

## **China's new bilateral investment treaty programme: Substance, rational and implications for international investment law making**

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### **Abstract:**

This article aims at empirically investigating the evolution of China's BIT policy since the early 1980s and compares it with current developed country approaches. Analysing the development of substantive and procedural investment protection provisions, it argues that China has pro-actively initiated a remarkable change of its formerly restrictive BIT policy towards a liberal approach. Since 1998, Beijing is negotiating BITs that contain comprehensive investor-state dispute settlement provisions. China even abandoned its hostile stance on national treatment of foreign investors. Notwithstanding existing reservations towards unrestricted national treatment, the current Chinese model agreement is comparable to the admission model BIT adopted by European countries. The prospects of the proposed Sino-US BIT, however, are looking rather bleak. This is mainly due to fundamental differences with respect to the parties view on the protection of FDI in the pre-establishment phase and the current political environment in the US that accentuates national security concerns with regard to foreign investors from developed and emerging countries.

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## 1 Introduction

China's rise as an economic player is causing significant power shifts in the world economy.<sup>1</sup> Its strength as a low cost manufacturer helps to supply global markets with cheap products and simultaneously increases the global demand for commodities. This growing economic presence – in accordance with the classical argument by Paul Kennedy on “The Rise and Fall of the Great Powers”<sup>2</sup> – consequentially augments China's political influence in international relations.

A phenomenon demonstrating China's economic rise is its growing outward foreign direct investments (FDI). They have recently been discussed widely in the literature as part of a larger trend of developing countries emergence as sources of investments.<sup>3</sup> Less visible in the literature is a second trend, namely Beijing's growing acceptance of international investment agreements as legal instruments for the protection of FDI.<sup>4</sup> Most notably, China has been negotiating bilateral investment treaties (BIT) since the end of the 1990s that include far reaching substantive and procedural investment protection. This new policy was a turning away from China's traditional stance towards international investment law that accentuated the host country's sovereign right of regulating foreign investments – a policy typical for FDI-importing countries.

Against this background this paper aims at empirically investigating the evolution of China's BIT policy since the early 1980s and compares it with current developed country approaches. After the introduction, chapter 2 will give an overview of the development and substance of today's global BIT system. Chapter 3 describes the rise of China as a home country for outward FDI and its strategic determinants. Chapter 4 will outline China's traditional restrictive BIT approach. Chapter 5 argues that China is negotiating liberal BITs with developing as well as developed countries since 1998 that are similar to the European model treaty. Chapter 6 will summarise the main findings and give a preliminary assessment of the background and prospects of success of the ongoing BIT negotiations between China and the US.

## 2 Protection of foreign investment through bilateral investment treaties

The global governance system for FDI is made up of a dense and complex network of international investment agreements that are usually concluded on a bilateral basis. Bilateral investment treaties (BIT) hence form the most important legal institution for the governance

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<sup>1</sup> See e.g. Kaplinsky and Messner (2008).

<sup>2</sup> Kennedy (1987).

<sup>3</sup> See e.g. Sauvart (2005); UNCTAD (2006); Aykut and Goldstein (2006); Broadman (2007); Pamlin and Baijin (2007); UNCTAD and UNDP (2007).

<sup>4</sup> See e.g. Kong (2003); Cai (2006; 2007); Chen (2006; 2007); Braun and Schonard (2007); Rooney (2007); Berger (2008a); Heymann (2008).

of FDI.<sup>5</sup> They are defined as agreements that “protect investments by investors of one state in the territory of another state by articulating substantive rules governing the host state’s treatment of the investment and by establishing dispute resolution mechanisms applicable to alleged violations of those rules.”<sup>6</sup> The aim of BIT contracting parties is to promote economic cooperation, believing that enhanced legal protection will ultimately result in increasing FDI flows fostering economic development processes in host as well as home countries. BITs, however, do not allow for direct regulatory measures by host states potentially increasing the developmental impact of FDI. Furthermore, the results of quantitative econometric studies on the effectiveness of BIT in increasing FDI flows are mixed and lead to an inconclusive picture.<sup>7</sup>

The concept of *legalisation* as developed by Abbott et al. will be used to describe the characteristics of the global BIT system.<sup>8</sup> Legalisation is a special form of institutionalisation – understood as the expansion of rules, norms and decision-making procedures that influences expectations, interests and behaviour of actors – and “represents the decision [...] to impose international legal constraints on governments.”<sup>9</sup> The degree of legalisation varies substantially from one issue area to another and within issue areas over time. Along three main criteria – *obligation, precision and delegation* – the degree of legalisation can be described as a continuum ranging from soft to hard law. In this respect,

“[h]ighly legalized institutions are those in which rules are obligatory on parties through links to the established rules and principles of international law, in which rules are precise (or can be made precise through the exercise of delegated authority), and in which authority to interpret and apply the rules has been delegated to third parties acting under the constraints of rules.”<sup>10</sup>

The current institutional structure in the area of international investment protection is highly legalised according to the above mentioned characteristics. With respect to the first criteria, modern BITs entail rules that impose binding obligations on the parties which can be enforced through investor-state dispute settlement. Although BIT texts are often drafted in an open and imprecise manner – usually encompassing no more than ten pages – they can be described as hard law as they delegate the authority of interpretation and implementation to transnational

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<sup>5</sup> See e.g. Dolzer and Stevens 1995; UNCTAD 1998, 2007b. Beyond BITs, investment rules are increasingly being incorporated in double taxation treaties and economic integration agreements like free trade agreements. See UNCTAD (2000; 2006b). On the multilateral level, investment-related rules are mainly incorporated into single WTO agreements such as the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Among member countries of the OECD the whole spectrum of international investment relations is governed in the Code of Liberalization of Capital Movements (CCM) and the Declaration on International Investment and Multinational Enterprises (DIIME). See Berger (2008a): 3-5 for an overview.

