financial Liberalization Spur Growth?*, 77 J. OF FIN. ECON. 3, 3-55 (2005); Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth*, 88 AM. ECON. REV. 537, 537-58 (1998).

40. RICHARD A. BREALEY, STEWART C. MYERS & ALAN J. MARCUS, FUNDAMENTALS OF CORPORATE FINANCE 39 (3rd. ed. 2004).

41. See generally ROBERT C. HIGGINS, ANALYSIS FOR FINANCIAL MANAGEMENT 295-305 (11th ed. 2011) (discussing the risk-reward trade-off in investment decision making).

capital that the recipients of foreign capital would otherwise have to pay in the absence of treaty protection. Thus, it would seem that any inquiry into the effect of investment treaties should not only investigate the quantity of capital inflows resulting from investment treaties but should also ask a second fundamental question: Do investment treaties lower the cost of capital that recipient host countries must pay? In view of the billions of dollars in investment capital flowing to developing countries each year, a reduction in the cost of capital of as little as one percent can result in substantial savings both annually and cumulatively. Thus far, little research appears to have addressed this second question.

### III. THE COMPOSITION OF INTERNATIONAL CAPITAL FLOWS

Foreign private capital flows to countries are generally composed of three elements: 1) direct foreign investment, that is, equity investments giving an investor ten percent or more voting rights in an enterprise; 2) portfolio foreign investments, which consists of both equity of less than 10 percent voting rights as well as debt securities, such as bonds, notes, money market, and financial derivatives; and 3) bank loans and other debt, which include inter-company loans, trade credits, bank deposits, currency and similar assets and liabilities.<sup>42</sup> In tracking international flows of capital, specific institutions, such as the International Monetary Fund, the World Bank, the Bank for International Settlements, and the Institute of International Finance, may use somewhat differing definitions. Furthermore, they may sometimes change their definitions, a factor that may complicate comparisons.<sup>43</sup> Nonetheless, the three categories mentioned above are generally recognized as the basic functional types of international capital flows.<sup>44</sup> Moreover, variations in the definition of the three components are not significant for the purpose of understanding their impact on specific countries.

The role that each of the three may play in the total capital flows to a particular country may vary over time, depending on circumstances, both internal and external. For example, the deregulation of stock markets in many developing countries allowing foreigners to invest more freely in the

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42. WENDY DOBSON & GARY HOFBAUER, *WORLD CAPITAL MARKETS: CHALLENGE TO THE G-10*, 169–96 (2001), Appx. A.

43. Compare, for example, two studies of private capital flows to South Africa, one prepared by an official of the South African Reserve Bank, Barend de Beer, and the other by the International Monetary Fund. The first study employed the three functional types described above. The second grouped total capital flows to South Africa into only two categories, Direct Foreign Investment and Portfolio Investment, with the Portfolio Investment Category being subdivided into “Equity Inflows” and “Bond Inflows.” See Barend de Beer, *South Africa’s Experience with Capital Flows Since the Financial Crisis: From Measurement to Analysis*, paper presented at the IFC satellite meeting during the 60th ISI conference (July 24, 2015), [https://www.bis.org/ifc/events/sat\\_semi\\_rio\\_jul15/1\\_beer\\_paper.pdf](https://www.bis.org/ifc/events/sat_semi_rio_jul15/1_beer_paper.pdf); Faisal Ahmed, Rabah Arezki & Norbert Funke, *The Composition of Capital Flows: Is South Africa Different?* IMF Working Paper WP/05/40, 2005, <https://www.imf.org/external/pubs/ft/wp/2005/wp0540.pdf>.

44. Kirabaeva & Razin, *supra* note 36, at 2.

early 1990s resulted in significant increases in portfolio flows to those countries.<sup>45</sup> On the other hand, the inability of Mexico in 1994–1995 and certain Asian countries in 1998–1999 to service their existing debt led to a significant diminution in debt flows to those countries in the years immediately after. External forces can also affect international capital flows. For example, an increase in interest rates in the United States usually has the effect, all other things being equal, of lessening portfolio flows to developing countries, but a reduction in U.S. interest rates often has the opposite effect. The reason is that the sudden increase in U.S. interest rates offers short-term investors a better return on a risk-adjusted basis than do emerging markets so international investors reduce their investments in emerging markets and transfer their funds to the United States. In addition, major financial crises and shocks can have profound effects on capital flows to the countries concerned. For example, one study examined capital flows to South Africa during the period 2000–2014. During the period 2000–2007, out of total capital inflows to the country 36% consisted of direct foreign investment, 53% consisted of portfolio investment, and 12% consisted of “other investment.” When the global financial crisis of 2008 struck, the country experienced a massive outflow of portfolio investment causing the proportions of direct foreign investment and other investment to increase significantly. During the period 2009–2014, after the crisis had subsided, direct foreign investment was at 16%, less than half of its pre-crisis proportion, and portfolio investment was at 48%, but the country’s “other investments” were 31% of total capital flows, a proportion almost three times its pre-crisis level.<sup>46</sup>

By virtue of the broad definition of “investment” employed by most treaties, all three of these traditional categories of capital inflows, as well as any variations thereof, are considered “investments” and therefore subject to treaty protection. In cases covered by such broad definitions, investor-state arbitration tribunals have not hesitated to grant treaty protection to portfolio and debt transactions, including loan agreements,<sup>47</sup> loan guarantee agreements,<sup>48</sup> promissory notes,<sup>49</sup> and shares.<sup>50</sup> Because of the significance of all three of the basic components of capital flows for a country’s economic de-

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45. See Romon Moreno, *What Explains Capital Flows?*, FRBSF Economic Letter 2000-22, June 21, 2000, <http://www.frbsf.org/economic-research/publications/economic-letter/2000/july/what-explains-capital-flows/>.

46. See Barend de Beer, *supra* note 43, at 4-5.

47. See *Ceskoslovenska Obchodni Banka, A.S. v. Slovak Republic*, ICSID Case No. ARB/97/4, Award on Jurisdiction, ¶ 76-77 (May 24, 1999), 14 ICSID Rev. 251 (1999) (Loan facility made available by Claimant Czech bank to entity of Respondent losses from which Respondent had agreed to cover as part of bank restructuring plan was “investment” within the meaning of Article 1 of 1992 Slovak-Czech BIT and Article 25 of ICSID Convention).

48. See *Suez v. Argentine Republic*, ICSID Case No. ARB/03/19, Final Award, ¶ 67 (Apr. 9, 2015), 21 ICSID Rev. 342 (2006) (Losses sustained by Claimants on their guarantees of loans by multilateral lenders to entity in which they were also direct investors and on which they were required to make payments when that entity failed as a result of treaty violations by Respondent were compensable under applicable France-Argentina, U.K.-Argentina, and Spain-Argentina BITs).

velopment, it is important to determine what impact investment treaties may have on all of them, both with respect to the quantity of inflows and the cost that host countries must pay to obtain them.

#### IV. A FUNCTIONAL ANALYSIS OF INVESTMENT TREATIES

##### A. *Background*

Developing countries make investment treaties in order to encourage investors from other contracting states to invest in their territories. Through the treaty-making process, they seek to influence investor behavior. This proposition raises a basic question: how exactly does concluding an investment treaty with another country influence the behavior of potential investors from that country? The short theoretical answer is that investment treaties, as instruments of international law, reduce investment risk, particularly political risk to which investments may be subject in a particular developing country. An evaluation of risk, of course, is a crucial element in any investment decision. All other things being equal, the less risk that investors perceive in a host country, the more likely they will invest in that country. Equally important, the less risk they perceive in a country, the less they will demand as a return on capital invested in that country.

This short answer that investment treaties promote investment by reducing risk provokes another question: What is it about investment treaties that may cause investors to lower their evaluation of risk in the country concerned? Scholarship on the question has pointed to two inter-related functional causes: 1) handcuffs and 2) signals.

##### B. *Investment Treaties as Handcuffs*

While host country governments may welcome foreign investment at a particular time by making generous promises, all investors are aware that host governments may unilaterally change those promises to the investor's detriment at a later time. Once the investor has transferred its capital to the

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49. See *Fedax N.V. v. Republic of Venezuela*, ICSID Case No. ARB/96/3, Award on Jurisdiction, ¶ 43 (July 11, 1997), 37 ILM 1378 (1998) (Six promissory notes issued by Respondent to third company in payment of services and subsequently transferred to Claimant were held to be "investments" under Article 1 of 1991 Netherland-Venezuela BIT and Article 25 of ICSID Convention).

50. See, e.g., *Asian Agric. Prod. Ltd. v. Republic of Sri Lanka*, ICSID Case No. ARB/87/3, Final Award, ¶ 95 (Jun. 27, 1990), 6 ICSID Rev. 526 (1991) (Claimant's "investment" protected under 1980 UK-Sri Lanka BIT was its shares in the Sri Lankan company in which it had invested, not company's assets destroyed by government actions); *Am. Mfg. and Trading, Inc. v. Republic of Zaire*, ICSID Case No. ARB/93/1, Final Award, ¶ 5.15 (Feb. 21, 1997), 36 ILM 1534 (1997) (The ownership by Claimant of 94% of equity capital of Zaire company is "investment" under both Article 1 of 1984 US-Zaire BIT and Article 25 of ICSID Convention); *CMS Gas Transmission Co. v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award on Jurisdiction, ¶ 51 (Jul. 17, 2003), 42 ILM 788 (2003) (Ownership by American Claimant of minority non-controlling equity in Argentine corporation is "investment" under both Article 1 of 1991 Argentina-US BIT and Article 25 of ICSID Convention).

country and placed assets under the sovereignty of a foreign state, both its bargaining power with the host government and its ability to protect itself from negative governmental action are significantly reduced. One scholar has referred to this situation as the problem of the “obsolescing bargain.”<sup>51</sup> To allay that risk, host governments need some way of making a *credible commitment* to investors about the treatment they may expect from the host government *after* the investment is made. In short, they need a “hands-tying mechanism,”<sup>52</sup> that is, “handcuffs,” to assure investors that a host government will not take future action in violation of the promises that it or a prior government made at the time the investment was undertaken. One vehicle for making a credible commitment is the investment treaty. This legal instrument makes a state’s promises on investment treatment subject to international law, not national law alone, and gives injured investors the right to sue the offending host state for monetary compensation before an independent international arbitral tribunal for the injuries caused by the host government’s treaty violations. Thus, the handcuff theory assumes that the prospect of paying significant monetary damages, possibly amounting to hundreds of millions of dollars, the high costs of defending itself in an international arbitration, and injury to its international credit rating and reputation as a site for foreign investment, will cause host governments to refrain from taking actions that violate its treaty commitments. The risk of incurring such costs thus has the effect of tying the hands of host governments, causing them to refrain from actions that would violate promised treatment to foreign investments. This “handcuff mechanism” as a restraint on governmental action has been given increasing credibility over the past two decades as international arbitration tribunals have imposed heavy monetary damage awards against offending states.<sup>53</sup>

### C. *Investment Treaties as Signals*

The conclusion of an investment treaty between sovereign states is the most formal and official means that each state has of signaling its intentions toward the investors of the other contracting state. Because of its signaling function, one might liken an investment treaty to a beacon that sends a signal to international capital markets about the intentions of the concerned governments with respect to the treatment they will accord to investors from one state in the territory of the other. In this respect, an investment treaty is a means, first and foremost, of attracting investors’ attention to a country seeking needed capital. Whether that signal will have any effect on

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51. See RAYMOND VERNON, SOVEREIGNTY AT BAY: THE MULTINATIONAL SPREAD OF U.S. ENTERPRISES 46 (1971). See also JESWALD W. SALACUSE, THE THREE LAWS OF INTERNATIONAL INVESTMENT: NATIONAL, CONTRACTUAL, AND INTERNATIONAL FRAMEWORKS FOR FOREIGN CAPITAL 141–42 (2013).

