The Association of Economic Crises and Investor-State Arbitration Cases

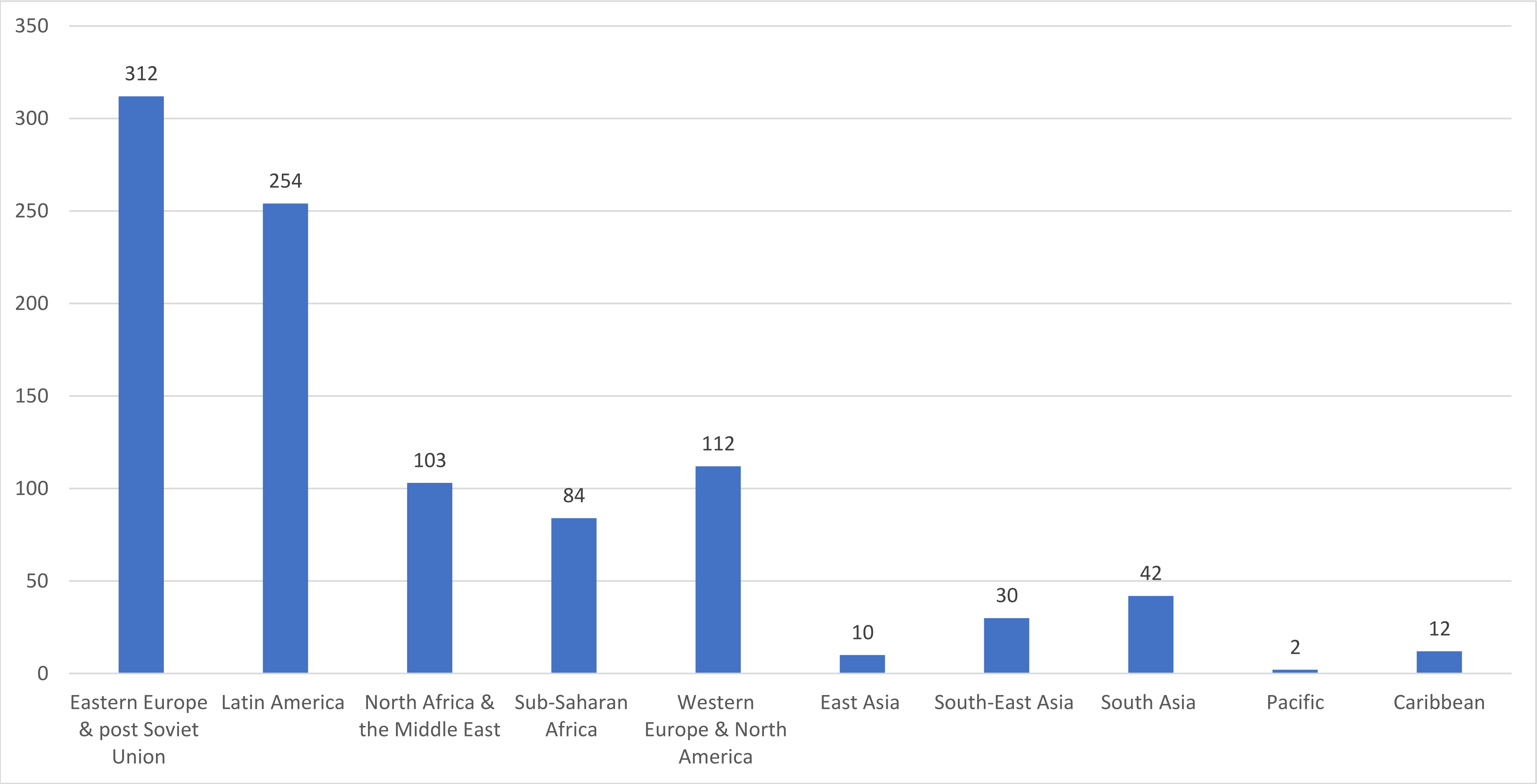
By Christian Bellak and Markus Leibrecht

