

**China's Integration into the Liberal International Economic Order and Its Changing  
Policies on Legalized Bilateral Investment Treaties**

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## Introduction

The last two decades have seen a surge in Bilateral Investment Treaties (BITs) around the world; BITs have become the most important international legal mechanism governing foreign direct investment (FDI). These treaties represent new trends in the liberalization of FDI and the legalization of dispute resolution in international politics: treaty provisions have become more precise, binding, and enforceable, and states have been willing to delegate investment disputes to international arbitration authorities, especially the International Centre for the Settlement of Investment Disputes (ICSID), a permanent legal institution for solving disputes between host states and private investors (Allee and Peinhardt 2011; 2012).

Since its first treaty with Sweden in 1982, China has signed BITs with more than 110 countries, second only to Germany.<sup>1</sup> Yet, most BITs signed in the 1980s and the 1990s granted foreign investors solely most-favored-nation (MFN) treatment, and delegated only one type of disputes to the ICSID or *ad hoc* arbitration. The contents of China's BITs have changed notably since the late 1990s, offering foreign investors more substantial protection than did earlier treaties. China has become ever more willing to provide national in addition to MFN treatment to foreign investors, and to delegate all types of investment disputes between state and private actors to the ICSID. As delegating legal authority to independent international institutions will impose significant sovereignty costs on states, China's changing attitude toward international arbitration is not insignificant. This paper will examine why China, often perceived as a strong advocate of the sovereignty norm, has been willing to accept national treatment clauses and delegate dispute resolution to international legal authorities in legalized BITs since 2000.

This paper identifies two main forces that contribute to the evolution of China's BIT practices

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<sup>1</sup> China has renegotiated nearly a dozen BITs since 2003. The total number of 110 refers to the countries that signed BITs with China, not the total number of China's BITs.

in the most recent decade. One is the initiation of China's new state-led developmental strategy of "going out" [*zou chuqu*]: the government has actively promoted China's overseas investment in order to strengthen the competitiveness of its firms and sustain its long-term economic growth. The other force is the formation of a new boundary-transgressing<sup>2</sup> belief among Chinese leaders that economic globalization is an inevitable trend independent of men's view, and that China should liberalize its trade and investment so as to thrive in fierce international competition. The increased material benefits of protecting China's own overseas investment partially offset the high sovereignty costs of more liberal and legalized BITs; the new belief in the inevitability of globalization gradually weakens the previous Westphalian sovereignty norm and lowers the normative costs in delegating sovereign authority in economic issue areas.

Nevertheless, these factors cannot completely replace the traditional sovereignty norm in shaping China's BIT policies. In order to minimize the sovereignty costs associated with more liberal and legalized BITs, China has made reservations to several boundary-transgressing treaty provisions. Therefore, although China has closely followed the international trend of liberalizing FDI, it has been cautious about loosening state control in economic sovereignty and tried to maintain a delicate balance between its dual roles as a capital exporting and importing state. China is still in a weak socialization process when it gradually deepens its ties with international governance institutions and tries to become a "responsible power" of the international society, because the preexisting sovereignty norm has limited the degree to which China fully accepts new boundary-transgressing norms and integrates with the liberal international economic order.

This paper is organized as follows. The first section describes the trends of liberalization of

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<sup>2</sup> This concept is borrowed from Allen Carlson, who differentiates "boundary-reinforcing" and "boundary-transgressing" behaviors, policies, and norms. The former constructs "the division between internal and external affairs by emphasizing the inviolability of sovereignty rights"; while the latter blurs the division by promoting or acknowledging the malleability of state sovereignty (Carlson 2005: 24).

FDI and the legalization of BITs at the global level. The second part provides an overview of the theory of sovereignty costs and the evolution of China's BIT practices from the early 1980s to the current stage. It then discusses in the third section how the changes in China's material interests and the initiation of the "going out" strategy influence decision makers' benefit-cost calculation of the new BITs. The fourth section focuses on how Chinese leaders' new boundary-transgressing belief in the inevitability of economic globalization changes their perceptions on state sovereignty and influences their decision making on major foreign economic policies. Section Five analyzes the impacts of the Westphalian sovereignty norm in economic issue areas and examines China's reservations to the major treaty provisions of its new BITs. The paper then concludes with the sixth section.