<sup>6</sup> Vandeveld (2000): 469–470.

<sup>7</sup> See e.g. Hallward-Driemeier (2003) and Tobin and Rose-Ackermann (2005) that find no or only little evidence for the effectiveness of BITs. Banga (2003), Neumayer and Spess (2005) and Busse et al. (2008), instead, arrive at a positive relationship between BIT and FDI.

<sup>8</sup> Abbott et al. (2000).

<sup>9</sup> Goldstein et al. (2000): 386.

<sup>10</sup> Abbott et al. (2000): 418.

arbitration bodies.<sup>11</sup> BITs notably grant foreign investors direct legal personality under international law.<sup>12</sup> Without being obliged to submit a claim to domestic courts, foreign investors may sue host countries directly before a transnational tribunal and thus limit national legal sovereignty: “once in force, the role played by non-state actors in the regime’s enforcement mechanisms can be of greater significance than the role played by states.”<sup>13</sup>

Modern BITs usually provide foreign investors with high levels of substantive and procedural protection. They follow a *liberal approach* to international investment protection.<sup>14</sup> Liberal, i.e. highly legalised, BITs include broad definitions of investment, comprehensive absolute and relative standards of treatment, provisions on the compensation for expropriation and the free transfer of funds as well as unrestricted investor-state dispute settlement mechanisms. While providing high levels of legal protection for foreign investors, liberal BITs limit host countries’ regulatory discretion to restrict national laws and regulations on the entry and operation of multinational enterprises (MNE). The utilisation of liberal investment agreements tends to lead to a more open and less regulated global investment regime. The *restrictive approach*, in contrast, includes several regulations limiting the substantive and procedural protection of foreign investments and thereby preserves the sovereign right of host states to maintain national laws and regulations on the entry and operation of foreign investors in accordance with national development strategies.

Throughout the colonial period foreign investments in developing countries were protected mainly by customary international law. The home state – not the foreign investing company – was the single party allowed to seek redress of an alleged injury by the host state and only breaches of minimum standards of the treatment of foreign investors gave rise to a claim under such law of state responsibility. Hence, customary international investment law provided very little protection.<sup>15</sup> The earliest rules to protect FDI flows were incorporated in treaties on friendship, commerce and navigation (FCN) first concluded by the US in large numbers during the late 18<sup>th</sup> century. These early FCN treaties, however, only partially contained rules on investment. Post-Second World War FCN treaties used to be more investment specific, containing a number of substantive and procedural rules for investment protection that were later adopted in BITs.<sup>16</sup>

The first BIT was signed between Germany and Pakistan in 1959, in 2006 their total number has been accounted to more than 2,500 treaties worldwide.<sup>17</sup> Throughout the 1970s and 1980s

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<sup>11</sup> Keohane et al. (2000): 485 state that in „transnational dispute resolution, [...] access to courts and tribunals and the subsequent enforcement of their decisions are legally insulated from the will of individual national governments. These tribunals are therefore more open to individuals and groups in civil society.”

<sup>12</sup> See Peterson (2005): 8.

<sup>13</sup> Schneidermann (2004): 68.

<sup>14</sup> Both the liberal and the restrictive BIT approaches are understood as ideal types. In the Weberian sense ideal types are “formed by the one-sided accentuation of one or more points of view and by the synthesis of a great many diffuse, discrete, more or less present and occasionally absent concrete individual phenomena, which are arranged according to those one-sidedly emphasized viewpoints into a unified analytical construct”, see Weber (1997): 88.

<sup>15</sup> See Weil (2001).

<sup>16</sup> See Vandeveld (1992); Sornarajah (1994).

<sup>17</sup> See UNCTAD (2007a).

BITs slowly spread, with roughly 20 treaties being signed annually mainly between European and developing countries. With the decision of the US to adopt BITs as a foreign investment protection device their number started to increase sharply. When the block of developing countries decided to give up their struggle for a “New International Economic Order”, including the right of host states to expropriate foreign companies’ investments in the natural resource sector, the number of BITs rose even further since developing countries started to compete in capturing a share of global FDI flows, facing the dilemma of either signing BITs that privileged the contracting party exporting FDI or possibly losing FDI to other countries increasing their competitive advantage.<sup>18</sup>

Although BITs are generally negotiated on a reciprocal basis, providing the same level of legal protection for both signatories, they are in fact agreements between a FDI-exporting and a FDI-importing country. The actual level of investment protection found in BIT provisions, therefore, is a function of the expectations of both parties and their respective bargaining power. Due to the fact that developing countries depend on FDI inflows as a source of external financing they usually agree to the model agreements put forward by FDI-exporting countries. The level of legalisation in international investment law has therefore grown strongly since the early 1990s. Only large developing countries like China, India and Brazil were able to refrain from signing liberal BITs.<sup>19</sup>