52. See Andrew Kerner, *Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties* 53 INT’L STUD. Q. 73, 76 (2009).

53. See, e.g., *supra* note 8.

the behavior of potential investors from the other state will depend on whether and how investors perceive, interpret, and ultimately believe that signal. In particular, it will depend on potential investors' belief in the likelihood that the governments concerned will in fact give investors the treatment promised in the treaties. To the extent that they have a strong belief in the credibility of the promised treatment commitments, investors will perceive the political risk to their potential investments as lower than if they have serious doubts about host governments' intentions.

In analyzing the signaling effect of investment treaties, one may enlist the insights of "signaling theory," a body of knowledge drawn from the economics of information.<sup>54</sup> Signaling theory recognizes that the functioning of markets is complicated and often impeded by the asymmetry of information that often exists among market participants. Signaling theory is concerned about the ways participants in markets seek to reduce that asymmetry by sending signals to other participants and thereby encourage market transactions. According to Michael Spence, a principal proponent of signaling theory, signals are "things that one does that are visible and in part designed to communicate."<sup>55</sup>

Two broad categories of information are particularly important with respect to that asymmetry: information about *quality* and information about *intentions*.<sup>56</sup> The first is important where a market participant, say, an investor, is not fully informed of certain characteristics of the other party, for example, the size of a country's oil reserves or the existence of environmental hazards in a potential investment site. The second is about another party's behavior or behavioral intentions, such as the likelihood of a government to expropriate investors or to change regulations on which an investor has relied in evaluating an investment project. On all four of these matters, the first two presenting questions of quality and the second two raising questions of intentions, there exists an asymmetry of information from the point of view of the investor in that the host government knows much about the size of its petroleum reserves or the existence of environmental hazards and about its behavior and behavioral intentions with respect to expropriation or existing governmental regulations than does the investor.<sup>57</sup> Such asymmetry

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54. See Joseph E. Stiglitz, *The Contributions of the Economics of Information to Twentieth Century Economics*, 115 Q. J. ECON. 1441 (2000); Michael Spence, *Signaling in Retrospect and the Informational Structure of Markets*, 92 AM. ECON. REV. 434 (2002). In 2001, Stiglitz and Spence, along with George Akerlof, shared the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel "...for their analyses of markets with asymmetric information." See Press Release, Royal Academy of Sciences, The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2001, [http://www.nobelprize.org/nobel\\_prizes/economic-sciences/laureates/2001/press.html](http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/press.html).

55. Spence, *supra* note 54, at 434, note 1.

56. See Brian L. Connelly et al., *Signaling Theory: A Review and Assessment*, 37 J. MGMT. 39, 42 (2011).

57. On the other hand, an asymmetry of information usually exists in favor of the investor about the quality of the investment to be made and the ability of the investor to undertake it because the investor usually knows much more about the investment to be made and its own ability to undertake it than does the host government.

of information leads to uncertainty about asset quality and host governmental intentions and may cause investors to resist making investments in that country. While an investor can often reduce the asymmetry of information about investment qualities by employing experts and undertaking studies on matters such as the size of petroleum reserves or the existence of environmental hazards, the asymmetry of information about governmental intentions is much harder to overcome because it requires a prediction about an uncertain future. Indeed, at the heart of virtually all investor-state disputes is an action or inaction by a government that the investor did not foresee and could not have predicted with certainty at the time it made its investment in that country.

In an effort to reduce that asymmetry and encourage investment, host countries send out numerous signals to communicate their country's physical attractions for certain types of investment and their benign intentions toward foreign investment. These signals are embodied in the actions and statements that governments make. As the economist Joseph Stiglitz wrote, "[T]he fact that actions convey information leads people to alter their behavior . . . and this is why information perfections have such profound effects."<sup>58</sup> To reduce the information asymmetry that inhibits foreign investment and thereby induce a change of behavior in investors, host countries will take many actions, such as purchasing full page advertisements in international newspapers and magazines welcoming foreign investment, sending delegations to conduct promotional road shows in international financial capitals, and enacting new foreign investment laws promising tax and other incentives to foreign investors. Such efforts may reduce the asymmetry of information about the quality of investment opportunities in the country but may be less than convincing about governmental intentions, particularly in countries that have a history of unfavorable actions toward foreign investors, such as expropriation.

Perhaps the most significant and credible signal that a country may give of its intentions toward foreign investment is the conclusion of investment treaties with countries in which potential investors are located. One important factor affecting the credibility of such a signal is that a prospective investor will be a legal beneficiary of the treaties' "handcuff provisions." That is, the investor will be legally able to sue the host country in international arbitration for any treaty violation. For handcuffs to be effective, potential investors must be protected by the treaty, which means not only that their investment comes within the treaty definition of the term "investment," but also that they themselves meet the treaty definition of "investor." For protection under most treaties, the "investor" usually must be a national, a resident, or a corporate creation of a country that is a party to the treaty. Depending on the definition of "investor" employed by a specific

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58. Joseph E. Stiglitz, *Information and the Change in the Paradigm in Economics*, 92 AM. ECON. REV. 460, 473 (2002).



treaty, it may give protection to assets that are owned by persons who are not residents or nationals of either of the two signatory states.<sup>59</sup> As a result, such treaties may also give positive signals to investors in capital markets located outside of the territorial limits of the two countries concerned.

There is evidence that in certain situations investment treaties may also encourage investment from corporations and persons who do not meet the definition of “investor” and thus, are not specifically protected by an investment treaty with the host country.<sup>60</sup> The reason for this phenomenon is not completely clear. One explanation is that the conclusion of investment treaties under certain conditions sends a positive signal to international capital markets generally, not just to investors in countries that are treaty partners, that their investment capital is welcome and will be protected. So if a country has concluded treaties with leading capital exporting countries such as the United States, the United Kingdom, and Germany, promising not to expropriate the investments of their nationals and backs up that promise with an acceptance of international arbitration to resolve treaty disputes, nationals from other capital exporting countries such as Canada and France will have enough confidence in the investment climate of that country and in the benevolent intentions of its government to invest capital even if they are not specifically protected by treaties.

#### *D. The Quality of the Signal*

The Nobel Laureate Eugene Fama and others have underscored the rapidity and efficiency of markets in absorbing information to price assets and investment opportunities.<sup>61</sup> The international capital markets are no exception. They will rapidly absorb and evaluate the fact that countries have concluded an investment treaty and will make a determination, using that fact as well as other relevant information, about the appropriate risk and therefore the price of a contemplated investment. To counter the argument that investment treaties may influence investment decisions, one scholar has contended that investment treaties have no effect on investor decisions since an admittedly old and limited survey shows that “there is suggestive evidence that historically investors have not paid much attention at all to the treaties or to international legal protections for their investments more generally.”<sup>62</sup> With respect, one may counter this argument by pointing out that by the time an investor is considering a particular investment, international capital

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59. See, e.g., *Tokios Tokelés v. Ukraine*, ICSID Case No. ARB/02/18, Decision on Jurisdiction, ¶ 36 (Apr. 29, 2004), 20 ICSID Rev. 205 (2005).

60. See Andrew Kerner, *supra* note 19 at 73–102 (finding that BITs attract significant amounts of investment both from investors who are protected by treaties and from those who are not).

61. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383–417 (1970); Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575–617 (1991).

62. Jason Webb Yackee, *Do BITs Really Work? Revising the Empirical Link Between Investment Treaties and Foreign Direct Investment* 5 (U. Wis. Law Sch. Legal Stud. Res. Paper No. 1054, 2007), <http://www.srn.com/abstract=896762>.

markets, through numerous mechanisms, including the financial press, credit rating agencies, banking networks, and many others, have already absorbed whether a specific country has entered into investment treaties. Regardless of a particular investor's knowledge, then, international capital markets have already processed that information to arrive at prices on the elements of the investment and its required cost of capital. Thus the knowledge or lack thereof of a particular executive about investment treaties is quite frankly irrelevant to the fundamental factor in making an investment decision—the cost of capital.

The ability of investment treaties to influence investor behavior depends on the quality of the signal that such treaties provide to international capital markets. In theory, a beacon may send out strong signals, weak signals or, like the sirens of the *Odyssey*, signals that are false. Signaling theory underscores two important qualities of an efficacious signal: signal *observability* and signal *cost*.<sup>63</sup> The requirement of observability is based on the notion that for the intended recipient of the signal to change behavior that signal should be readily apparent to that receiver. Since the conclusion of an investment treaty is a public sovereign act of a state, usually accompanied by publicity and certain formalities, the conclusion of such a treaty is usually easily observable by international capital markets. With regard to the second requirement for an efficacious signal, the apparent costliness of a signal may lead intended recipients to believe in its reliability. Thus the potential cost to a host country that concluded an investment treaty with a provision for investor-state arbitration may lead potential investors to attach greater credence in its promises of benevolent investor treatment than would a treaty that does not have such a provision and is therefore a less costly signal for a potential host country to make.

If, then, one looks at investment treaties not just as statements of legal rights but as signals to international capital markets, one may ask how best may a developing country use the investment treaty-making process to send a positive, strong signal to international capital markets that will result in the maximum amount of capital inflows. Based on signaling theory, the following four factors are among the most important.

1. *Treaty Legal Effectiveness: Ratification, not Just Signature*

In most cases, although the signing of an investment treaty may be accompanied by significant publicity and a diplomatic ceremony, mere signature by the states concerned does not mean that the treaty is legally effective. By their terms, investment treaties usually contain a provision that the treaty will not go into effect until the contracting parties have each completed their individual constitutional procedures on treaty ratification and have then notified the other contracting party that such procedures have

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63. See Connelly et al., *supra* note 56, at 45.

been fulfilled.<sup>64</sup> With certain exceptions specifically stipulated in the treaty,<sup>65</sup> mere signature of a treaty is not sufficient. As a result of such provisions, each signatory must engage in certain internal procedures and actions to make those treaties effective, a process that can give various domestic interest groups, such as labor unions and economic nationalists fearful of the entry of foreign capital, an opportunity to oppose the treaty. Such oppositional efforts may succeed. Brazil, for example, had signed twenty BITs as of September 2016 but because of opposition in the Brazilian legislature, the government has failed to secure the ratification of any of them.<sup>66</sup> To succeed at ratification, a government may have to expend significant political capital, a factor that shows strong intent by the government to live up to its treaty commitments.