## **1. The BITs and the Liberalization of Foreign Investment**

BITs are bilateral international agreements establishing the terms and conditions for private investment by the individuals and companies of one country in the jurisdiction of another. Most treaties are signed between a developed and a developing country, or between two developing states. As the international society has not been able to establish a global-level multilateral regime to govern foreign investments, BITs have become the most important international legal instruments in facilitating and governing foreign direct investment (FDI) in recent decades (Elkins, Guzman, and Simmons 2006: 812; Yu, J. 2007: 43). The contents of BITs usually include the most favored nation (MFN) and national treatment of foreign investors, compensation in the event of expropriation and nationalization, free currency transfer from the host to the home country, and dispute settlement mechanism (DSM) for solving disputes between contracting states as well as between private investors and host states (Dolzer and Stevens 1995; UNCTAD 2007).

BITs have proliferated and become more legalized around the world only in the recent two or

three decades. For a long time after the post-WWII independence of the third world, international practices regarding FDI and BITs had been more sensitive to state sovereignty as developing countries strove to build a “new international economic order” (NIEO) and tried to put foreign investment under states’ control. Alongside the rising trend of nationalizing foreign investment across the third world in the 1960s, developing countries advocated the pro-sovereignty Calvo Doctrine, which holds that jurisdiction in international investment disputes lies with the host country and that foreign investors have to exhaust local remedies before resorting to the protection and intervention of the home state.<sup>3</sup> This doctrine challenged the pro-investment Hull Rule supported by developed countries, which requires the host state to provide “prompt, adequate and effective payment” in cases of nationalization and expropriation.<sup>4</sup> The collective efforts of developing countries in this period enabled the UN General Assembly to adopt a series of Resolutions on Permanent Sovereignty over Natural Resources that confirmed the Calvo Doctrine and prioritized state sovereignty over investors’ rights in the 1960s and 70s. For example, Resolution 1803 in 1962 allowed expropriation of foreign investment by host states in the name of the national and public interest with merely “appropriate” compensation, and Resolution 3171 in 1973 stated that in the event of nationalization, “each State is entitled to determine the amount of possible compensation and the mode of payment” (UN 1962: 16; 1973: 52).

However, the third world’s attitudes and approaches to FDI and BITs have changed greatly in recent decades, as most developing countries have embraced neo-liberal developmental ideas and undertaken pro-market economic reforms since the 1980s. The profusion and legalization of BITs is in accordance with a rising trend of liberalization of foreign investment around the world (Elkins et al 2006; UNCTAD 2003; 2006; 2007). FDI has been widely accepted as one of the most

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<sup>3</sup> For reviews of the “Calvo Doctrine”, see Manning-Cabrol 1995; Yackee 2007; Shan 2007.

<sup>4</sup> For a discussion on the “Hull Rule”, see Guzman 1998.

effective means to boost the economic growth of a host state; ever more developing countries have loosened their control of FDI and signed more liberal and legalized BITs to facilitate capital inflows.

BITs with mandatory DSMs reflect an ongoing legalization of world politics. Highly legalized treaties are hard law in that they define rules unambiguously, bind states strongly, scrutinize their behaviors through international and domestic legal mechanisms, and delegate broad authority to independent legal entities to implement the rules they contain (Abbott and Snidal 2000; Goldstein et al 2000: 387). Delegation mechanisms, such as compulsory dispute settlement, strengthen the enforceability of BITs. When states ratify such a treaty, they formally commit to accept independent legal institutions as the highest authority in adjudicating disputes. Moreover, private foreign investors can bring disputes with host government directly to international arbitration panels and thus further limit states' decision-making autonomy.