BIT contents today show a considerable uniformity with regard to general provisions on substantive and procedural protection of foreign investments. The main difference found in liberal BITs is the degree to which they protect investments already in the pre-establishment phase – i.e. before the FDI project has been admitted through the host country’s authorities in accordance with national laws and regulations:

“This approach consists in providing foreign investors with national treatment and MFN treatment not only once the investment has been established, but also with respect to the establishment. This means that investors of one party will receive treatment not less favourable with regard to investing in the territory of the other party than domestic investors and investors of any other third country.”<sup>20</sup>

The *admission model* BIT that has been adopted by European countries and developing countries such as China alike provides investment protection only after the admission of the FDI project. The *pre-establishment model*, applied by the US from the 1980s onwards, by Canada from the mid 1990s onwards, and by Japan from the beginning of this century entails provisions on the protection of FDI even before their admission. These treaties restrict the screening powers of host states in the pre-establishment phase and their sovereignty in regulating the entry of foreign investors, leading to a liberalisation of host countries’ regulatory systems.<sup>21</sup>

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<sup>18</sup> See e.g. Guzman (1998) and Elkins et al. (2006).

<sup>19</sup> China’s traditional restrictive BIT approach will be described in more detail in section 4.

<sup>20</sup> UNCTAD (2007b): 22.

<sup>21</sup> Gugler and Tomsik (2007); UNCTAD (2007b): 23.

### 3 China's emerging outward foreign investments

The growth of Chinese outward FDI is the latest stage of an economic growth process that started in the late 1970s with the Chinese leadership's decision to gradually open up the economy. During the last three decades China has been mostly perceived as the workbench of the global economy, receiving large inflows of foreign investments in export oriented industries. China is traditionally seen as the largest developing host country of global FDI. It accounted for a total stock of US\$292 billion in 2006 and attracted FDI flows amounting to US\$69 billion in 2006. With China still being a net FDI-importing country, it has recently become an important source country for foreign investments, too. Outward FDI flows grew particularly strongly from a low basis in the first half of the 1990s, before slowing down toward 2000 and increasing again thereafter. Especially noteworthy is the sharp increase of outward FDI flows from US\$12 billion in 2005 to US\$16 billion in 2006. China is currently the 7<sup>th</sup> largest foreign investor among developing countries in terms of stocks. Accumulated outward FDI, having been marginal during the first half of the 1980s, have since grown strongly and reached US\$73 billion in 2006.<sup>22</sup>

Apart from the strong growth of foreign investments by Chinese enterprises in absolute terms, outward FDI is still surpassed by the volume of inward FDI. However, the outward/inward FDI ratio – an indicator which refers to what Dunning has called a “country's net international direct investment position”<sup>23</sup> – shows that outflows from China grew more rapidly than inflows during the last years, demonstrating that China's overall importance as an FDI-exporting economy is evolving. China's total outward/inward FDI ratio has been growing strongly – although from a low basis – since 2002 and stood at 17 in 2005. Notably, the outward/inward FDI ratio towards developing countries is almost double the overall ratio and roughly six times higher than the ratio towards developed countries. This summary of the relative distribution of reciprocal FDI flows suggests that China's interest in strong legal investment protection through BITs is especially pronounced towards developing countries.<sup>24</sup>

The geographical distribution of Chinese outward FDI flows has undergone a major shift since the beginning of the 1990s. While developed countries were its main destination during the 1980s, Chinese outward FDI today is predominantly conducted on a South-South basis; i.e. its main recipients are developing countries. Apart from this general observation, disaggregated Chinese outward FDI flows have to be interpreted with great caution. Statistical problems occur with regard to the treatment of round-tripping FDI and foreign investments in offshore-financial centres.<sup>25</sup> Against this background, the following figures are indicative only. A compilation of data from various editions of the “Almanac of China's Foreign Economic Relations and Trade”, published annually by the Chinese Ministry of Commerce (MOFCOM), shows that Asia has been the main destination of Chinese FDI during the period of 2003 to 2005, attracting 38 per cent of all Chinese outward FDI. During the same period, Latin America absorbed 32 per cent and Europe 15 per cent. Africa ranked fourth, accounting

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<sup>22</sup> UNCTAD (2007a): 299-306.

<sup>23</sup> Dunning (1981): 30.

<sup>24</sup> See Berger (2008a): 11-15.

<sup>25</sup> See Berger (2008a): 8-9.

for 7 per cent of Chinese outward FDI even ahead of North America's 4 per cent. Oceania attracted 3 per cent of Chinese outward FDI during the respective period.<sup>26</sup> With regard to their sectoral distribution, Chinese outward FDI are mainly conducted in the manufacturing, resource-seeking and the IT and software sectors.<sup>27</sup>

Chinese outward FDI is bound to increase in the future. Reasons for this dynamic can be found in political and business sector drivers. With respect to the latter, increasing foreign investments is a result of push factors at the domestic level and pull factors at the global level. On the one hand, in the wake of the accession to the World Trade Organization (WTO) in 2001 and the subsequent need to relocate mature industries to lower wage economies, especially to neighbouring Asian countries, Chinese companies are confronted with a growing competitive pressure on the domestic market.<sup>28</sup> On the other hand Chinese companies are increasingly taking advantage of the global business environment's opportunities. In contrast to the traditional perspective found in the business literature that attributes (Western) multinationals' internationalisation to a previous accumulation of competitive advantages (asset exploitation), recent studies suggest that multinationals from emerging economies tend to internationalise in order to build up competitive advantages (asset augmentation).<sup>29</sup> Recent large merger & acquisitions (M&A) emphasize that this development applies especially to Chinese multinationals. They invest abroad in order to acquire scarce advanced technologies, brand names, distribution networks and managerial know-how,<sup>30</sup> and as Wang argues, Chinese enterprises frequently use outward FDI as a means to gain access to developed country markets often protected by trade barriers of regional blocs.<sup>31</sup>

