Memo to US: only fools rush in

If negotiators aren't careful, a US-China investment treaty could prove as explosive as currency manipulation or climate change

Sarah Anderson
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US diplomats are no doubt eager to find something – anything – on which the Obama administration and China can agree. So perhaps it should come as no surprise that they appear eager to make progress in the seemingly sleepy arena of bilateral investment treaty (BIT) negotiations.

It's true these deals haven't grabbed headlines in the past, but if US officials aren't careful, this one could become as explosive as current redhot issues with China, such as currency manipulation, computer hacking, and climate change.

It was President Bush who launched the US-China BIT negotiations. Then last November, Presidents Barack Obama and Hu Jintao announced they would "expedite" them. According to Inside US Trade, undersecretary of state Robert Hormats said on 10 March that the administration is very close to having model treaty text.

Similar to the investment chapters in US trade agreements, BITs give foreign investors the right to bypass domestic courts and sue governments in international arbitration tribunals.

The United States has been at limited risk of being the target of such "investor-state" lawsuits because its 40 current treaty partners are nearly all developing economies with little investment in the US market. This lopsidedness has created a one-way street in favour of US corporations operating abroad.

The China negotiations could change all that. Chinese investors have ploughed billions into the US economy, particularly in the financial industry. Under a treaty based on current models, these investors would have standing to sue the US government over breaches of a long list of host government obligations.

Of particular relevance to the China BIT is the obligation to provide foreign investors "fair and equitable treatment." In some cases, tribunals have interpreted these vague terms to mean that a government must provide a stable and predictable regulatory environment. On this basis, they have ordered governments to pay compensation to investors who claimed that changes in regulations or tax policies had made their investments less valuable.

At a time when our regulations have just failed to prevent the worst financial crisis in nearly 80 years, predictability should not be a top priority. And indeed, the Obama administration is pursuing reforms that would have been quite unpredictable two years ago and which would strike at least a short-term blow to some Chinese investments.

Take, for example, the nearly 10% stake in Morgan Stanley held by China Investment Corporation (CIC), a sovereign wealth fund. Recently, Goldman Sachs researchers estimated that proposed regulatory reforms could reduce Morgan Stanley's annual earnings by 15%. President Obama's plan for a Financial Crisis Responsibility Fee could cost the firm $800m, they predict, while the proposed "Volcker rule" to prohibit proprietary trading by banks could cost another $600m per year.

Could Chinese investors use a bilateral investment treaty to undermine such US financial reforms? Legal experts are divided. Some argue that a provision in current US treaties gives sufficient protection against claims related to financial stability measures. Others, such as Professor Robert Stumberg, director of the Harrison Institute for Public Law at Georgetown University, disagrees, pointing to language in the same provision that arbitrators could interpret as a self-cancelling loophole.

If the ambiguity isn't fixed, investors could file their claims before a tribunal and let the commercial arbitrators decide. If the government lost, they'd have two choices: repeal the reform or pay off the foreign investors. Neither option would be a winner with the American public.

Last year, I served on an advisory committee representing business associations, labour unions, environmental groups, and other investment experts which unanimously recommended that the administration conduct a legal analysis of this matter. Nine of us went further to call for a whole new approach to BITs, including the replacement of the investor-state dispute mechanism with a government-to-government one. It's our view that the current system simply gives foreign investors – including US corporations operating abroad – way too much power.

Negotiators need to keep in mind that BITs are like straitjackets, with rules locked in for a minimum of 20 years. With US leaders struggling to fix our broken financial system, this is no time to rush into a deal we'll be stuck with for decades to come.