From a legal point of view, signed treaties that are not yet in effect offer investors no protections under international law and do not entitle aggrieved foreign investors to invoke international arbitration to press their claims. Moreover, from a political point of view, signed but unratified treaties are clear indications of strong opposition to foreign capital in the country and may mean that a government's efforts at international investment promotion have little political legitimacy at home. As a result, signed but unratified treaties are a very weak signal of welcome to international capital, and studies indicate that they have no effect on the flow of direct foreign investment into developing countries.<sup>67</sup> They are, in the words of one scholar, merely "cheap talk."<sup>68</sup> In short, they are a signal that entails few costs and are therefore unreliable. Moreover, they utterly fail as handcuffs since unratified treaties do not possess the restraining force on governmental action caused by the possibility of an investor claim before an international arbitration tribunal, a risk that is inherent in a fully ratified investment treaty effectively in force. Commentary on the effect of investment treaties on FDI

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64. See, e.g., Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Federative Republic of Brazil, Braz.-Neth., art. 14, Nov. 25, 1998, Trb. 1998, 283 (Neth.) ("The present Agreement shall enter into force on the first day of the second month following the date on which the Contracting Parties have notified each other in writing that their constitutionally required procedures have been complied with, and shall remain in force for a period of ten years."); Treaty Between the Government of the United States of America and the Government of the Republic of Estonia for the Encouragement and Reciprocal Protection of Investment, U.S.-Est., art. 12, Apr. 19, 1994, T.I.A.S. No. 97-216 ("This Treaty shall enter into force thirty days after the date of exchange of instruments of ratification.")

65. See, e.g., Agreement Concerning the Promotion and Reciprocal Protection of Investments, China-U.K., art. 11, May 15, 1986, 1462 U.N.T.S. 255 ("This Agreement shall enter into force on the day of signature.")

66. See *International Investment Agreements Navigator*, UNCTAD, <http://investmentpolicyhub.unctad.org/IIA/liasByCountry#iiaInnerMenu> (follow "Brazil" hyperlink under "IIAs BY ECONOMY") (last visited Sept. 5, 2016) [hereinafter *Navigator*]; see also Yoram Z. Haftel & Alexander Thompson, *Delayed Ratification: The Domestic Fate of Bilateral Investment Treaties*, 67 INT'L. ORG. 355, 357 (2013).

67. See, e.g., Yoram Z. Haftel, *Ratification Counts: U.S. Investment Treaties and FDI Flows into Developing Countries*, 17 REV. INT'L. POL. ECON. 348, 359 (2010) (concluding that mutually ratified BITs with the United States increase U.S. FDI to treaty partners but signed and unratified BITs do not).

68. *Id.* at 352.

flows sometimes ignores the distinction between ratified and unratified BITs. Convincing research has shown that the existence of BITs has a positive effect on FDI flows but only to the extent that the BITs have been ratified and are legally in force.<sup>69</sup>

## 2. *Nature of Treaty Partners: Richer Is Better than Poorer*

A developing country's investment treaties gain strength and effectiveness as a signal to capital markets to the extent that they are made with major capital-exporting countries. There are several reasons for this phenomenon. First, and most obviously, major-capital exporting countries are those that are most likely to have large numbers of potential investors with access to great amounts of capital. In short, rich countries are where the money is. Second, large capital-exporting states are likely to have the negotiating power to obtain high levels of protection from their treaty partners. Third, large capital exporting countries are also likely to possess sufficient diplomatic and political power to persuade investment treaty partners to respect the treaty commitments that have been made to their treaty-protected nationals. And finally, in addition to investor-state arbitration, virtually all investment treaties grant the contracting states the power to enforce their treaty rights through inter-state arbitration, although few have chosen to do so thus far.<sup>70</sup> On the other hand, although an investment treaty with a country like the United States or Germany sends a strong positive message to international capital markets and may yield investment, a BIT between two poor developing countries is not a signal that is likely to have much impact on investors from other countries or international capital markets in general, though it may serve to build diplomatic relationships between them. Because of the bilateral structure of BITs, the intended recipients of the signal sent by an investment treaty are only the investors of signatory countries, not the world at large. Moreover, signaling theory research holds that the effectiveness of a signal is partially determined by the nature of the receiver, a quality known as receiver attention, and that signaling will have little result if the intended receiver is not attentive to the signal or does not know how to interpret it.<sup>71</sup> Thus a poor developing country is much less likely to have companies seeking foreign investment opportunities than is a rich developed country and therefore its receiver attention to investment treaties as signals will be much less.

In general, developing countries seeking capital should follow what one may call the "Willie Sutton Rule of investment-treaty making"—focus your efforts on the developed capital-exporting countries because that's

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69. *Id.* at 368 ("BITs in force increase, but signed treaties have no effect on, FDI inflows.").

70. *But see* Republic of Italy v. Republic of Cuba, Interim Award (Sentence Préliminaire) (Ad Hoc Tribunal 2005); Republic of Italy v. Republic of Cuba, Final Award (Sentence Finale) (Ad Hoc Tribunal 2008); Michele Potestà, *Republic of Italy v. Republic of Cuba*, 106 AM. J. INT'L L. 341, 341-47 (2012).

71. *See* Connelly, *supra* note 56, at 54.

where the money is. William Francis “Willie” Sutton, a notorious American bank robber in the early- to mid-twentieth century, when asked why he robbed banks, replied, “Why, that’s where the money is.” That statement gave rise to the development of “Willie Sutton rules” or “laws” in various professional domains to the effect that in seeking to solve a problem one should concentrate his or her efforts on apparently high-yield activities rather than those where the yield is potentially less.<sup>72</sup>

### 3. *Number of Treaties Made: More Is Better than Less*

Signaling theory also holds that increasing the number of signals sent can enhance efficacy, a quality known as signal frequency.<sup>73</sup> As a result, one may postulate that the strength of the signal that a developing country sends to capital markets concerning its openness and receptivity to foreign investment is directly proportional to the number of treaties it concludes with significant capital-exporting countries. Moreover, the amount of capital a country is likely to receive through its treaty program will grow with the number of treaties it concludes with major capital-exporting states. Then, too, its numerous international treaty commitments to wealthy countries will communicate a message to investors from other countries that their investment will also be safe. Therefore, when it comes to investment treaties as a signal, more is better than less.

### 4. *Time Period Within Which Treaties Are Made: Shorter Is Better than Longer*

As advertising and electoral campaigns demonstrate and signaling theory affirms, the more often a message is repeated within a short period of time, the more impact that such message is likely to have on the behavior of consumers and voters. Applying this same principle to investment treaty-making as a signaling process, one may say that concluding numerous investment treaties with major capital-exporting countries within a short period of time, say a few years, is likely to have a greater impact on capital markets than a treaty-making process that stretches over a couple of decades. In fact, countries intent on promoting foreign investment at the beginning of a new political or economic era have adopted precisely this approach in communicating their intentions to foreign capital markets. For example, South Africa dramatically moved to a democratic majority government in 1994 after years of apartheid, political struggle, economic sanctions, and after having been assisted in its struggle by communist groups, almost immediately began a program to reassure international capital markets of its benevolent intentions toward foreign investment through a series of BITs

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72. See, e.g., ROBERT S. KAPLAN ET AL., COST AND EFFECT: USING INTEGRATED COST SYSTEMS TO DRIVE PROFITABILITY AND PERFORMANCE 100 (1997) (cost-accounting); David Rytland, *Sutton's or Dock's Law?* 302 NEW ENG. J. MED. 929, 972 (1980) (medical diagnostics).

73. See Connelly, *supra* note 56, at 53.

with important capital-exporting countries. Within five years, it had ratified and brought fourteen such agreements into effect.<sup>74</sup> Similarly, Croatia, having emerged from the break-up of Yugoslavia and four years of armed conflict in the Balkan war in 1995, also began a program of negotiating BITs with leading capital-exporting states. During a five-year period, it secured the effectiveness of fourteen BITs.<sup>75</sup> And finally, Poland, which abandoned communism and Soviet influence in 1989, undertook a program of investment treaty making shortly thereafter in order to build its relations with Western capital markets. Within five years it had ratified sixteen BITs with major capital-exporting states.<sup>76</sup> All three countries seem to have been guided by the principle that the effectiveness of their message to international capital markets depended on making numerous investment treaties within a short time with capital-exporting countries. Indeed, looking at the nature of their negotiating partners, the number and pace of the BITs they negotiated, and their effectiveness in securing the ratification of the treaties they negotiated, one may say that all three countries embarked upon and executed definite comprehensive BIT negotiation programs in order to encourage investment and reassure international capital markets of their benevolent intentions toward foreign capital.

## 5. *Conclusions*

On the basis of the above discussion, one may postulate that a developing country, in order to maximize the effect of using investment treaties as a signal to promote investment, should be guided by the following four principles:

- a) Its treaties must be ratified;
- b) Its treaties should be concluded with major capital-exporting countries;
- c) It should conclude as many of such treaties as possible; and
- d) It should conclude as many investment treaties as possible within as short a time as possible.

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74. South Africa would ultimately sign nearly fifty BITs between 1994 and 2009; however, while it ratified nearly all of the treaties that it signed with major capital-exporting countries between 1994 and 1999, it failed to ratify any treaty signed after that date. Many in the latter group were with countries such as Iran, Cuba, and Chad which could not be called significant capital-exporting countries. For background, see LAUGE N. SKOVGAARD POULSEN, *BOUNDED RATIONALITY AND ECONOMIC DIPLOMACY: THE POLITICS OF INVESTMENT TREATIES IN DEVELOPING COUNTRIES* 162–91 (2015).

75. *Navigator*, *supra* note 66 (follow “Croatia” hyperlink under “IIAs BY ECONOMY”).

76. *Navigator*, *supra* note 66 (follow “Poland” hyperlink under “IIAs BY ECONOMY”).

## V. QUANTITATIVE RESEARCH ON INVESTMENT TREATIES AND CAPITAL FLOWS

### A. *Introduction*

In order to determine the nature of the connection between investment treaties and capital flows to the developing countries that make them, the author undertook research to examine whether any association exists between a country that has concluded investment treaties and 1) an increase in the total amount of capital flowing to that country and 2) the cost that such country must pay for the capital it is to receive. The research project did not examine all developing countries. Instead, it concentrated on those developing countries whose investment-treaty making embodied the four characteristics mentioned above and therefore were most likely to have an impact on foreign investors and international capital markets. In particular, it examined only those developing countries that had brought into effect at least ten investment treaties within a maximum period of five years with major capital-exporting countries. While these numerical limits on the number of treaties and the time period in which they were made were arbitrary, it was felt that a treaty program having these characteristics would send a sufficiently strong signal to international capital markets. The project also assumed that if countries with treaties that met the four listed criteria did not experience a rise in capital flows, countries whose treaties did not meet the four criteria were not likely to achieve better results from their treaty efforts.

In order to carry out the research on investment treaties and capital flows, the project first had to define “major capital-exporting countries” and then identify those developing countries whose investment treaty programs satisfied the four-point model discussed above.