BITs can function as a legal means for capital-importing countries to make credible commitments and attract FDI. Unlike industrialized countries with well-established domestic legal institutions, many developing countries lack the sound institutional environments that can provide adequate protection for FDI. Foreign investors usually face great uncertainties and risks when investing in those countries. In order to effectively attract FDI, developing countries have to solve the commitment problem and send credible signals to potential investors. As BITs set up a set of legal obligations and impose sovereignty costs for host states, capital-scarce states can use the treaties to tie their hands and signal their commitment to protecting and liberalizing foreign investments (Ginsburg 2005; Buthe and Milner 2009; Allee and Peinhardt 2011).

Because of the increasing competition pressure for developing countries to attract FDI, they have been willing to bear higher sovereignty costs and grant foreign investors more substantive

rights in hard BITs. The zeal of the third world countries for establishing a NIEO has been replaced by their goal of following the trend of economic globalization and integrating with the liberal international order (Vandeveld 1998; Elkins, Guzman, and Simmons 2006). In response to the rising demands of developing countries for FDI, developed countries have actively promoted more liberal and legalized BITs and significantly raised the standards (i.e. the sovereignty costs) of signing the treaties. The importance of the pro-sovereignty Calvo Doctrine has gradually decreased vis-à-vis the pro-investment Hull Rules in determining the contents of BITs in recent decades.

The United States has played an especially important role in strengthening the trend of liberalization and legalization of the treaties. Although initiating BIT practices relatively late in the 1980s, the United States has since then taken the lead to liberalize FDI and driven up the standards of the BITs.<sup>5</sup> Unlike many European countries that focus on investment protection and are more willing to accommodate the sovereignty concerns of capital-importing states, the United States has always emphasized liberalization in addition to the protection of investment and rarely lowered its standards when negotiating the treaties (Reading 1992; Salacuse and Sullivan 2005: 73; Elkins et al 2006: 815). Although most BITs signed between developed and developing countries since the late 1980s are hard laws in nature, the American type represents a higher degree of liberalization and legalization, and imposes much higher sovereignty costs on host countries than do the treaties promoted by its European counterparts—also known as the German type.<sup>6</sup>

The two most important treaty clauses determining the degree of liberalization and legalization

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<sup>5</sup> For discussions on the US role and its BITs, see Gann 1985; Vandeveld 1993.

<sup>6</sup> German and America's BITs can be downloaded from the UNCTAD website:

[http://www.unctadxi.org/templates/DocSearch\\_\\_\\_\\_779.aspx](http://www.unctadxi.org/templates/DocSearch____779.aspx).

America's BITs that are currently in force can also be obtained from the Trade Compliance Center website:

[http://tcc.export.gov/Trade\\_Agreements/Bilateral\\_Investment\\_Treaties/index.asp](http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp).

of BITs are the national treatment clause and the dispute resolution mechanism.<sup>7</sup> The national treatment clause represents the biggest difference between the American and German types of BITs. The German type is more conservative, requiring national treatment only in the post-establishment phase. That means that once foreign investors are allowed to set up business in the host state, they should be treated the same as domestic investors; yet the host state still has the right to review and disapprove a potential investment in the first place. In contrast, the American type is more intrusive to state sovereignty, as it requires national treatment to foreign capitals at both the pre- and post-establishment stages. Foreign investors should be able to enter the market of the host state and set up business freely without prior approval, except for certain special industries concerning national security and critical public interests. Thus, the American type of national treatment not only strengthens investment protection, but further liberalizes FDI accession.

In terms of the DSM clause, legalized BITs require states to accept international arbitration, especially the ICSID's jurisdiction, over most investment-related disputes between the host state and private foreign investors. Granting such investors direct access to international arbitration strengthens the enforceability of the treaties and increases the bargaining power of the private actor vis-à-vis the host state. Even if a dispute does not eventually go to an arbitration tribunal for settlement, investors can use the delegation mechanism as a credible threat to force the host state to better comply with treaty provisions. The most legalized treaties require states to accept the ICSID's jurisdiction *unconditionally* without imposing the "exhaustion of local remedy" restrictions; while a less legalized DSM allows host states to require that investors exhaust

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<sup>7</sup> In addition to the national treatment and DSM clauses, the liberalization tendency and the rising sovereignty costs of hard BITs are reflected in the changes in several other treaty provisions, such as the definitions of "investment", "investor", and "expropriation", compensation for expropriation, and the restriction of "performance requirements".



domestic legal or administrative remedies before resorting to international arbitration. Although the United States and Western European countries all advocate a highly legalized DSM, European countries are more flexible than the US, being willing to sign treaties with some countries that insist on the “exhaustion of local remedy” condition in certain circumstances.