Large Chinese companies rely strongly on their government's support when intent on investing in strategically important sectors and countries, especially in developing countries. The current Chinese "Going Global" strategy aims at encouraging Chinese companies' foreign investments abroad. This strategy, which was first announced in 1998 and was embedded in the Tenth Five-Year Plan for National Economy and Social Development in 2001, marked the transition of Beijing's outward FDI policy from *regulations* to *encouragement*.<sup>32</sup> The build-up of a number of global champions capable of competing on the global market has since been an explicit industrial policy goal reconfirmed by the "Going Global" strategy. The current government gives priority to resource exploration projects, the export promotion of domestic technologies, overseas research and development as well as M&As enhancing the international competitiveness of Chinese enterprises, accelerating their foreign market presence.<sup>33</sup>

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<sup>26</sup> See Berger (2008a): 11-12.

<sup>27</sup> MOFCOM data for the year 2005 shows the following sectoral distribution of Chinese OFDI: manufacturing (30 per cent), resource-seeking (29.8 per cent), IT and software (27.3 %), business services (5.4 per cent), retail (3.4 per cent), communication (2.2 per cent) and others (5.4 per cent), cited in Lunding (2006): 2.

<sup>28</sup> UNCTAD (2004): 25, 27.

<sup>29</sup> See e.g. Mathews (2002; 2006).

<sup>30</sup> See Lunding (2006): 4.

<sup>31</sup> Wang (2002): 202.

<sup>32</sup> See Cai (2006): 626.

<sup>33</sup> See UNCTAD (2006): 210.

The growth of Chinese outward FDI in recent years emphasises the need to comprehend China not only as an FDI-importing country, but increasingly as an FDI-exporting economy, too. The reconfiguration of Chinese FDI flows is thought to have led to a significant change of Beijing's stance on the protection of foreign investments from a restrictive to a liberal approach. Before chapter five will investigate China's new liberal BIT policy, it will be necessary to describe the main features of its old restrictive approach in the following chapter.

#### 4 China's traditional approach towards international investment law

The overall economic reform process which started in 1978 led to significant changes in China's stance on international investment law. During the first three decades of self-imposed isolation from the world market (all through the 1950s until the late 1970s), Beijing adopted a hostile approach towards international investment law and the protection of FDI. One major rationale for this policy can be found in China's adherence to the Marxist doctrine of rejection of private property. Another rationale for China's hostile stance on international investment protection lay in China's experience of colonial rule and foreign interventions. International (investment) law had hence been viewed by Chinese politicians and scholars as a means "used by the imperialists and hegemonists [...] to carry out aggression, oppression and exploitation".<sup>34</sup> Its validity, had therefore been rejected. China's hostile approach towards foreign investments and its import-substitution strategy notably coincided with most developing countries' attempts to establish a New International Economic Order. In sum, China's policy accentuated the sovereign right to control the entry of FDI, regulate foreign investors and nationalise foreign property without being obliged to compensation. Consequently, China signed no BIT until 1982 when it concluded a first treaty with Sweden.<sup>35</sup>

In June 2007, China had already concluded 120 BITs,<sup>36</sup> making it the second largest contracting party to BITs worldwide.<sup>37</sup> This increase in the sheer number of agreements since the early 1980s reveals Beijing's growing acceptance of international investment law. With regard to actual treaty provisions and their effectiveness in protecting foreign investments, however, it takes two different stages important to be examined in order to gain a clear understanding of the historical evolution of China's BIT approach. In 1998 Beijing changed its international investment policy from a restrictive mode accentuating the regulation of inward FDI to a liberal approach emphasising the encouragement of outward Chinese FDI.<sup>38</sup> This remarkable change in China's international investment policy making has been ascribed by a number of scholars to China's evolution from a mere FDI-importing country to an economy that – while still receiving large amounts of foreign investments – is increasingly investing abroad. China is becoming a FDI-exporting economy.

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<sup>34</sup> Kong (2003): 108.

<sup>35</sup> Kong (2003): 109.

<sup>36</sup> See the Investment Treaties Online database provided by UNCTAD, available at: [http://www.unctadxi.org/templates/DocSearch\\_779.aspx](http://www.unctadxi.org/templates/DocSearch_779.aspx), accessed 16 October 2008.

<sup>37</sup> Germany has signed 136 BITs until June 2007.

<sup>38</sup> See e.g. Cai (2006): 626.



The remaining part of this chapter will investigate the main first-generation BIT provisions that characterise the restrictive approach, while the next chapter will examine the characteristics of China's second-generation of BITs, comparing them with both the European admission model and the US pre-establishment model.