### B. *Defining “Major Capital-Exporting Countries”*

In order to identify “major capital-exporting countries,” the research project examined data on FDI outflows from all countries in each year during the period 1990 to 2013, drawing on UNCTAD data.<sup>77</sup> To determine countries’ relative standing as a major source of foreign investment capital for other countries throughout the period, the research project chose to rank countries in order of FDI outflows in each of the twenty-four years with a point-score, using the following scoring system: countries ranking at or within the top 1% of FDI outflow providers for a particular year received one point; countries ranking from the top 5% and up to but not including

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77. See *FDI Statistics Division on Investment and Enterprise*, UNCTAD, <http://www.unctad.org/fdistatistics> (last visited Oct. 3, 2016). Because statistics on total capital flows during the twenty-four-year period were not available, it was decided to use FDI statistics as a proxy for the quality of being a capital-exporting country on the assumption that a country that was a leading exporter of FDI was also a significant exporter of other forms of capital.

the top 1% of FDI providers, received 0.8; countries ranking between the top 10% and up to but not including the top 5% received a score of 0.6; countries ranking between the top 25% and up to but not including the top 10% received 0.4; countries ranking between the top 50% and up to but not including the top 25% received 0.2. Countries ranking in the bottom 50% received a score of zero for the year. The scores received by each country during the twenty-four years surveyed were then summed and the countries were ranked according to their total scores for the entire twenty-four-year period. The study designated a country receiving a total gross score of ten out of a possible twenty-four points as a "major capital-exporting country." It determined that twenty-seven countries qualified for this designation. Their identities and the point scores they received were as follows:



TABLE 1: MAJOR FDI EXPORTING COUNTRIES<sup>78</sup>

No.	FDI Exporting Countries	FDI Export Score
1	USA	23.6
2	United Kingdom	22.0
3	France	20.8
4	Germany	20.6
5	Japan	20.2
6	Hong Kong	19.0
7	Canada	18.8
8	Netherlands	18.8
9	Switzerland	18.0
10	Spain	17.0
11	BLEU <sup>78</sup>	16.8
12	Sweden	16.6
13	Italy	16.4
14	China	15.0
15	Singapore	14.6
16	Korea	14.2
17	Taiwan	13.4
18	Austria	13.2
19	Russian Federation	12.8
20	Norway	12.8
21	Australia	12.6
22	Ireland	12.6
23	Denmark	11.8
24	Malaysia	11.0
25	Portugal	10.6
26	Finland	10.2
27	Chile	10.0

For a developing country's investment treaty to meet the criteria of being made with a "major capital-exporting country" for purposes of the study, such treaty had to be concluded and in force with one of these twenty-seven countries.

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78. Belgium-Luxembourg Economic Union.

*C. Identifying Qualified Developing Countries*

Having identified the major capital-exporting countries, the study then ascertained those developing countries meeting the four criteria specified above for maximizing the signaling effectiveness of their BIT programs, namely that their BITs must: 1) be legally in effect; 2) have been concluded with major capital-exporting countries; 3) be sufficient in number, which for purposes of the study means at least ten BITs with major capital-exporting countries; and 4) must have been concluded within a reasonably short period of time, which for purposes of the research was a maximum of five years. The study accomplished this task in two steps. First, relying on UNCTAD's "Investment Policy Hub, IIAs By Economy Data on Investment Treaties,"<sup>79</sup> the initial step in this process was to identify developing countries that had concluded and brought into effect bilateral investment treaties with major capital-exporting countries, treaties that the study designated as "Qualified BITs" or "Q-BITs." Second, the study then identified those developing countries that had brought into effect at least ten Q-BITs within a maximum period of five years. It referred to the investment treaties in this group as "Strong Signal Qualified BITs." South Africa, for example, brought into force fourteen Q-BITs from 1997 and 1999 (three years). It was therefore selected as having Strong Signal Q-BITs and each of the Qualified BITs brought into effect during the period 1997-1999 was designated a "Strong Signal BIT." Ultimately, the study determined that twenty-six countries had Strong Signal Q-BITs in force and thus fulfilled the four criteria in the model for countries intent on using investment treaties as signaling devices to international capital markets. They are identified in Table 2.

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79. *Navigator*, *supra* note 66.

TABLE 2: STRONG SIGNAL Q-BITs COUNTRIES (10 Q-BITs IN FORCE IN 5 YEARS)

No.	Country	Total Q-BITs	Minimum Period of 10 Effective Q-BITs
1	Albania	18	2
2	Argentina	21	3
3	Chile	16	4
4	Croatia	19	4
5	Cuba	13	5
6	Czech Republic	24	2
7	Estonia	15	4
8	Hungary	21	3
9	India	19	5
10	Indonesia	23	3
11	Iran	11	5
12	Latvia	19	4
13	Lebanon	16	4
14	Lithuania	19	4
15	Macedonia	14	4
16	Mexico	17	4
17	Peru	18	2
18	Philippines	19	5
19	Poland	23	3
20	Romania	22	2
21	Russian Federation	18	1
22	Slovakia	20	2
23	Slovenia	15	4
24	South Africa	14	3
25	Ukraine	20	2
26	Viet Nam	20	4

The twenty-six countries listed concluded a total of 475 Q-BITs, both Strong Signal and otherwise, each country averaging 18.3 effective Q-BITs.

The study next determined for each of the twenty-six countries the precise years during which the Strong Signal Q-BITs came into effect, a period

identified as the “Strong Signal Q-BIT Period” (the Period). Since the aim of the study was to determine the association of BITs with capital flows, it was essential to know when the signaling period began and when it ended so as to be able to determine the change, if any, in the amount of capital inflows to that country from just before the beginning of the signaling period and its end and afterwards. For example, South Africa made fourteen Q-BITs during the period 1997-2000. Its Strong Signal Q-BIT Period, therefore, ran for purposes of the study from the beginning of 1997 until the end of 2000.

As shown in Table 3 below, the Strong Signaling Periods of Q-BITs for the twenty-six selected countries range from one year (Russia) to nine years (Ukraine) with an average period of 5.7 years. A total 376 Q-BITs entered into force during the Periods, and each country on average entered into 14.5 Q-BITs.

TABLE 3: STRONG SIGNAL Q-BIT PERIOD

No.	Country	Strong Signal Q-BIT Period			
		Year From	Year To	Period (years)	BITs
1	Albania	1993	1999	7	14
2	Argentina	1992	1997	6	20
3	Chile	1994	1999	6	14
4	Croatia	1996	2002	7	16
5	Cuba	1995	1999	5	10
6	Czech Republic	1991	1996	6	19
7	Estonia	1992	1995	4	10
8	Hungary	1987	1993	7	17
9	India	1996	2002	7	16
10	Indonesia	1993	1996	4	11
11	Iran	2004	2008	5	10
12	Latvia	1992	1999	8	17
13	Lebanon	1997	2004	8	15
14	Lithuania	1992	1997	6	14
15	Macedonia	1997	2002	6	13
16	Mexico	1999	2003	5	11
17	Peru	1993	1997	5	15
18	Philippines	1995	1999	5	10
19	Poland	1988	1994	7	21
20	Romania	1992	1998	7	19
21	Russian Federation	1991	1991	1	11
22	Slovakia	1991	1992	2	14
23	Slovenia	1997	2003	7	14
24	South Africa	1997	2000	4	14
25	Ukraine	1993	2001	9	18
26	Viet Nam	1993	1996	4	13

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#### D. *Capital Inflows to Qualified Developing Countries Before and After the Strong Signal Q-BIT Period*

##### 1. *In General*

In order to ascertain the association of Strong Signal Q-BITs with capital flows to the countries concerned, the study drew on databases of the World Bank Group<sup>80</sup> and the International Monetary Fund<sup>81</sup> to determine the amount of capital inflows in current U.S. Dollars into twenty-two of the twenty-six Qualified Developing Countries both before and after the Strong Signal Q-BIT Period. Due to the lack of relevant data on four developing countries listed in Table 2, Cuba, Czech Republic, the Russian Federation, and Slovakia could not be ascertained; these four countries were omitted from the study. For each of the twenty-two other countries, charts of capital flows for the period 1980 until 2013 were made with shaded areas indicating the Strong Signal Periods. Copies of the charts may be found in the appendix to this article.<sup>82</sup> The charts reflect total capital flows during that time, as well as the three individual capital flow components of FDI, portfolio, and debt. Separate charts for each country tracked capital flows in absolute quantities as well as a percentage of Gross National Income (GNI) or Gross Domestic Product (GDP), depending on the data source. In analyzing the data, the study sought to determine both the immediate results of the Strong Signal BITs and the long-term results of capital inflows to the countries concerned.

##### 2. *Immediate Results*

To examine the immediate results with respect to capital inflows of Strong Signal Q-BITs, the research project applied two indicators:

1) The ratio of the total capital flows in the last year of the Period to the average of the total capital flows in the first year of the Period and the year immediately prior thereto. This ratio was labeled as the “End/Base Multiple.” Applying this methodology to Croatia, for example, the study determined that the ratio was 2.5, meaning that Croatia at the end of the Period received capital flows two and a half times higher than what it received in the first and prior year of the period. Slovenia, on the other hand, had an End/Base Multiple of 0.5.

2) The second method, labeled the “Max/Base Multiple,” divided the maximum annual amount of capital inflow received during the period by the average inflow in the first and prior years of the Period. Under this method Croatia had a 2.5 ratio while Slovenia registered 1.6. If one consid-

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80. *International Debt Statistics*, WORLD BANK, <http://data.worldbank.org/data-catalog/international-debt-statistics> (last updated Dec. 16, 2015).

81. *International Financial Statistics*, INT’L MONETARY FUND, <http://data.imf.org/?sk=5DABAFF2-C5AD-4D27-A175-1253419C02D1> (last visited Dec. 16, 2015).

82. The appendix to this article is archived at <https://perma.cc/YPE3-4DPC>.

ers a multiple of 1.1 of either indicator to be positive since it indicates an increase of 10% in capital flows, one finds in surveying the instant effects on all twenty-two countries, reflected in Table 4, that all of them had positive instant effects as measured by the Max/Base Multiple and only two failed to achieve a similar result when the End/Base Multiple is applied. The study also compared the changes in total capital inflows as a percentage of Gross National Income (GNI) or Gross Domestic Product (GDP) in addition to absolute measurements discussed above. By comparing relative terms, the study sought to adjust changes in capital inflows for growth in the total economy of the individual countries concerned. As Table 5 below demonstrates, all twenty-two countries achieved positive results with respect to capital inflows as a percentage of GDP (or GNI) as measured by the Max/Base Multiple while only four failed to attain an End/Base multiple of 1.1 (i.e. 10% increase).

Equally significant, the study concluded that for each of the twenty-two countries, the average capital inflow at the end of the Strong Signaling Period was nearly twice the amount it was receiving at the beginning. Thus the average End/Base Multiple for each country in the group was 1.82 and the average Max/Base multiple was 2.47. It would therefore seem that a strong correlation exists between the signaling undertaken by the countries concerned and an increase in capital inflows by the end of the Strong BIT Signal Period.

### 3. *Long-Term Results*

One may assume that developing countries engaged in a BIT program to attract foreign capital were seeking inflows that would continue long after the treaties had gone into effect. The study therefore considered it important to determine the long-term results of countries' efforts at investment-treaty making. The study therefore examined the nine-year period following the end of the Strong Signaling Period, dividing the nine years into three segments of three years each. It then sought to compare the average annual capital inflow at the beginning and at the end of each three-year period, expressing that relationship in a numerical ratio or multiplier. For example, Croatia registered positive ratios of 2.1, 3.8, and 1.4 in each of the three three-year segments following the end of the Strong Signaling Period while Slovenia had ratios of 3.4, 5.2, and 0.5 for the three segments of the nine-year period following its own Strong Signaling Period. For the countries as a group (with Iran excluded because of unavailability of data after 2008), the average multiple for the three three-year periods was 1.0, 1.82, and 2.77. One may therefore conclude that a strong correlation existed between the conclusion of investment treaties and the continuation of positive inflows in years after the end of the Strong Signaling Period.