Liberal and legalized BITs greatly weaken the policy autonomy of developing countries (Guzman 1998; Neumayer and Spess 2005; Yackee 2007). If a treaty adopts a looser definition of expropriation and imposes fewer restrictions for foreign investors to submit disputes to the ICSID, any domestic policy or legal changes that have impacts on foreign investment can trigger arbitration (Elkins, Guzman, and Simmons 2006: 825). For example, when the Argentine government took emergency measures and removed the one-to-one peg with the US Dollar during the 2001 financial crisis, more than thirty multinational companies filed investment disputes with the ICSID. Some analysts estimate that the total value of the claims made by foreign investors could reach 80 billion USD (Wong 2005; Burke-White 2008: 204). The high sovereignty costs the Argentine government incurs when dealing with those cases have led Argentina to reverse its previous liberal stance on FDI and BITs. Moreover, Argentina’s experiences as well as arbitration charges and decisions against other developing countries in the past decade may have sent some warning signals to third world countries, dampening their enthusiasm for signing BITs in recent years.<sup>8</sup>

Because of the potentially high sovereignty costs of hard BITs, the UNCTAD has suggested that developing countries should maintain enough policy space and enable governments to flexibly use necessary economic policies within the legal framework of the treaties (UNCTAD 2003: xvii).

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<sup>8</sup> According to the 2012 UNCTAD *World Investment Report*, the BITs have lost their burgeoning momentum since the late 2000s, partly due to the rise of regionalized treaty making and partly due to the controversial and politically sensitive investor-state arbitrations (UNCTAD 2012: 84).

As the benefits of highly legalized BITs may not outweigh the potential sovereignty costs of losing economic control rights, the biggest challenge for developing countries when negotiating BITs is to balance between the degree of legalization of the treaties and the policy autonomy of the state, so that they can effectively attract FDI without sacrificing state sovereignty unnecessarily.

## **2. The Theory of Sovereignty Costs and the Evolution of China's Positions on BITs<sup>9</sup>**

Today's liberal international norms and global governance institutions have increasingly exhibited boundary-transgressing features, limiting the freedom of states to make domestic and foreign policies, requiring them to cede certain policy making authority to independent third parties, and thus encroaching on state sovereignty to various degrees. Although the sovereignty norm is still the foundation of the "society of states", integration with the world and participating in international cooperation means states must bear some losses of sovereign control rights and decision making autonomy. The higher degree a state is socialized into the liberal international order, the more sovereignty it would like to cede for the common causes and the advance of liberal norms of the international society.

### ***2.1 Sovereignty Costs, Material Incentives, and Socialization***

Sovereignty can be viewed as the authority and control rights that states possess over their territory, population, and all types of activities within their borders. Cooley and Spruyt characterize sovereignty as consisting of "a bundle of rights" which, "like property rights ... can be split or shared by states and other international actors" (2009: xi). According to Carlson, the bundle of control rights can be further broken down into four distinctive types of rights: territorial sovereignty, jurisdictional sovereignty, sovereign authority, and economic control rights (2005).

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<sup>9</sup> The analysis of this section is based on the BITs China signed from 1982 to 2011. The full texts of those treaties can be obtained from the following three websites:

UNCTAD: [http://www.unctadxi.org/templates/DocSearch\\_\\_\\_\\_779.aspx](http://www.unctadxi.org/templates/DocSearch____779.aspx).

MOFCOM: <http://tfs.mofcom.gov.cn/article/Nocategory/201111/20111107819474.shtml>.