Definition Investor – State Arbitration and Motivation

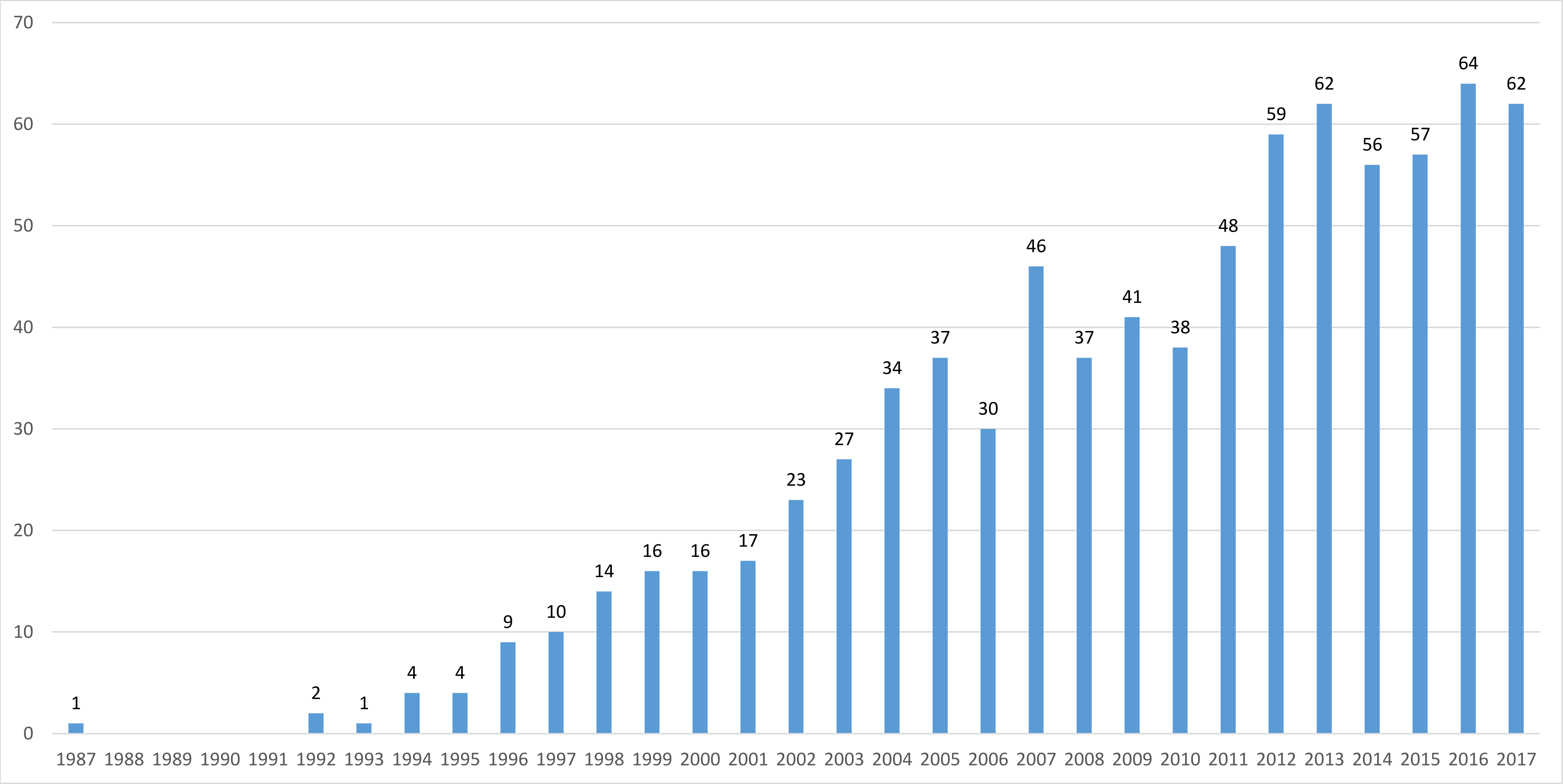
- Procedural standards in IIAs (international investment agreements) grant foreign investors access to ISDS (investor state dispute settlement), designed to solve conflicts between foreign investors and host country governments over the rights of investors (e.g., Simmons, 2014).

- Determinants are still not fully understood:
  - Institutional environment matters (e.g., rule of law; already researched).
  - Qualitative discussion of various cases in a crisis context: e.g., Argentina 2001, Czech Republic 2001, Spain 2012.

Number of Cases across Host Regions over 1987 – 2017



Number of Dyads with at least one Arbitral Case over 1987 – 2017



Why is it an important topic?

Particularly during and after crises, government interventions in the market process are desirable from a social welfare perspective.

Yet, there are substantial **costs** involved:

- Claims may lead to negative reputation effects and loss of foreign investment.
- Claims may spoil the relationship between the claimant firm and the host country.
- Possible retaliation of home countries of foreign investors also imposes costs.
- Filing claims involves substantial direct monetary costs not only for the claimant firm but also the host country (e.g., Allee and Peinhardt, 2011; Aisbett et al., 2018; Jensen et al., 2019).

Conceptual background I

- Opportunity
  - The opportunity of foreign investors to bring an arbitral dispute before an arbitration council.
  - The opportunity to breach an IIA.
- Willingness
  - Firms’ willingness to file a claim
  - Governments‘ willingness to violate an IIA

Conceptual background II

Generally, rational governments "calculate the positive and negative effects of compliance / non-compliance with a particular investment treaty and, consequently, to adopt the strategy that best serves their interests." (Hirsch, 2009, p. 865)

In times of crisis:

- The net **benefits** of governments from implementing policy measures for stabilizing the macro-economy are **high**, even if these measure breach IIAs.
- The **costs** of breaching an IIA are also taken into consideration, yet may be systematically **underweighted**.