Tables 4 and 5 below show changes in capital inflows both before and after the Strong Signaling Period.

TABLE 4: THE CHANGE OF CAPITAL INFLOW WITHIN AND AFTER THE STRONG SIGNALING PERIOD

No.	Country Name	Instant Effect		Long Term Effect (multiples of the average within the Period)		
		End/Base Multiple (x)	Max/Base Multiple (x)	1st 3-years	2nd 3-years	3rd 3-years
1	Albania	0.9x	1.2x	2.1x	4.2x	9.1x
2	Argentina	4.5x	4.5x	1.0x	-0.2x	0.3x
3	Chile	2.5x	2.5x	0.7x	1.1x	2.3x
4	Croatia	2.5x	2.5x	2.1x	3.8x	1.4x
5	Estonia	3.0x	3.0x	3.2x	2.5x	7.4x
6	Hungary	10.3x	10.3x	2.5x	3.1x	3.9x
7	India	1.0x	1.9x	3.0x	12.4x	13.9x
8	Indonesia	3.0x	3.0x	-0.2x	-0.8x	-0.1x
9	Iran	-0.3x	1.1x	1.1x	0.0x	NA
10	Latvia	3.6x	4.4x	1.4x	4.4x	12.8x
11	Lebanon	2.5x	3.2x	1.3x	1.3x	1.4x
12	Lithuania*	36.2x	36.2x	5.7x	4.0x	11.3x
13	Macedonia	0.9x	2.7x	2.1x	3.2x	3.1x
14	Mexico	0.9x	1.6x	0.9x	1.5x	3.6x
15	Peru	4.0x	6.3x	0.3x	0.5x	0.8x
16	Philippines	3.1x	4.3x	0.6x	0.4x	0.3x
17	Poland*	138.9x	138.9x	6.4x	11.4x	6.7x
18	Romania	2.4x	3.1x	1.6x	4.9x	15.7x
19	Slovenia	0.5x	1.6x	3.4x	5.2x	0.5x
20	South Africa	11.5x	11.5x	0.2x	1.6x	1.2x
21	Ukraine	16.6x	16.6x	1.7x	10.8x	11.1x
22	Viet Nam	11.5x	11.5x	1.2x	0.9x	2.0x



TABLE 5: THE CHANGE OF CAPITAL INFLOW AS PERCENTAGE OF GNI (OR GDP) WITHIN AND AFTER THE STRONG SIGNALING PERIOD OF Q-BITs

No.	Country Name	Instant Effect		Long Term Effect (x of average within the Period)		
		End/Base Multiple (x)	Max/Base Multiple (x)	1st 3-years	2nd 3-years	3rd 3-years
1	Albania	0.2x	0.9x	1.0x	1.1x	1.5x
2	Argentina	2.7x	2.9x	0.9x	-0.5x	0.4x
3	Chile*	1.9x	1.9x	0.7x	0.7x	1.0x
4	Croatia*	1.9x	2.6x	1.1x	1.4x	0.5x
5	Estonia*	1.3x	2.8x	1.4x	1.0x	1.5x
6	Hungary	6.7x	6.7x	2.0x	2.3x	2.4x
7	India	0.7x	1.5x	1.9x	5.0x	3.9x
8	Indonesia	1.7x	1.7x	-0.6x	-1.0x	-0.1x
9	Iran	-0.1x	1.1x	1.3x	0.1x	NA
10	Latvia*	0.6x	1.0x	0.8x	1.5x	2.2x
11	Lebanon	2.0x	2.8x	1.0x	0.7x	0.6x
12	Lithuania* **	10.5x	10.5x	3.9x	2.1x	3.1x
13	Macedonia	1.0x	3.1x	1.4x	1.4x	1.1x
14	Mexico	0.7x	1.2x	0.8x	1.1x	2.2x
15	Peru	2.3x	4.1x	0.3x	0.4x	0.5x
16	Philippines	2.2x	3.4x	0.6x	0.3x	0.2x
17	Poland* **	83.8x	96.7x	3.6x	5.3x	2.6x
18	Romania	1.1x	1.5x	1.3x	2.5x	4.0x
19	Slovenia*	1.5x	2.4x	2.1x	2.5x	0.2x
20	South Africa	0.6x	1.6x	0.3x	0.9x	0.6x
21	Ukraine	20.8x	20.8x	1.3x	3.9x	3.2x
22	Viet Nam	5.6x	5.9x	0.8x	0.4x	0.7x

\* Using GDP instead of GNI data

\*\* Using FDI inflow instead of total capital inflow

#### 4. Comparisons with a Group of Weak BIT Signal Countries

To further examine the effect of strong BIT signals on capital inflows to host countries, the research study selected as a Comparison Group fifteen

countries that, because of the small number and timing of their BITs, could qualify as “Weak BIT Signal Countries.” To form the Comparison Group, the study first identified thirty-four countries having three or less BITs in force, according to UNCTAD’s International Investment Agreements database.<sup>83</sup> Second, from this group the study deleted two developed (or high-income) countries (Macau and New Zealand), thirteen countries with populations of less than one million people (Antigua and Barbuda, Comoros, Djibouti, Dominica, Equatorial Guinea, Grenada, Saint Lucia, Saint Vincent and the Grenadines, Seychelles, Suriname, Tonga, Bahamas, and Bhutan), and four countries with on-going armed conflicts (Afghanistan, Iraq, Occupied Palestinian territory, and Timor-Leste). The resulting comparison group consists of the following fifteen countries, as presented in Table 6.

TABLE 6: WEAK BIT SIGNAL COUNTRIES (THE COMPARISON GROUP)

No.	Countries	2013 Population (million)	2013 GDP per capita (USD)	BIT Numbers
1	Botswana	2.0	7,313.2	2
2	Central African Republic	4.6	333.2	2
3	Chad	12.8	1,053.0	3
4	Eritrea	6.3	543.8	1
5	Gambia	1.8	488.6	2
6	Guinea-Bissau	1.7	563.8	1
7	Haiti	10.3	819.7	3
8	Lesotho	2.1	1,125.8	3
9	Liberia	4.3	454.4	3
10	Malawi	16.4	226.5	3
11	Niger	17.8	415.4	2
12	Sierra Leone	6.1	678.9	2
13	Somalia	6.3	145.0	2
14	Swaziland	1.3	3,032.8	2
15	Togo	6.8	636.5	2

Due to lack of complete data, the study was able to track capital inflows to the group of Strong Signal BIT Countries and the group of Weak Signal BIT Countries only from 1994 to 2013. Within that period of twenty years, the total capital inflow to the Strong Q-BITs Signal Group increased from U.S. \$70.2 billion in 1994 to U.S. \$479 billion in 2013, while the total

83. *Navigators*, *supra* note 66.

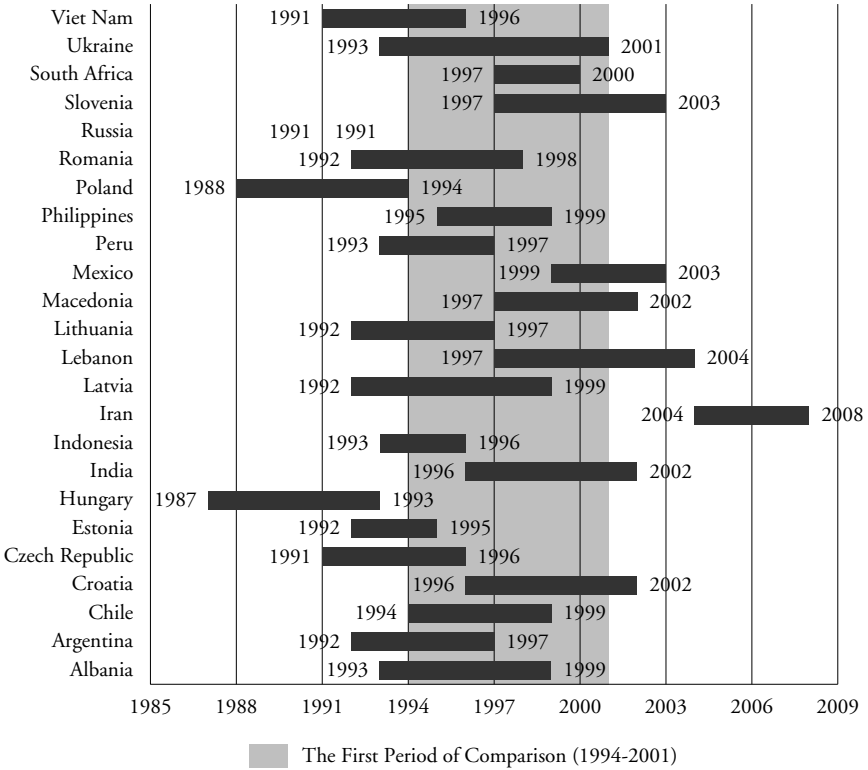
capital inflow to the Comparison Group increased from U.S. \$0.5 billion in 1994 to U.S. \$4.1 billion in 2013. Although the total capital inflow of both groups had similar Compound Annual Growth Rates (CAGR) of around 11%<sup>84</sup> within the twenty years, the absolute gap in inflows between the two groups grew from U.S. \$70 billion in 1994 to U.S. \$475 billion in 2013.

Detailed trends between the two groups differed significantly when the comparison period is divided into three intervals. The first interval consists of the eight years from 1994 to 2001, a period when most of the Strong Q-BITs Signal countries were still in the process of completing their BIT programs and many of their Q-BITs were not yet in force. As shown in Table 7 below, the Strong Q-BITs Signaling Periods defined previously first started in Hungary in 1987 and ended in Iran in 2008 and were very concentrated in the 1990s. By the year of 2001, 71% of the countries in the Strong Q-BITs Signal Group had completed their Q-BITs periods. The second interval consists of the seven years between 2001 and 2007, when the strong signals of Q-BITs had mostly gone into effect. The last interval spans the seven-year period from 2007 to 2013, the period of the global financial crisis and the subsequent recovery.

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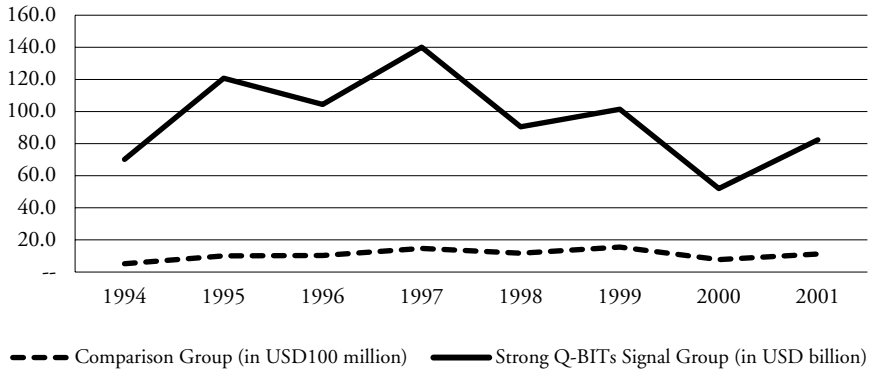
84. The CAGR for the Comparison Group is 11.49%, which is slightly higher than the CAGR of 10.64% for the Strong Q-BITs Signal Group. The slightly higher growth is largely due to the very low base amount of capital inflow into the Control Group in 1994.