<http://www.fdi.gov.cn/pub/FDI/zcfg/zcfg2/default.jsp?type=1074>.

Moreover, the norms of sovereignty refers to the organizing rules and principles of sovereign rights and authority. The default and most entrenched sovereignty norm in the international society is the Westphalian norm, which, according to Krasner, is based on two principles: “territoriality and the exclusion of external actors from domestic authority structures” (1999: 20). Under the Westphalian system, sovereign rights are in theory indivisible and non-transferable: states should always enjoy absolute autonomy within their own territories without interference by other states.

States giving up their decision-making autonomy or delegating control right have to bear the costs of losing authority as well as the costs of deviating from the sovereignty norm. Sovereignty costs in this paper is defined as the costs of ceding sovereign control rights and policy autonomy to other parties, and can be broken down into two parts: material values of the control rights being ceded, and additional “normative costs” due to states’ deviation from the Westphalian norm. Sovereignty costs can be denoted by the equation of “ $SC=MC+NC$ ,” where “SC” represents the overall sovereignty costs, “MC” the Material values of the control rights, and “NC” the normative costs.

This conceptualization of sovereignty costs substantiate the rationalist definition with normative meanings. In the delegation literature, the concept has been widely used to refer to “the costs that a state incurs by delegating a function ordinarily performed domestically to an international institution over which it has little, if any, control” (Simmons and Danner 2010: 235). The costs “can range from simple differences in outcome on particular issues, to loss of authority over decision making in an issue-area, to more fundamental encroachments on state sovereignty” (Abbott and Snidal 2000: 436).<sup>10</sup> Most rationalist usage of the concept are rather ad hoc, and it is conveniently constructed as an all-encompassing concept consisting of all kinds of costs associated

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<sup>10</sup> Similar definition can be found in Elkins, Guzman, and Simmons 2006 and Simmons and Danner 2010.

with delegation. Moreover, the rationalist definition implies that sovereignty costs are essentially material, as if the costs are “objective” market values that can be realized in a market transaction in exchange for equal or higher material benefits.

What rationalists miss is the role that the Westphalian norm plays in determining sovereignty costs. Because of the existence of the established Westphalian norm, state sovereignty has been constructed as indivisible and invaluable in theory. Once the norm is internalized by states, discrepancies between beliefs and practices will impose normative in addition to material costs of control rights. The more strongly states internalize the norm, the higher the value they assign to their sovereign control rights and thus the higher the normative costs (NC) for states to deviate from their beliefs.

Defining sovereignty costs as consisting of both material value of the control rights being ceded and the normative costs incurred by the deviation from the Westphalian norm better reflects the nature of state sovereignty. On the one hand, sovereignty costs capture the transferability and divisibility of sovereign control rights. On the other hand, the concept indicates that states will not easily trade their sovereign rights for any kind of gains or give up the rights unlimitedly without enough compensation. The stronger states’ Westphalian beliefs, the greater the normative sovereignty costs of losing state autonomy. Applying the concept can facilitate our understanding of the nature of states’ pro-social or cooperative behaviors and the degree of socialization into the liberal international economic order. From the sovereignty costs perspective, states will cede more control rights over time either when the material benefits of doing so increase and can *offset* the overall sovereignty costs (SC), or when the normative costs (NC) of sovereignty costs *decrease* due to the weakening of the sovereignty belief by sweeping social forces or the internalization of new boundary-transgressing norms.

The mechanism associated with weak socialization is social forces, such as peer pressure, social incentives/punishments, and sweeping social trends (Finnemore and Sikkink 1998; Risse and Sikkink 1998; Johnston 2008). States' sovereignty beliefs can be weakened and the normative sovereignty costs decrease when the formation of national interests and the ways states pursue their aims are influenced by other states in the international society. States may feel obliged to follow the majority of in-group members, because they are embedded in a social environment and willing to become social, or because they believe the inevitability of a social trend. Social forces of the weak socialization process can only *incrementally* lower the normative costs of ceding control rights; at this stage, although states have formed social-oriented interests, such as maintaining a good social image and pursuing high social status, they do not necessarily truly believe in the moral meaning of social norms, and material self-interests and the sovereignty norm still play more important roles in determining their policies and behaviors.