Conceptual background III

In the crisis context it is important to distinguish between two types of policy measures governments are willing to implement:

- **Emergency measures**: short-run measures for macro-stabilization like fiscal and monetary austerity measures, devaluation of the currency, exchange rate and price controls
- **Structural reforms**: imply a change in entitlement, are subject to broad political debate: product-, labor- and financial-sector reforms but also structural consolidations in public taxation and spending ("fiscal measures")
  - Structural measures may affect a large number of foreign investors / certain industries. Hence, arbitration claims are neither evenly distributed across countries nor over time.

Main Hypothesis

As the willingness of governments to engage in disputable behavior increases during and after crisis, violations of IIAs become more likely and foreign investors consequently may file claims at an international arbitration tribunal.

Quantitative empirical studies on determinants of investor-state arbitration …

- … mainly investigate the importance of the level of democratization and the strengths of the rule of law as drivers of international arbitration cases.
- … find strong evidence for a negative association between the number of arbitral claims and a host country’s institutional capacity, measured via the strengths of the rule of law, the extent of corruption or the degree of property rights protection.

Dupont et al. (2016) analyze statistically the association between treaty-based arbitration cases and economic crises and do not find a significant association between economic crises and arbitration cases.

→ Dupont et al. assert that their result is due to their operationalization of economic crisis via growth rate in real GDP.

Methodology: conditional Poisson distribution

$$E\left[\frac{cases_{ijt}}{\gamma_{ij}, \vartheta_t, X_{ijt}, Z_{it}, W_{jt}}\right] = \exp\left(\gamma_{ij} + \vartheta_t + X'_{ijt}\beta_1 + Z'_{it}\beta_2 + W'_{jt}\beta_3\right)$$

where i = host (defendant) country

j = home country (of claimant firm)

ij = country-dyad

t = year (1996, …2017)

$cases_{ijt}$ = (0, 1,…..9)

γ_{ij} and ϑ_t are dyad- and year-fixed effects

X'_{ijt}, Z'_{it} and W'_{jt} include variables that are associated with $cases_{ijt}$ and that vary across time and country-dyads (ijt), across time and host countries (it) and time and home countries (jt).

Crisis and arbitration variables

- **Arbitration variable**
  - number of arbitration cases a country-dyad records in a particular year
- **Economic crises**: inflation rate crisis, exchange rate crisis, economic growth crisis, sovereign debt crisis; combined crisis measure.
  - Lack of general definition of crisis; relative crisis measures are preferable, as what constitutes a crisis is country-specific. Definitions
  - We also consider recent macroeconomic development in our crisis definitions in addition to standard thresholds.
  - Definitions: Reinhart and Rogoff, 2010, Agnello et al., 2015, Bjørnskov, 2016 etc.
  - Sources: Laeven and Valencia (2018), Teorell et al., (2017) and other databases

Regressor variables included in the analysis

Foreign Investor's View	Expected Sign	**Host Government's View**	Expected Sign
Opportunity to file an arbitration claim		**Opportunity to breach an IIA**	
(1) *Bilateral Investment Treaty*	+	(5) *Rule of Law*	–
(2) *Energy Charter Treaty*	+	(7) *Infeasibility of Policy Change*	–
(3) *FDI Inward Stock*	+	(8) *GDP per Capita*	–
Willingness to file an arbitration claim		**Willingness to breach an IIA**	
(4) *Cumulated Cases of Home Country*	?	(3) *FDI Inward Stock*	–
(5) *Rule of Law*	–	(9) *Economic Crises*	+
(6) *Quality of Regulation*	–	(10) *Political Crises*	
		(10a) *War*	+
		(10b) *Regime Durability*	+
		(11) *World Bank Loans*	–

Results for crisis variables

Year	Inflation crisis	Economic Growth crisis	Exchange rate crisis	Sovereign Debt Crisis	Crisis “overall”
t-1	0.930*	0.198	0.381**	-0.230	0.306**
	(0.488)	(0.156)	(0.161)	(0.157)	(0.132)
t-2	0.296	0.129	0.052	0.733***	0.287
	(0.350)	(0.246)	(0.140)	(0.159)	(0.191)
t-3	0.372	0.446**	-0.452***	-0.027	0.159
	(0.265)	(0.180)	(0.172)	(0.203)	(0.167)
t-4	0.018	0.497**	-0.251	-0.202	0.255
	(0.372)	(0.229)	(0.275)	(0.293)	(0.206)
Obser-vations	9308	9462	9428	9458	9506