TABLE 7: STRONG Q-BITs SIGNAL PERIODS OF THE TWENTY-FOUR COUNTRIES IN THE STRONG Q-BITs SIGNAL GROUP



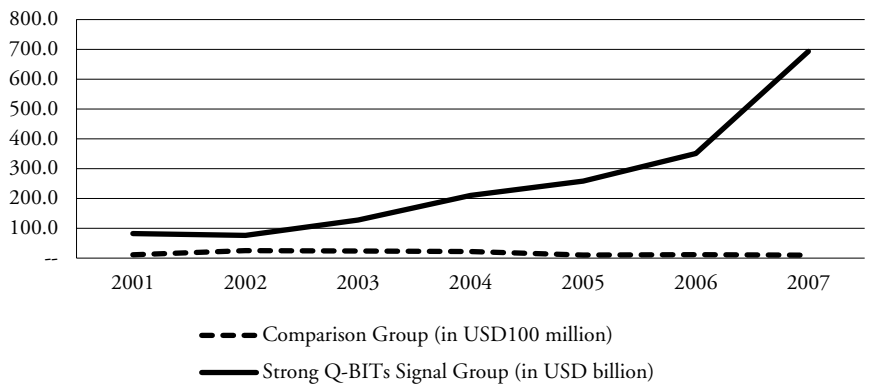
The first period between 1994 and 2001 exhibited a fluctuating but clear trend of increased capital inflow in both groups. During this period, as shown in Table 8 below, the total capital inflow into the Comparison Group only slightly increased from U.S. \$0.5 billion to U.S. \$1.1 billion with CAGR of 11.7%. The capital inflow into Strong Q-BITs Signal Group during the same period was very volatile, increasing from U.S. \$70.2 billion to U.S. \$82.4 billion with even smaller CAGR of only 2.3%. Both of these findings support the importance for a county to fulfill all of the four elements of the model in order to send effective signals to international capital markets.

TABLE 8: TOTAL CAPITAL INFLOWS OF COMPARISON GROUP AND STRONG Q-BIT SIGNAL GROUP FROM 1994 TO 2001



The second period (between 2001 and 2007), by which time virtually all countries in the Strong Signal Q-BIT Group had completed their BIT programs, was a period of striking differences in capital inflows for the two groups. Thus, the growth rate (CAGR) of the Strong Q-BITs Signal Group was 42.6%, compared to -2.6% of the Comparison Group. During this period, the capital inflows of the Strong Q-BITs Signal Group increased by 8.4 times, while inflows actually decreased from U.S. \$1.1 million to U.S. \$1.0 million for the Comparison Group. In 2001, the total capital inflow of the Strong Q-BITs Signal Group was seventy-four times the capital inflow of the Comparison Group, while the ratio enlarged to 727 times in 2007. Table 9 below illustrates the significant difference between the two groups.

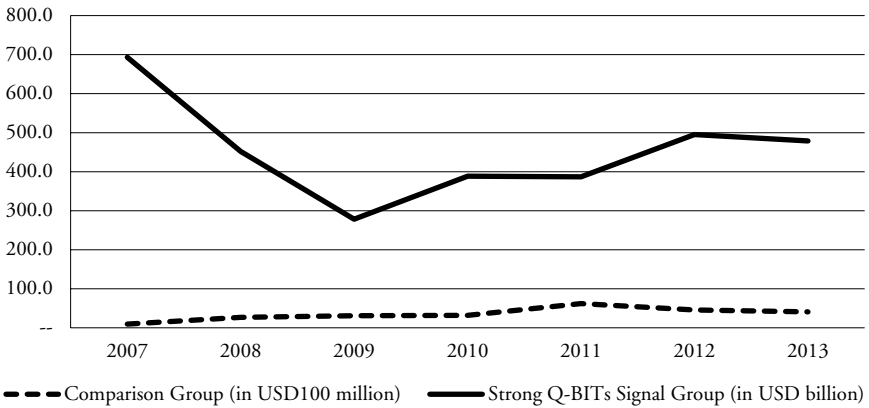
TABLE 9: TOTAL CAPITAL INFLOWS OF COMPARISON GROUP AND STRONG Q-BIT SIGNAL GROUP FROM 2001 TO 2007 (IN USD BILLION)



During the third period, which coincides with the global recession that began in 2007, capital inflows of the Strong Q-BITs Signal Group countries

drastically fell from its peak of U.S. \$693 billion in 2007 to U.S. \$278 billion in 2009 and only weakly recovered to U.S. \$479 billion in 2013. In contrast, the impact of the global financial crisis on the capital inflows to the Comparison Group was not equivalently significant. During this period, capital inflows to the Comparison Group increased from U.S. \$1.0 billion in 2007 to U.S. \$4.1 billion in 2013 with compound annual growth rate of 27%. This increase seems largely driven by the investment boom into some emerging African countries, such as Chad, Sierra Leone, and Niger. More importantly, the declines in inflows to the Strong Signal Q-BIT Group is almost certainly due to global macroeconomic factors, particularly the Great Recession that began in 2007.

TABLE 10: TOTAL CAPITAL INFLOWS OF COMPARISON GROUP AND STRONG Q-BIT SIGNAL GROUP FROM 2007 TO 2013



5. *Tentative Conclusions on the Investment Treaties and the Quantity of Capital Inflows*

Looking at the data as a whole and taking account of individual country differences, financial crises, and the great global recession that struck in 2007, there is reason to believe that countries that undertook programs of executing Strong Signal Q-BITs, as defined above, increased the quantity of international capital inflows compared to their performance prior to such programs and that they also did better in that regard than countries that failed to undertake such programs.

## VI. INVESTMENT TREATIES AND THE COST OF CAPITAL

A. *The Cost of Capital in General*

Whether they are investing debt or equity in an enterprise, providers of capital require compensation for their investment. For the enterprise receiving the investment, that compensation represents the cost of capital that it must pay. Normally, the cost of capital for debt is manifested in the interest rate specified in the agreement governing a loan or other form of debt obligation. The cost of capital for equity, on the other hand, is determined by the investor's "hurdle rate," the minimum rate of return that the investor requires to make the investment, based on its risk.<sup>85</sup> The investor will work to structure an equity investment through various contractual arrangements in such a way as to assure that the investor's rate of return from the investment will meet or exceed the required hurdle rate.

The cost of capital for a particular investment is based on the notion of opportunity cost, the return on an investment that an investor would earn from a similar investment presenting a similar risk. The concept of the cost of capital recognizes that an investor has other opportunities to invest capital and that to persuade an investor to provide capital to a particular investment the entity seeking that capital must offer the investor a rate of return and level of risk at least as favorable as that which the investor is being asked to forego. Thus in deciding whether to make an investment, rational investors must have knowledge of their own cost of capital, the returns they would earn from other uses of its capital, and the risks that such uses present.

A decision on whether to commit capital to an investment in a particular country must take account of not only the economic risks presented by a specific enterprise, such as a power plant, but also the *country risk* arising from facts and circumstances of the country concerned, for example building a power plant in India. Country risk consists of various individual risks such as political risk, exchange rate risk, monetary transfer risk, and country economic risk—risks that arise because the investment is made in a particular country.<sup>86</sup> Usually, a foreign investor will first calculate the normal risk arising from a particular economic activity, for example electrical power generation, by initially determining the required rate of return if that activity were being undertaken in a low-risk country, such as the United States or the United Kingdom. The investor would then add to that amount a *country risk premium* in order to arrive at the required rate of return on either

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85. CHAN S. PARK, CONTEMPORARY ENGINEERING ECONOMICS 216 (4th ed. 2007). See generally Iwan Meier & Vefa Tarhan, *Corporate Investment Decision Practices and the Hurdle Rate Premium Puzzle* (2007), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=960161](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=960161).

86. See LAURENT L. JACQUE, INTERNATIONAL CORPORATE FINANCE 539–44 (2014).

a debt or equity projected investment in the country concerned.<sup>87</sup> In the domain of sovereign debt obligations, the country risk attached to a particular investment is often captured in the notion of “the spread”—the difference between the interest rate or yield on a sovereign bond issued by the government of a developing country and a bond of similar duration issued by the United States government. The greater the sovereign risk in a particular bond the larger will be the spread between the interest rate that sovereign must pay for capital and the rate that investors will charge the U.S. government for debt obligations of similar duration.

Finally, it should be noted that although the terms “country risk,” “political risk,” and “sovereign risk” are all widely, and often interchangeably, employed in the international financial sector, they are not in strict analytical terms exactly the same, although their basic concepts do overlap. The concept of country risk has the broadest extension and is defined by one authoritative source as “covering the downside of a country’s business environment including legal environment, levels of corruption, and socioeconomic variables such as income disparity.”<sup>88</sup> According to the same source, “sovereign ratings capture the risk of a country defaulting on its commercial debt obligations” and as a result many financial analysts would use the sovereign risk, measured by sovereign ratings, as a proxy for country risk, despite the fact that both indicators are not perfectly identical.<sup>89</sup> For purposes of ascertaining the cost of capital associated with bilateral investment treaties, this article will employ the term “country risk” as risks “. . . consisting of various individual risks such as political risk, exchange rate risk, monetary transfer risk, and country economic risk—risks that arise because the investment is made in a particular country.”<sup>90</sup>

### B. *Investment Treaties and Country Risk*

The intent of investment treaties is to protect covered foreign investments and investors from many types of country risk. Thus, treaty provisions prohibiting expropriation without just compensation or promising the investment fair and equitable treatment and full protection and security are aimed at countering important sub-categories of political risks. Treaty guarantees to investors of freedom to make monetary transfers out of and into the host country seek to provide assurance against transfer risks. To the extent that individual investors and the international capital market in general accept these treaty assurances as credible, it would follow, at least in theory,

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87. See Pablo Fernández et al., *Market Risk Premiums Used in 56 Countries in 2011: A Survey with 6,014 Answers*, (IESE Bus. Sch., Working Paper No. 920, 2011), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1947301](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1947301).

88. MARCEL HEINRICHS ET AL., *S&P CAPITAL IQ, COUNTRY RISK AND SOVEREIGN RISK: BUILDING CLEARER BORDERS 1* (2013).

89. *Id.*

90. See LAURENT L. JACQUE, *supra* note 86, at 539-42, (discussing the elements of this definition).



that such investors would view a country making such assurances as less risky than a similar country that does not; investors would apply a reduced country-risk premium in making investments and therefore would require a lesser amount of compensation in the form of interest payments or equity returns than otherwise. In short, if a country concludes one or more credible investment treaties aimed at reducing political risk, such treaties should have the result of reducing that country's cost of capital. Thus in theory, investment treaties could have a double benefit for developing countries that make them: 1) an increase in the amount of capital flows to that country and 2) a reduction in the cost that such country would otherwise have to pay for the capital it receives. The first part of this article explored the question of the association of BITs with increased capital flows. The next part will explore the second issue—the question of the cost of capital.