Norm internalization is the mechanism of strong or high degree of socialization. International norms are "principled beliefs", which "consist of normative ideas that specify criteria for distinguishing right from wrong and just from unjust" (Goldstein and Keohane 1993: 9). They do not have instrumentalist connotations, but follow the logic of appropriateness. Such beliefs not only regulate and constrain states' behaviors and choices, but also constitute their identities and interests (Jepperson, Wendt, and Katzenstein 1996). For norm-receiving states, internalization comes after a long-term process of socialization, resulting in "congruence between (perceived) interests and the legitimated rules and institutions" (Hurd 2007: 41). Norm internalization can further weaken the Westphalian beliefs of states and *significantly* lower the normative costs of delegating sovereign authority. States in a strong socialization process will not even feel the conflicts between their self- and social identities or between new ideational and other types of

interests, as the norm is taken for granted and norm-conforming practices are habitualized (Finnemore and Sikkink 1998; Risse and Sikkink 1998). Even if conflicts of different types of interests do emerge, states will prioritize their new ideational interests over material and sovereignty concerns. At this point, states should view the internalized boundary-transgressing norms as morally superior to the Westphalian norm and an encroachment on sovereignty as legitimate in a normative sense.

Although strong socialization usually evolves from weak one, weak socialization does not necessarily lead to strong one.<sup>11</sup> A state may be in a stable weak socialization process for a long time without accepting the moral superiority of any boundary-transgressing international norms; or it may even experience setbacks and never be able to move to a strong norm internalization stage. Therefore, the concepts of weak and strong socialization developed in this paper should be viewed as two ideal-types of socialization processes, rather than two stages of one linear progressive process with a teleological purpose.

Hard BITs with high sovereignty costs are especially important for examining the degree of China's socialization into the liberal international order. It is one of the *hardest* socialization test for a previous outsider of the international society, such as China, to pass. Prior literature on China's integration with the world has mainly focuses on China's behaviors in soft institutions, and tended to show that China's interests and policies have changed significantly in almost every issue area (see, for example, Kim 1994; Kent 1998, 2007; Economy and Oksenberg eds., 1999; Foot 2000; Lardy 2002; Carlson 2005; Pearson 2004; Johnston 2003, 2008). Nevertheless, the

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<sup>11</sup> Constructivist theories, such as Finnemore and Sikkink's three-stage norm diffusion model (1998) or Risse and Sikkink's five-phase spiral model (1999), often view the three mechanisms as characterizing different progressive stages of socialization, and only the final stage of strong socialization is a stable equilibrium, while the other stages should eventually lead to norm internalization so as to complete the full cycle of socialization. For constructivists, only norm internalization is theoretically significant, as it is the really meaningful mechanism that can differentiate socialization from rationalist adaptation.