Chinese BITs contain all standard provisions found in global BIT practice. They usually start with a preamble stating the intention of creating "favourable conditions for investments of investors of one Contracting Party in the territory of the other Contracting Party" aiming at promoting mutual investments. The BIT is meant to "intensify the economic cooperation of both States on the basis of equality and mutual benefit."<sup>39</sup> The general pre-1998 (as well as the post-1998) BIT adopts the widespread admission model. Accordingly, absolute and relative standards of treatment of FDI in Chinese BITs are only in force once the investment has been admitted by the host countries' government. Furthermore, Chinese BITs entail provisions on the definition of investment and the investor, their treatment, expropriation, the transfer of funds, compensation for losses due to war, civil strife and the settlement of disputes. In the following, the main emphasis will be laid on relative and procedural investment protection provisions. They are for one part generally acknowledged to represent the most important elements of BITs and they are furthermore central to the understanding of the evolution of China's approach.

Throughout the 1980s and 1990s China adopted an international investment policy approach characteristic of any given FDI-importing developing country. China's restrictive policy adopted the so-called "three guiding principles" of international economic co-operation and exchange. China's authorities upheld their *sovereignty* to screen and regulate FDI, insisted on the *equality and mutual benefit* of host and home state and referred to the *international practice*.<sup>40</sup> Kong observes that it "is obvious that utilitarianism or even mercantilism has been the driving force behind the investment legislation" and that "China's attitude towards FDI in this period was rooted in mixed feelings of attraction and aversion."<sup>41</sup> While negotiating BITs in great numbers, the Chinese international investment policy until the late 1990s remained marked by a reluctance to imply strong legal protection to foreign investments.

Until 1998, China signed BITs containing serious reservations towards strong substantive as well as procedural protection of foreign investments. With regard to relative standards of treatment of foreign investors, China appeared reluctant to grant national treatment; i.e. not to discriminate between domestic and international investors. The aim of protecting infant industries and especially state-owned enterprises from foreign companies' competition may serve as an explanation in this regard. A number of BITs with developed countries made an exception and included provisions on national treatment; however, they contained far-reaching qualifications limiting the effective protection of foreign investments. Article 3 (3) of the Sino-UK BIT concluded in 1986 states that:

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<sup>39</sup> See e.g. China-Egypt BIT (1994).

<sup>40</sup> Kong (2003): 110.

<sup>41</sup> Kong (2003): 110.

“either Contracting Party shall to the extent possible, accord treatment in accordance with the stipulations of its laws and regulations to the investments of national or companies of the other Contracting Party the same as that accorded to its own nationals or companies.”

Similar provisions can be found in the BITs with Slovenia (1993) and Iceland (1994). The best-effort character and the requirement to comply with national laws and regulations substantially reduced the effectiveness of these national treatment provisions. The wording of Article 3 (1) of the Sino-Japan BIT from 1988 implies a rather strong national treatment provision in comparison:

“The treatment accorded by either Contracting Party within its territory to nationals and companies of the other Contracting Party with respect to investments, returns and business activities in connection with the investment shall not be less favourable than that accorded to nationals and companies of the former Contracting Party.”

This provision, however, is being qualified by further explanations of the term “less favourable” in paragraph 3 of the Sino-Japan BIT's protocol:

“For the purpose of the provision of paragraph 2 of Article 3 of the Agreement, it shall not be deemed ‘treatment less favourable’ for either Contracting Party to accord discriminatory treatment, in accordance with its applicable laws and regulations, to nationals and companies of the other Contracting Party, in case it is really necessary for the reason of public order, national security or sound development of national economy.

In sum, national treatment provisions were very rarely included in the first generation of Chinese BITs. In case that they formed part of the treaties, they were qualified to the extent that they enabled the Chinese authorities to discriminate against foreign investors in favour of domestic industries. Most Chinese BITs throughout the 1980s and the 1990s guaranteed most-favoured-nation treatment only.

As for national treatment, China rather warily granted foreign investors the right to transnational arbitration as a means to settle disputes over breaches of BIT-provisions. Earlier BITs at times did not even contain investor-state dispute resolution provisions at all.<sup>42</sup> China had started in 1985 to concede investor-state arbitration even before it signed the convention of the International Centre for Settlement of Investment Disputes (ICSID) on February 9 1990. The respective provisions on investor-state arbitration mentioned various forms of tribunals that a case could be filed at, e.g. ad hoc tribunals established under the common agreements of the disputing parties under the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL) or by a tribunal established under the ICSID convention.<sup>43</sup> First-generation BITs including investor-state dispute resolution provisions usually limited them to disputes concerning the amount of compensation due in case of expropriation and nationalization. Foreign investors' possibilities to appeal to transnational arbitration were restricted through various “safeguards”.<sup>44</sup> Investors were required to exhaust local remedies first before being allowed to seek resort to transnational arbitration. Further restrictions found in China's first-generation BITs require the consent of

<sup>42</sup> See e.g. China-Sweden (1982), China-Norway (1984), China-Thailand (1985) and China-Austria (1985).

<sup>43</sup> See Rooney (2007): 704.

<sup>44</sup> See Chen (2006).

both parties for a dispute's submission to a transnational tribunal and the application of the host country's laws. In essence, such restrictions reduce the effectiveness of investor-state dispute settlement provisions found in China's first-generation BITs, granting them a mere symbolic nature. They comply with the "Chinese tradition of avoiding litigation"<sup>45</sup> and were meant to preserve the sovereign rights of the host states' authorities in regulating FDI.<sup>46</sup>

In sum, China's refusal to include unrestricted national treatment and liberal investor-state dispute resolution provisions in Sino-foreign BITs can be traced back to China's history as an FDI-importing country. The Chinese development model depended heavily on the positive discrimination of domestic companies through the imposition of local content and performance requirement on foreign investing companies.