### *C. The Effect of Investment Treaties on the Cost of Capital*

In order to measure the effects on a country's risk premium of its investment treaties, one would begin the inquiry by ascertaining such country's risk premium before it began a program to conclude treaties and would then compare the results with respect to the country risk premium after such treaties had been concluded and were in effect. That type of inquiry is unfortunately constrained by a lack of relevant, reliable data. While available data on the amount of capital flows to developing countries is reliable and spans a relatively long historical period, data on political risk of comparable reliability and breadth does not seem available. In short, there is no single authoritative database tracking country risk premiums of individual nations over the last several decades. As a result, one must resort to various other alternative indicators or "proxies" to estimate country risk and therefore the country risk premium at a particular time. In practice, this approach is precisely the methodology employed by international investment and money managers to gauge the country risk and the country-risk premium that their contemplated foreign investments may incur.

Two important indicators, among others, employed by investors to determine country risk are 1) sovereign debt credit ratings and 2) the World Bank's Worldwide Governance Indicators, particularly those relating to the rule of law, both of which will be relied on in this study to ascertain whether the Strong Signal Q-BIT Countries in the survey also were perceived as having diminished political or country risk as a result of the BITs that they concluded.<sup>91</sup>

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91. Although the study considered using the "spreads" on sovereign debt discussed above as proxies for country risk, securing spread data proved to be prohibitively expensive.

### 1. *Sovereign Debt Credit Ratings and Investment Treaties*

The long-term debt obligations of governments, often referred to as “sovereign bonds,” are the subject of periodic evaluations as to their credit worthiness by private organizations known as credit rating agencies. Three of the most significant of these agencies are Moody’s Investor Services, Standard & Poor’s, and Fitch Ratings, which together control nearly 95% of the credit ratings market.<sup>92</sup> The role of credit rating agencies is to make an informed judgment on the credit worthiness of the obligation under evaluation. The purpose of such evaluation is to determine the likelihood that the issuing government will actually make scheduled payments required by the bond or other obligation. In carrying out this task, rating agencies award a letter grade to the obligation in question. Thus, the systems used by Standard & Poor’s and Fitch have twenty-two separate grade levels (Moody’s has 21) ranging from AAA, meaning that “an obligor’s capacity to meet its financial obligations is extremely strong,” to D in the case of Standard & Poor’s or DDD in the case of Fitch, indicating that “the obligation is in default . . . that payment on an obligation are not made on the date due.”<sup>93</sup>

Sovereign credit ratings may serve as indicators of country risk in at least three ways. First, since political elements may influence the ability of a government to service the particular sovereign debt being rated, its rating captures the perceived political risk of that specific sovereign obligation. Second, a sovereign debt rating may be reflective of the capital market’s perception of a government’s general willingness and ability to meet its other obligations. And third, the credit rating may be evidence of a government’s willingness to recognize and enforce private contracts and property rights within its territory. The existence of an investment treaty may influence each of these three aspects of country risk and thereby influence the rating. With regard to the first dimension, depending on a treaty’s definition of “investment,” the sovereign debt being rated may be a protected investment under the treaty. The treaty, therefore, would give debt holders added protection under international law and recourse to international arbitration as an additional remedy in cases of default. These safeguards would reduce the debt’s perceived risk.<sup>94</sup> Second, an improved credit rating follow-

92. See *The Credit Rating Controversy*, COUNCIL FOREIGN REL.: BACKGROUNDERS (last updated Feb. 19, 2015), <http://www.cfr.org/financial-crises/credit-rating-controversy/p22328>.

93. Standard and Poor, *S&P Global Ratings Definitions* 4–5 (May 3, 2016), [https://www.standardandpoors.com/en\\_EU/delegate/getPDF?articleId=1663724&type=COMMENTS&subType=REGULATORY](https://www.standardandpoors.com/en_EU/delegate/getPDF?articleId=1663724&type=COMMENTS&subType=REGULATORY).

94. See, e.g., *Abaclat v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, ¶ 713 (Aug. 4, 2011), [https://www.standardandpoors.com/en\\_EU/delegate/getPDF?articleId=1663724&type=COMMENTS&subType=REGULATORY](https://www.standardandpoors.com/en_EU/delegate/getPDF?articleId=1663724&type=COMMENTS&subType=REGULATORY); *Ambiente Ufficio SPA v. Argentine Republic*, ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility, ¶ 472 (Feb. 8, 2013), <http://www.italaw.com/cases/1750> (in which the tribunals held that sovereign bonds were covered by the Argentina-Italy BIT). But similar claims could not have been brought under the UK-Colombia BIT. Bilateral Agreement for the Promotion and Protection of Investments between the Government of the United Kingdom of Great Britain and Northern Ireland and the Republic of Colombia, Colom.-Gr.

ing the entry into force of BITs may be indicative of increased confidence by capital markets in the general ability and willingness of the government concerned to fulfill its other legal obligations. Third, an investment treaty—by protecting the property and contractual rights of foreign investors—may reflect the quality of a government’s general respect for and willingness to enforce contractual and property rights of foreigners and nationals alike, thereby reducing capital markets’ perception of country risk.

A change in sovereign debt credit rating, upwards or downwards, can have significant consequences for both the government concerned and for firms operating in the country of that government. First, an improvement in credit rating means that the government will pay less to borrow money while a downgrade will mean that it will pay more. The impact of sovereign credit downgrades is not limited to governments alone. Downgrades have consequences that ripple throughout the economy in a variety of ways. For example, since foreign lenders will hardly ever lend to private firms in a given country on terms more favorable than those given to that country’s government, an increase in a government’s borrowing costs because of a rating downgrade will almost always result in a comparable increase in borrowing costs for private firms. More broadly, foreign providers of capital look to sovereign debt ratings in estimating the political risk of a country and therefore in calculating the country-risk premium they should charge for their investments in that country.<sup>95</sup> Thus, factors that lead to sovereign credit rating downgrades will ultimately result in increasing a country’s cost of capital, while forces that lead to upgrades will reduce the cost of capital. An important question, then, is whether the conclusion of investment treaties by countries will have an impact on their sovereign credit rating and therefore on their cost of capital.

## 2. *Sovereign Credit Ratings of Strong Signaling Q-BIT Countries*

To explore this question, the research study sought to examine the credit ratings of the twenty-six countries it had previously identified as “Strong Signal Q-BIT Countries” discussed earlier in this article. All of the twenty-six Strong Signal BIT Countries listed in Table 2 issued sovereign bonds that were subject to credit agency ratings. The study therefore endeavored to compare each country’s sovereign credit rating before and after the Q-BIT Signaling Period to determine any correlation between concluding BITs and a change in credit rating. Five countries (Albania, Estonia, Iran, Macedonia, and Slovakia) had to be eliminated from this aspect of the study because

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Brit., art. I(2)(b)(i), Mar. 17, 2010, Gr. Brit. TS No. 024/2014. Though that treaty provides a broad asset-based definition of “investment” with an illustrative list, it states that “investment” does not include “public debt operations.” *Id.*

95. See Heitor Almeida et al., *The Real Effects of Sovereign Rating Downgrades* 32–33 (Jan. 22, 2014) (unpublished manuscript) (available at <https://www2.bc.edu/felipe-restrepogomez>) (follow “The Real Effects of Sovereign Rating Downgrades” hyperlink under “Working Papers”).

credit ratings of their sovereign debts only began several years after the Q-BIT Signaling Period or because rating information was considered insufficient. For the remaining twenty-one countries, drawing on data provided by Bloomberg,<sup>96</sup> the study converted their individual credit ratings into numerical scores reflecting the twenty-two categories of the agency rating systems mentioned above, with the highest rating (e.g. AAA) being given a twenty-two and the lowest, e.g. DDD, a one. The scores were then plotted on a graph over time. All twenty-one showed a positive effect through an improved credit rating either during or at the end of the Strong Signal Q-BIT Period. Thereafter, nearly all countries sustained or bettered that rating until the intervention of a major macroeconomic incident such as the Argentine crisis in 2001 or the global financial crisis that began in 2007. For example, Moody's rated Lithuania's sovereign debt in 1996 as Baa3 during the Strong Signal Q-BIT Period but after that Period its credit rating steadily rose a total of five steps until it reached Aa2 in 2006. S&P's rating of Hungary's sovereign debt had an initial grade of BBB in 1992—before the end of that country's Strong Signaling BIT period—but the rating would eventually rise to AA in 2002. Argentina itself had a Moody's rating of B1 just prior to the Strong Signaling Q-BIT Period in 1991. That rating would rise three steps to Baa1 by 1998, but because of the Argentine financial crisis, would eventually plunge to Caa2 in 2001. Thus, one can say that a strong correlation existed between a country's bringing BITs into effect and improving its credit rating, a fact that may be reflective of capital markets perceiving a decline in political country risk in the nations concerned because of the existence of Strong Signal Q-BITs in addition to other factors.

It is also worth noting that, beginning in 2012, when South Africa started withdrawing from BITs it had signed with EU states,<sup>97</sup> its sovereign debt also experienced a downgrading of two steps, thus reflecting an increased perception of political risk in that country by international capital markets.<sup>98</sup> At a time when certain other countries are thinking of following South Africa's lead, the downgrade of South African sovereign credit rating would seem to suggest that while concluding investment treaties under certain conditions may lead to a reduction in a country's cost of capital, withdrawing from investment treaties may result in increased costs. On the other hand, although Indonesia announced its intention in 2014 to withdraw from all sixty-seven of its BITs,<sup>99</sup> its sovereign debt credit rating, which had al-

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96. Sovereign Credit Ratings, via Bloomberg Finance LP, (last accessed November 10, 2016).

97. See *South Africa Begins Withdrawing from EU-Member BITs*, INV. TREATY NEWS: NEWS IN BRIEF (Oct. 30, 2012), <http://www.iisd.org/itn/2012/10/30/news-in-brief-9/>.

98. In 2011, for example, Moody's rated South African Sovereign debt as A2 but by 2014 its rating had declined to Baa1. Sovereign Credit Ratings, South Africa, via Bloomberg Finance LP (last accessed November 10, 2016).

99. See Ben Bland, *Indonesia To Terminate More Than 60 Bilateral Investment Treaties*, FIN. TIMES: ASIA PACIFIC (Mar. 16, 2014), <https://www.ft.com/content/3755c1b2-b4e2-11e3-af92-00144feabdc0> (last visited October 24, 2016).

ready been a low Baa3 since 2012, remained unchanged from the time of its declaration through the end of 2015.<sup>100</sup>

### 3. *Good Governance Indicators and Investment Treaties*

To examine the possible effects of strong Q-BITs signals on the perceived political risk of host countries, the study resorted to the Worldwide Governance Indicators database compiled by the World Bank.<sup>101</sup> For 215 countries over the period 1996-2014, this data set reports on six broad dimensions of governance including Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. Among these six dimensions, the research study determined that the Rule of Law indicator was the most reflective of political risk to investments since its purpose is to capture perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.<sup>102</sup> The Worldwide Governance Indicators database employs two principal indicators of “Rule of Law” in the dataset. The first one is the estimate score calculated by the World Bank, which gives a country’s score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. The second one is the percentile rank indicating the country’s rank among all countries covered by the aggregate indicator, with zero corresponding to lowest rank, and 100 to highest rank. Percentile ranks have been adjusted to correct for changes over time in the perception of the quality of the rule of law in the countries covered. The research study concluded that the second indicator—percentile rank—was more appropriate for purpose of examining political risk because the percentile rankings permitted more meaningful interpretative comparisons among countries and time periods while the estimate scores were much harder to interpret and did not facilitate meaningful comparisons.