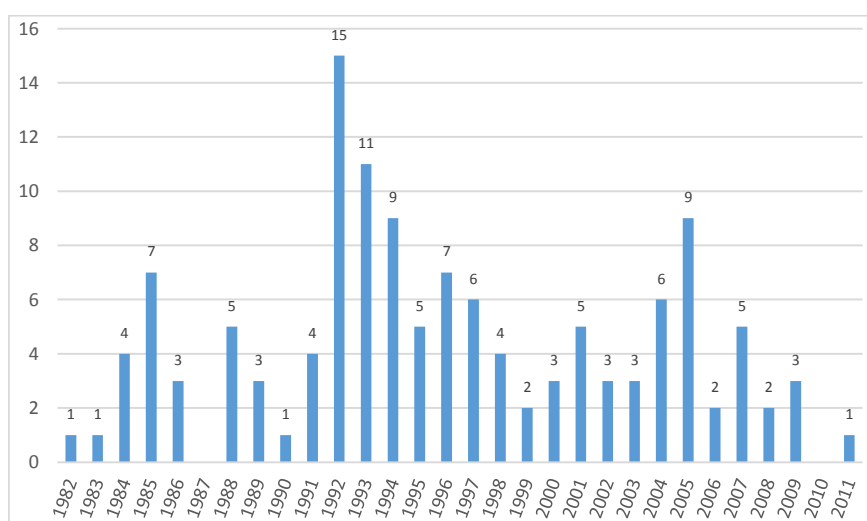
benchmarks scholars use to gauge those changes are China's behaviors at the very beginning of economic reform in the early 1980s or its policies in the brief isolation period immediately after the Tiananmen incident. Indeed, if using China's *own* past as a reference, China's discourses and behaviors in soft institutions are enough to demonstrate the unprecedented degree to which today's China is socialized by international norms and institutions. However, as the institutional and normative environments of the international society have constantly evolved, to understand how deeply China integrates with the world requires us to examine whether China's changes are in accordance with the development of new social trends, what the nature of the changes are, and how far China's positions are from the "majority will" of the international society. Because the ongoing trend of legalization in international economic institutions indicates that the international society has reached new institutional and normative equilibriums in economic issue areas, and because China is by no means an outsider in the world anymore, it is time to adopt the higher benchmark of legalization to gauge the depth of its integration and the limits of its deviation from the Westphalian norm.

## ***2.2 The Changes of China's BITs Practices***

China's BIT practices can be divided into three stages. In the 1980s, China signed BITs mainly with Western developed and newly industrialized Asian countries. All the treaties in the first stage were soft laws that did not include the national treatment clause or recognize the jurisdiction of the ICSID. Following the end of the Cold War in the 1990s, China signed the second wave of BITs with newly independent post-Soviet states as well as many developing countries in the Middle East, Latin America, and Africa. Some BITs signed in this period agreed to delegate limited disputes to the ICSID, although most treaties still did not grant national treatment to foreign investors. The third stage of China's BIT practices is now underway: China has substantively

revised the contents of its BITs, accepting both the national treatment clause and the ICSID's jurisdiction over all types of investment disputes, albeit with some reservations. It has signed more legalized BITs with many developing countries that had not previously signed treaties with China; in the meantime, it has also renegotiated with more than a dozen developed or OECD states and replaced the previous soft treaties with hard ones since 2001.

**Figure 2.1: The Number of BITs China Signed (1982-2011)**



Source: UNCTAD: [http://www.unctadxi.org/templates/DocSearch\\_779.aspx](http://www.unctadxi.org/templates/DocSearch_779.aspx)  
 MOFCOM: <http://tfs.mofcom.gov.cn/article/Nocategory/201111/20111107819474.shtml>

The evolution of China's BITs epitomizes the path of its integration with the liberal global economic order in the past three decades. In the first decade of this process, China was a capital-scarce developing country and urgently needed FDI to facilitate its economic development. In order to improve its investment environment and strengthen the protection of foreign investment, China signed the first wave of BITs with major capital-exporting countries, i.e., Western developed and newly industrialized Asian states, in the 1980s. Nevertheless, because China was still at the beginning of its economic reform and held strong sovereignty beliefs, the normative sovereignty costs of boundary-transgressing treaty obligations, such as national treatment and delegating



disputes with private investors, were prohibitively high.

As a result, those early BITs have more symbolic than substantive meaning, as most treaty provisions were very vague and lacked binding effects on China. None of those treaties incorporated the national treatment clause, and the best treatment China could offer to foreign investors was MFN. In terms of compulsory DSM, the first BIT signed with Sweden in 1982 did not even include the clause of dispute resolution between the host state and foreign investors. Although the subsequent treaties with other industrialized countries included the DSM with private investors in treaty protocols, only one type of dispute regarding the compensation amount of expropriation or nationalization could be submitted to an *ad hoc* arbitration tribunal. The ICSID was not acceptable to China as a possible choice for dispute resolution. Using *ad hoc* arbitration to solve disputes is more flexible and imposes fewer sovereignty costs than resorting to a permanent independent legal authority, as each party to the dispute can appoint one arbitrator of its own together with a third arbitrator from a third party, to form an *ad hoc* tribunal.