## 5 China's liberal international investment policy

In the second phase of its BIT policy, which started in 1998, China pro-actively began to negotiate liberal investment treaties. China initiated a gradual shift towards stronger provisions for substantive and procedural foreign investment protection. Chinese BITs today entail almost all standard provisions found in mainstream European-country BITs.

The China-Barbados BIT, signed in July 1998, can be described as a watershed as it was the first treaty to offer foreign investors unrestricted access to international arbitration. This pioneering provision on investor-state dispute settlement, which was adopted in 21 later BITs,<sup>47</sup> marked the turning away from the first-generation BIT approach of restricted investment dispute settlement. This change is all the more remarkable as "safeguards" against full-fledged investor-state arbitration were at the heart of the first-generation BIT approach. This evolutionary innovation has been described by Cai "as the most significant measure in Chinese BIT practice in recent years."<sup>48</sup> Not surprisingly, this acceptance of transnational arbitration has been criticised by some Chinese scholars of international law. Chen, for instance, calls for a reconsideration of China's current policy in order to better protect domestic companies from the increasing competition of foreign investors' operations in China. He argues, with the Chinese economy being in a transition phase still enjoying high investment inflows, such a liberal dispute settlement provisions will leave developing China worse off.<sup>49</sup>

The incorporation of liberal procedural FDI protection in the China-Barbados treaty broke with the tradition of including "safeguards" against transnational dispute settlement that was characteristic of older Sino-foreign BITs. The treaties' article 10 on the "Settlement of Investment Disputes", exemplary for later BITs, writes down the investor's right to

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<sup>45</sup> Kong (2003).

<sup>46</sup> Chen (2006): 900.

<sup>47</sup> See Cai (2006): 646. Not all pre-1998 BITs entailed liberal investment dispute settlement provisions though. The Sino-Quatar BIT (1999) and the Sino-Bahrain BIT (1999) adopted the traditional restrictive approach described in chapter 4.

<sup>48</sup> Cai (2006): 646.

<sup>49</sup> Chen (2006; 2007).

transnational arbitration with regard to all aspects of the treaty.<sup>50</sup> After an initial period of six months, where both parties have the opportunity to settle their dispute amicably, the investor is given the right to submit the dispute for resolution by international arbitration. Abstaining from putting down all procedural aspects of arbitration, article 2 (a, b) is referring to ICSID and UNCITRAL rules. The only restriction demanded by China is the refusal to grant the right for transnational arbitration once the investor has chosen to access the host country's domestic judiciary. Another restriction, namely the requirement to exhaust an Administrative Review Procedure that has been introduced in later BITs<sup>51</sup> is supposed to determine the proper and legal conduct of administrative agencies under Chinese law. This provision, however, does not involve court proceedings and has therefore only a very limited restrictive capacity.<sup>52</sup>

The noteworthy fact of Beijing's turn towards liberal investor-state arbitration is that it has been a pro-active undertaking aimed at protecting Chinese outward FDI. Some recent studies analyse liberal investor-state dispute settlement provisions mainly from the angle of Sino-developed country BITs.<sup>53</sup> The essence of China's new BIT policy, however, is that comprehensive investor-state dispute settlement procedures have been introduced first and foremost in treaties signed with developing countries which, as a group, are the main destination of Chinese outward FDI.<sup>54</sup> It shows China behaving like a FDI-exporting country, trying to increase the legal protection of its own foreign investments. Against this background, the (re-)negotiation of older BITs with among others The Netherlands, Finland and Germany is regarded as a mere consequence of this change.<sup>55</sup> A large majority of Sino-foreign BITs included comprehensive investor-state arbitration procedures has been signed with developing countries. Only three out of 22 BITs with liberal investor-state dispute settlement provisions have been signed with developed countries.<sup>56</sup>

Apart from liberal investor-state dispute settlement provisions, China gradually introduced a number of treaty innovations. The Chinese BIT with Botswana, signed in June 2000, includes a stronger provision for compensation for losses due to war and civil strife. In addition to the regular most-favoured-nation clause article 5 of this BIT grants foreign investors the same treatment as domestic investors in the case of war and civil strife:

“Investors of one Contracting Party whose investments in the territory of the other Contracting Party suffer losses owing to war, a state of national emergency, insurrection, riot or other similar events in the territory of the latter Contracting Party, shall be accorded by the latter Contracting Party treatment, as regards restitution, indemnification, compensation and other settlements not less favourable than that accorded to the investors of its own or any third State.”

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<sup>50</sup> The China-Barbados BIT refrained from restricting the validity of the investor-state dispute settlement to the amount of compensation, as older BITs had done. Other BITs, like the China-Botswana BIT (2000) in article 9 (1), explicitly allowed for transnational arbitration for “any dispute between an investor of one Contracting Party and the other Contracting Party.”

<sup>51</sup> See e.g. article 6 (a) of the Protocol of the China-German BIT (2003).

<sup>52</sup> See Schill (2007): 17.

<sup>53</sup> See e.g. Rooney (2007); Heymann (2008).