Summary of Results I

- Positive association between the occurrence of **economic crises** and the number of arbitration cases reported by host countries.
- Strength and timing of the crisis **impact varies across different types of economic crisis**.
  - It seems that inflation and exchange rate-based economic crises lead to an **earlier filing of arbitration cases** than the other types of crises.
  - The quantitative effect also varies by type of crisis, with measures taken after sovereign debt crises seem to lead to the largest semi-elasticity (percentage increase of arbitration cases in a country-dyad).
- Plausibility of magnitude of the impact

Results – selected other controls

	Inflation crisis	Economic Growth crisis	Exchange rate crisis	Sovereign Debt crisis	Crisis "overall"
Bilateral Investment Treaty (t-1)	1.974***	1.889***	2.024***	1.870***	1.875***
	(0.508)	(0.476)	(0.512)	(0.475)	(0.475)
Energy Charter Treaty (t-1)	1.062**	0.936*	1.161**	1.218*	0.889*
	(0.540)	(0.481)	(0.557)	(0.718)	(0.492)
Rule of Law (t-1)	-0.742**	-0.807***	-0.849***	-0.792**	-0.838***
	(0.376)	(0.281)	(0.318)	(0.332)	(0.300)
Observations	9308	9462	9428	9458	9506

Also controlled for:

- Quality of Regulation (t-1), GDP per Capita (t-1),
- Log FDI Stock (t-1),
- Infeasibility of Policy Change (t-1),
- War (t-1)**,
- Regime Durability (t-1),
- Log of World Bank Loans (t-1)**,
- Cumulated Cases Home Country (t-1)**

** = stat. signif.

Summary of Results II

- **Rule of law** as driver of international arbitration cases: we confirm the well established result from earlier literature: role of political constraints.
- Split by rule of law indicates that **economic crises matter across countries with weak and strong institutions**.

	Below Average Rule of Law	Above Average Rule of Law
Crisis (t-1)	0.393***	0.235
	(0.133)	(0.295)
Crisis (t-2)	0.394**	0.090
	(0.197)	(0.238)
Crisis (t-3)	0.052	0.416*
	(0.171)	(0.225)
Crisis (t-4)	-0.036	0.601**
	(0.185)	(0.243)
Observations	6233	3273

Sensitivity checks

We show robustness of results wrt:

- Zeros-Inflated-Poisson estimator
- Dynamic model
- 4 years lags all variables
- Standard measures of economic crisis (threshold based)
- Modelling of sum of cases per host and year over all home countries
- Country-jackknife analysis

Discussion - Caveats

- Despite using a large number of determinants as well as dyad-fixed effects, we are **not able to explicitly model the willingness of specific firms to file a claim**.
  - Omitted variable bias?
- As we include only lags up to four years, we are **not able to capture cases that have been initiated a rather long time after crisis-related policy measures have been introduced** by the host government.

Policy relevance

- Foreign investors should have a possibility to hold host country governments accountable for their actions.

→ “A crisis is just an extreme instance of policy failure.” (Rodrik, 1996)

Question arises, whether an argument could be made for **restricting host government’s liability** for certain types of economic policy measures (like emergency measures) in the wake of crises, e.g. in the form of an inclusion of a prescription period; carve outs etc.

- Governments seem to risk paying compensation to foreign investors for their actions in times when public spending is needed in other areas.

→ Governments may counter the risk of large compensation payments by **setting up rainy day funds** during non-crisis times.

Additional Information

International Investment Agreements

Most BITs, besides protection standards, include provisions for Investor-State-Dispute-Settlement.

- **International tribunal** of three arbitrators (appointment case-by-case) decides about case.
- Their **decision** is usually **binding** (depending on venue of settlement).
- **No need** for investors to bring the case **before domestic courts** before they can bring it to international arbitration.
- **Monetary compensation** is the remedy.

Alleged Breaches of IIA Provisions

- Indirect expropriations (rather than direct expropriations)
- FET (Fair and Equitable Treatment)
- As of end of 2019, UNCTAD reports **406** alleged breaches of indirect expropriation and **483** breaches of FET (including minimum standards of treatment).

Crisis measures

- R_Inflation_Rate_Crisis_(it) = 1 if the inflation rate for country i in year t is > 20 percent and the change in the inflation rate from t-1 to t is > 100 percent

- R_Exchange_Rate_Crisis_(it) =1 if in year t a host country's currency depreciates by on average by more than 15 percent against the US-Dollar and the change in the growth rate of the exchange rate from t-1 to t is > 100 percent

- R_Economic_Growth_Crisis_(it) = 1 (i) if the growth rate of real GDP for country i in year t is < 0 after at least two consecutive years of positive economic growth rates (see Bjørnskov, 2016); in addition, this variable has entry 1 (ii) if real economic growth is already negative in t-1 but the drop in the economic growth rate from t-1 to t is > 100 percent.

Go back