As a first step, the research study examined the overall trend of the average percentile rank of the Strong Q-BITs Signal Group during the period from 1996, when the World Bank first began to compile data on perceptions of the rule of law, until 2014. The study found that the average percentile rank of the twenty-six countries in the Strong Q-BITs Signal Group

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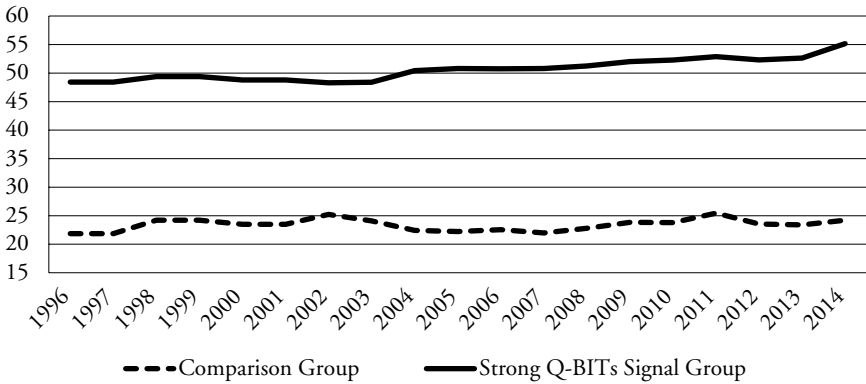
100. Sovereign Credit Ratings, Indonesia, via Bloomberg Finance LP (last accessed November 10, 2016).

101. *Worldwide Governance Indicators*, WORLD BANK, <http://data.worldbank.org/data-catalog/worldwide-governance-indicators> (last updated Sept. 25, 2015).

102. The World Bank Governance website states the scope of the rule of law for purposes of the database on governance: “Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. This table lists the individual variables from each data source used to construct this measure in the Worldwide Governance Indicators.” *Worldwide Governance Indicators*, WORLD BANK, <http://info.worldbank.org/governance/wgi/index.aspx#doc> (follow “Rule of Law” hyperlink under “Introduction”) (last visited Oct. 3, 2016).

increased from 48.4 in 1996 to 55.2 in 2014, an average increase of 6.7 percentage points. In contrast, the average percentile rank of the fifteen countries in the Comparison Group increased from 21.9 in 1996 to 24.2 in 2014, an increase of only 2.3 percentage points. As revealed in Table 11, the difference in the trends of the two groups is especially striking after 2002, as strong Q-BITs signals mostly took effect after that date. Between 2002 and 2014, the average percentile ranking in the Strong Signal Q-BITs Group rose by 6.9 percentage points, while that of the Control Group decreased by 1.0 points.

TABLE 11. AVERAGE PERCENTILE RANKING IN THE STRONG Q-BITs SIGNAL GROUP AND THE COMPARISON GROUP BETWEEN 1996 AND 2014



In a second step of the inquiry into political risk, the study examined the Percentile Rule of Law Rank Changes in each of the countries in the Strong Q-BITs Signal Group. Applying the same methodology used in the long-term effect analysis of capital flows discussed earlier in this article, it compared the average rule of law rankings in each of the three three-year intervals during the nine years after the Strong Q-BITs Signal Periods ended, with the average figure during the Strong Q-BITs Signal Periods as the base year number. Due to lack of available data, the study had to exclude two countries: Russia and Slovakia. The study, therefore, covered only twenty-four countries rather than twenty-six.<sup>103</sup> Based on an analysis of the data, compared to the base-year number, the study found that twelve countries (or 50%) improved percentile rank during the first three-year interval after Strong Q-BITs Periods ended, twelve countries (50%) improved percentile ranking during the second three-year interval, and fifteen countries (62.5%) improved percentile ranking during the third three-year interval. Overall,

103. The Strong Q-BITs Periods of Russia and Slovakia ended in 1991 and 1992. We could not find meaningful data for the base-year figure.

sixteen of the twenty-four countries, or two-thirds, in the Strong Q-BITs Signal Group showed improved ranking of the Rule of Law in at least one of the three three-year intervals after the Strong Q-BITs periods ended, compared to its average rank within the base years. Moreover, thirteen of the twenty-four countries (54.2%) in the Strong Q-BITs Signal Group showed improved ranking of the Rule of Law in at least two of the three three-year intervals after the Strong Q-BITs periods ended, compared to the average rank within the base years. The findings may well indicate a moderately positive association of a Strong Q-BITs Signal on the improvement of Rule of Law estimates in the host countries concerned. At the same time, it should be noted that the results of this analysis may underestimate the real effect of Strong Q-BITs Signals because the research study did not have ranking data before or at the beginning of the Strong Q-BITs Signal Periods. Therefore, the base-year ranking data applied in the analysis may actually have already incorporated the strong instant effects of Q-BITs enforcements discussed above. Table 12 presents the changes in Rule of Law ranking for each of the countries in the Q-BIT Strong Signal group.

TABLE 12. PERCENTILE RANKING CHANGE AFTER THE STRONG Q-BIT'S SIGNAL PERIODS

No.	Country Name	Q-BIT Period		Percentile Rank Change (v.s. base year)		
		From	To	1st 3-years	2nd 3-years	3rd 3-years
1	Albania	1993	1999	(1.52)	9.01	13.85
2	Argentina	1992	1997	(4.15)	(21.21)	(22.81)
3	Chile	1994	1999	3.35	3.99	4.29
4	Croatia	1996	2002	11.57	12.14	17.51
5	Cuba	1995	1999	0.64	(3.03)	7.85
6	Czech Republic	1991	1996	(1.28)	(7.81)	(2.71)
7	Estonia*	1992	1995	1.75	4.63	13.08
8	Hungary*	1987	1993	--	(1.28)	0.16
9	India	1996	2002	(2.92)	(2.19)	(4.71)
10	Indonesia	1993	1996	(8.29)	(13.88)	(15.95)
11	Iran	2004	2008	(6.22)	(7.04)	(10.38)
12	Latvia	1992	1999	2.31	12.04	16.62
13	Lebanon	1997	2004	(10.79)	(14.92)	(17.21)
14	Lithuania	1992	1997	2.87	0.48	6.70
15	Macedonia	1997	2002	6.38	5.97	13.59
16	Mexico	1999	2003	2.20	(6.32)	(3.35)
17	Peru	1993	1997	0.32	3.83	1.59
18	Philippines	1995	1999	(13.16)	(13.80)	(11.66)
19	Poland*	1988	1994	--	7.18	1.44
20	Romania	1992	1998	(2.55)	(3.35)	0.48
21	Slovenia	1997	2003	(5.17)	(1.80)	(2.22)
22	South Africa	1997	2000	0.08	2.47	1.42
23	Ukraine	1993	2001	9.09	10.21	10.26
24	Vietnam	1993	1996	1.28	1.75	3.35

\* For Estonia, Hungary and Poland, the percentile ranking in 1996 was used as the base-year figure.

#### 4. *Tentative Conclusions on Investment Treaties and the Cost of Capital*

The cost that a country must pay for foreign capital depends on a complex combination of factors, including the nature of the recipient, the purpose,



return and risk of the investment, and the country risk of the country concerned. To the extent that credit ratings and governance quality affect country risk perceptions by investors, they can have a direct bearing on the cost that countries will have to pay for that investment. The data in this study indicates that certain countries at least have experienced an improvement in credit rating and perceived governance quality following the completion of a program to bring investment treaties into effect and they therefore may have reduced their cost of capital as a result. A causation relationship remains to be proven. Nonetheless countries seeking to increase the flow of capital and reduced costs should consider the investment treaty as one tool, among many others, that may assist in securing increased quantities of capital at reduced cost.

## VII. GENERAL CONCLUSIONS

The purpose of this article has been to contribute to the debate on the utility of investment treaties by raising certain questions and offering certain perspectives that previous scholarship has not explored in depth. There are in effect six such issues and perspectives that this article has raised.

First, scholars of investment treaties should view investment treaties not merely as instruments of international law that impose legal rights and duties on signatory states but also as signals to international capital markets. In analyzing treaties as signals, one may usefully draw on signaling theory and the economics of information.

Second, studies of the effect of investment treaties should expand their scope to determine the impact of treaties on all types of capital flows, not just direct foreign investment, which seems to have been the almost exclusive focus of previous studies. Investment treaties generally protect all forms of foreign capital, an implicit recognition by contracting states that direct foreign investment tells only part of the development story: Debt and portfolio investments are also important sources of development finance. This article has tried to broaden the inquiry and has found evidence that bilateral investment treaties in sufficient numbers and under certain conditions may be associated with increased inflows of capital of all types to developing countries.

Third, in evaluating the utility of investment treaties, scholars and policymakers should not only look at the quantity of capital received by developing countries but also the price that they must pay for it. Thus far, few, if any, studies have asked if investment treaties result in a reduction of perceived country risk and therefore a reduction in a country's cost of capital. This article has sought to ask that question and to offer some tentative and preliminary data in that regard, data that suggests that bilateral investment treaties in sufficient numbers and under certain conditions may correlate with conditions leading to a reduction in the cost of capital. The

connection between investment treaties and their effect on country risk needs further exploration, perhaps by using data on sovereign risk spreads as a proxy for country risk. It is equally important for officials and scholars urging countries to withdraw from investment treaties to recognize that such withdrawals may have the result of increasing a country's cost of capital and that the amount of such potential cost increases needs to be taken account of in any decision to abandon particular investment treaties or any attempt to drop out of the investment treaty regime entirely.

Fourth, evidence supports the proposition that to attract meaningful amounts of capital at acceptable costs, the treaties that countries make should be part of a concerted program that envisages significant numbers of treaties with leading capital-exporting countries. Desultory treaty-making may yield diplomatic benefits, but it is not likely to result in large increases in capital inflows because of its weakness as a signal to international capital markets.

Fifth, while BITs are legally bilateral in structure in that they technically affect only the two countries concerned, it is apparent that when developing countries undertake concerted programs of investment treaty-making, they are also engaged in signaling their intentions to international capital markets generally; such countries should incorporate that insight into their strategies so as to take account of international capital markets, not just the two contracting states, and the signaling process toward those markets.

Sixth, and finally, the model of investment treaty-making in the minds of many scholars and officials is that it has been a process driven by capital-exporting countries in which developing countries have passively, if not reluctantly, engaged. While that model may be applicable to some developing countries, it does not apply to all. There is ample evidence that particular developing countries, such as South Africa, Croatia and Poland, actively undertook specific programs to negotiate bilateral investment treaties so as to assure international capital markets of their strong commitment to and benevolent intentions toward foreign capital.<sup>104</sup> They clearly saw investment treaties as important policy tools that would help them secure the capital they needed for their development.

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104. In the case of South Africa, for example, see POULSEN, *supra* note 74, at 162–91.