<sup>54</sup> See Schill (2007): 18.

<sup>55</sup> See Berger (2008a): 26.

<sup>56</sup> These numbers are based on Cai (2006): 646 as the UNCTAD's Investment Treaties Online database does not include all second-generation Sino-foreign BITs.

Apart from the treaty signed in 1988 with Australia, the first BIT to include up-to-date absolute standards of treatment of foreign investors was the Chinese BIT with Brunei signed in November 2000. It covered the general principles of fair and equitable treatment, full protection and security, and non-discrimination, without qualifying these provisions as older treaties had done before.

It has been stated in the previous chapter that a limited number of first-generation Sino-foreign BITs with developed countries included national treatment provision. They, however, contained far-reaching qualifications of their applicability. Three different approaches toward national treatment can be assessed in the second-generation of China's BIT practice. Firstly, until 2000, Chinese BITs with developing countries continued the practice not to include national treatment provisions at all.<sup>57</sup> Secondly, from 2000 onwards, China included qualified national treatment provisions in its BITs with developing countries.<sup>58</sup> These treaties adopted the national treatment provisions found in the first-generation BITs with the UK, Slovenia and Iceland. In example, Article 3 (2) of the Chinese BIT with Botswana reads as follows:

“Without prejudice to its laws and regulations, each Contracting Party accord to investments and activities associated with such investments by the investor of the other Contracting Party treatment not less favourable than that accorded to the investment and associated activities by its own investors.”

The legal reservation “without prejudice to its laws and regulations” limits the effectiveness of the national treatment provision to a best effort clause. In essence, these BITs do not provide for national treatment unless the host countries' laws and regulations grant foreign investors treatment not less favourable than that accorded to domestic investors. Most developing partner countries, however, have already agreed to grant national treatment in BITs with OECD countries. Furthermore, through the “multiplying effect” of the most-favoured nation clause that is an integral part of every Sino-foreign BIT, foreign investors can “import” stronger national treatment provisions from other BITs. Against this background, Chinese outward FDI de facto will be awarded national treatment. Thirdly, a number of Chinese BITs concluded with developed countries, entail national treatment provisions that are less restrictive.<sup>59</sup> The first treaty to include the new national treatment provision was the BIT concluded in 2001 between China and The Netherlands. Article 3 (3) reads as follows:

“Each Contracting Party shall accord to investments and activities associated with such investments by the investors of the other Contracting Party treatment no less favourable than that accorded to investments and activities by its own investors or investors of any third State.”

The restrictions towards national treatment are included in the protocol to these treaties:

“In respect of the People's Republic of China, Paragraphs 2 and 3 of Article 3 do not apply to:

- a) any existing non-conforming measures maintained within its territory;
- b) the continuation of any non-conforming measure referred to in subparagraph a);

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<sup>57</sup> See China-Barbados (1998); China-Quatar (1999); China-Bahrain (1999); China-Brunei (2000).

<sup>58</sup> See China-Botswana (2000); China-Iran (2000); China-Jordan (2001); China-Trinidad (2002); China-Côte d'Ivoire (2002); China-Guyana (2003); China-Djibouti (2003).

<sup>59</sup> See China-The Netherlands (2001); China-Bosnia (2002); China-Germany (2003); China-Finland (2004); China-Czech Republic (2005).

- c) an amendment to any non-conforming measure referred to in subparagraph a) to the extent that the amendment does not increase the non-conformity of the measure, as it existed immediately before the amendment, with those obligations.

It will be endeavoured to progressively remove the non-conforming measures.”

This amendment permits China to maintain laws and regulations towards foreign investors that are incompatible with national treatment. China, however, agrees in the protocol to include a standstill commitment towards “non-conforming measures”, i.e. not to increase discriminatory treatment towards foreign investors, and promises to gradually remove such measures. Due to these two obligations, the national treatment provision included in recent BITs between China and developed countries is stronger than the best effort provision found in Chinese BITs with developing countries. Remarkably, China is able to make developed partner countries to bear more obligations than it is willing to do. While Chinese authorities are still allowed to discriminate foreign investors, Chinese investors can rely on national treatment in the respective partner country. The declaration of intent to reduce discriminatory rules and regulations is a weak legal obligation. In other words, China is able to secure a special and differential treatment, a provision common to trade law, but rarely adopted in international investment agreements which are reciprocal in nature. This expansion, however, of national treatment provisions in Chinese BITs, notwithstanding their limited applicability, can be explained by the growing acceptance of national treatment in Chinese law especially with respect to the accession to the WTO.<sup>60</sup>

In sum, this analysis of individual standard provisions of Chinese BITs reveals a gradual yet decisive policy change towards stronger and more comprehensive substantive and procedural investment protection. This shows that China increasingly adheres to international standards of the legal protection of FDI. On balance, Chinese BITs with developed countries provide for slightly higher levels of substantive investment protection than Chinese BITs with developing countries. From the angle of a host country, China accepts the admission model agreements put forward by European partner countries. China, however, is able to maintain special and differential treatment with respect to national treatment. As a home country of outward FDI in developing countries, China adopts a model agreement<sup>61</sup> that establishes stronger investment protection than it was willing to admit during the 1980s and 1990s when China was in the position of a mere FDI-importing country.

What are the consequences of China's turn towards a liberal international investment policy? Some authors expect Chinese investors to increasingly make use of liberal BIT provisions through transnational arbitration.<sup>62</sup> To the knowledge of the author, there is only one publicly known case where a Chinese investor is involved.<sup>63</sup> This limited utilisation of transnational arbitration by Chinese companies is somewhat surprising against the background of liberal investor-state dispute settlement provisions being adopted in Sino-foreign BITs already in 1998 and Chinese outward FDI facing considerable political risks in developing countries and national sentiments in developed countries. One possible explanation for this puzzle is the

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<sup>60</sup> See Wang (2005): 778.

<sup>61</sup> The text of the Chinese model agreement has been reprinted in Dolzer and Schreuer (2008): 352-359.

<sup>62</sup> See e.g. Rooney (2007): 711 and Heymann (2008): 526.

<sup>63</sup> See Diaz (2007).

“Chinese lack of affinity for international arbitration”<sup>64</sup> and their preference for settling disputes informally through diplomatic consultations. Another explanation is the limited coverage of liberal investor-state dispute settlement provisions in terms of the volume of outward FDI. In other words, the partner countries of the 22 Chinese BITs that entail liberal investor-state dispute settlement provisions are only of minor importance as outward FDI destinations. Within this group, only Germany is among the top host countries of Chinese investments. Cai hence argues “that the actual effect of the investment protection offered by these 22 Sino-foreign BITs is wholly negligible” and “that, at least in the near future, Chinese OFDI can't significantly benefit from these 22 Sino-foreign BITs.”<sup>65</sup> In this respect it would be too rash to apply the behaviour of multinational enterprises from OECD countries that caused a substantial increase of transnational arbitration to Chinese companies of which a considerable number are still state-owned. Unless the actual coverage of Chinese BITs will be substantially extended in the medium term, Chinese outward FDI face high political risks and diplomatic relations between China and host countries are aggravated transnational arbitration cases involving Chinese investors will remain rare.

## 6 Outlook on the negotiations towards a Sino-US BIT

This article argues that China has pro-actively initiated a remarkable change of its formerly restrictive BIT policy towards a liberal approach. Since 1998, Beijing has been negotiating treaties that contain comprehensive investor-state dispute settlement provisions. China even abandoned its hostile stance on national treatment of foreign investors, a policy that was characteristic of its development strategy during the transitional process that started in the late 1970s. National treatment provisions are a common feature of China's current BIT policy. In its new BITs with developing countries China uses the respective provision of its current model agreement that restrictively grants national treatment without prejudice to the host countries' laws and regulations. In BITs with developed countries China agrees only to grant national treatment of foreign investors unless the continuation of existing “non-conforming measures” is guaranteed. This exception notably applies only for the Chinese market, Chinese investments in the respective developed partner country have to be treated not less favourable than domestic investors. The growth of outward FDI has led the Chinese government to abandon its traditional restrictive approach that aimed at regulating inward FDI and to adopt a new liberal policy that – in line with the “Going Global” strategy – provides Chinese investors with strong substantial and procedural investment protection. Notwithstanding the reservations towards unrestricted national treatment, the current Chinese model agreement is comparable to the admission model BIT adopted by European countries.

To what extent is China's new liberal BIT policy compatible with the pre-establishment model applied by the US? This question is crucial for any assessment of the prospects of success of the ongoing negotiations between China and the US towards a BIT. These negotiations are part of the Strategic Economic Dialogue that was launched in September

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<sup>64</sup> Kong (2003): 130.

<sup>65</sup> Cai (2006): 647.

2006 and aims at easing economic tensions between both countries. The launch of BIT negotiations has been announced in June 2008 after 17 months of preliminary talks. The rationale of the treaty would be to increase the level of protection of mutual investments as US companies are frequently complaining about the lack of enforcement of intellectual property rights in China and as Chinese investors have experienced increasing protectionism in the US. With a second round of negotiations being held in Beijing in October 2008, it is too early to predict with certainty that a Sino-US BIT (and what kind of) will be concluded at the end of the day. Currently, the parties are still exchanging their views on their respective approaches towards the protection of foreign investments; i.e. there has not been much progress on substantive issues.

Against the background of fundamental differences in the respective international investment policy approaches and the current political environment in the US, however, the prospects of a Sino-US BIT are looking rather bleak. With regard to substantive issues, main controversies can be expected with respect to the US policy to demand national and most-favoured nation treatment of FDI already in the establishment phase.<sup>66</sup> China's potential acceptance of such a provision would amount to a further revolution of its BIT practice. It is, however, very unlikely that China agrees to a liberalisation of investment flows (in addition to protecting established investments) that would substantially reduce its regulatory power as a host country. Other peculiarities of the US model BIT such as transparency requirements seem to be less controversial. Apart from these fundamentally different approaches towards the liberalisation and protection of FDI, the current political situation in the US increases the obstacles to a Sino-US BIT granting Chinese investors comprehensive investment protection on the US market. Especially the highly publicised, yet aborted, takeover of the American oil company Unocal by the state-owned Chinese China National Offshore Oil Corporation (CNOOC) in 2005 and the failed bid by the United Arab Emirates based ports management business Dubai Ports World for six major US seaports makes clear that national security concerns are an increasing threat to foreign investments from emerging markets.

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<sup>66</sup> See article 3 and 4 of the US model BIT reprinted in Dolzer and Schreuer (2008): 389-390.



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