China's acceptance of the ICSID jurisdiction in the early 1990s signifies the starting point of the second stage of its BIT practices. It agreed to delegate only disputes over *the amount of compensation* resulting from expropriation and nationalization to the ICSID in several subsequent treaties signed with developing countries. This incremental change indicated that Chinese elites' sovereignty beliefs had slightly softened in the early and mid-1990s. They perceived the disputes over compensation amount as having mainly material meaning and therefore lacking strong normative connotation. Nevertheless, the normative costs of ceding control rights over other types of economic disputes were still very high. For example, Chinese elites believed that sovereign states had the inherent right to nationalize foreign investment in their own territories and that such rights *per se* could not be questioned by international legal authority; therefore, they refused to

delegate disputes regarding the legitimacy of states' expropriation and nationalization to the ICSID.

The third stage of China's BIT policies started with the first legalized BIT, signed with the Latin American island state of Barbados in 1998. Although this treaty did not include the national treatment clause and was the only one in the 1990s that allowed private investors to submit "any investment related disputes" to the ICSID, it opened the door for China to accept more liberal and legalized treaty provisions in the following decade. Since 2001, China has systematically made more substantial boundary-transgressing commitments in its new BITs. Most treaties signed in the last decade have promised to grant national treatment to foreign investors in the post-establishment stage and also incorporated the ICSID as a formal arbitration institution to deal with any investment-related disputes between foreign investors and the host state. In addition to the national treatment and the DSM clauses, China has accepted more precise and broader definitions of "investment" and "expropriation," and greatly loosened the restrictions for investors to transfer returns from host to home states (Chen, A. 2007; Cai, C. 2007; Wang, 2007).<sup>12</sup>

Although China's BITs in the last decade have become much more liberal and legalized than those signed in the 1980s and the 1990s, China still tries to lower the sovereignty costs of its new BITs by making reservations to several boundary-transgressing treaty provisions, especially the national treatment and the DSM clauses. It does not grant private investors unconditional national treatment even in the post-establishment stage, and it maintains the right to require investors to exhaust domestic administrative remedies before resorting to international arbitration. As Table

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<sup>12</sup> In the meantime, China has actively negotiated and signed Free Trade Area Agreements (FTAs) with countries in various regions since 2000. The formats and contents of the FTA Investment Agreements with some countries, such as New Zealand, the ASEAN States, and Peru, closely resemble the language of its new BITs. Those preferential FTA Investment Agreements have thus replaced the old soft BITs and served the same function as the new legalized ones in governing bilateral investment relations between China and relevant states.

2.1 shows, although China's new treaty template is based on the German-type legalized BIT, it imposes lower sovereignty costs and achieves lower degrees of liberalization and legalization than the unconditional German and American types do.

**Table 2.1: Sovereignty Costs and Legalization Degrees of BITs**

	<b>Soft BITs without delegation</b>	<b>Soft BITs with limited delegation</b>	<b>German-type hard BITs with Reservation</b>	<b>German-type hard BITs without Reservation</b>	<b>American- type hard BITs</b>
<b>Sovereignty Costs/ Legalization Degrees</b>	Lowest	Low	Medium High	High	Highest
<b>Example</b>	China's BITs in the 1980s	China's BITs in the 1990s	China's BITs after 2000	BIT between Germany and Bolivia in 1987	BIT between US and Uruguay in 2005
<b>Treatment</b>	MFN only (no national treatment)	MFN only (no national treatment)	Conditional post- establishment national	Unconditional post- establishment national	Unconditional pre- and post- establishment national
<b>Delegation</b>	No delegation or expropriation amount to <i>ad hoc</i> arbitration	Only expropriation amount to the ICSID	All types of disputes to the ICSID with reservation	All types of disputes to the ICSID without reservation	All types of disputes to the ICSID without reservation

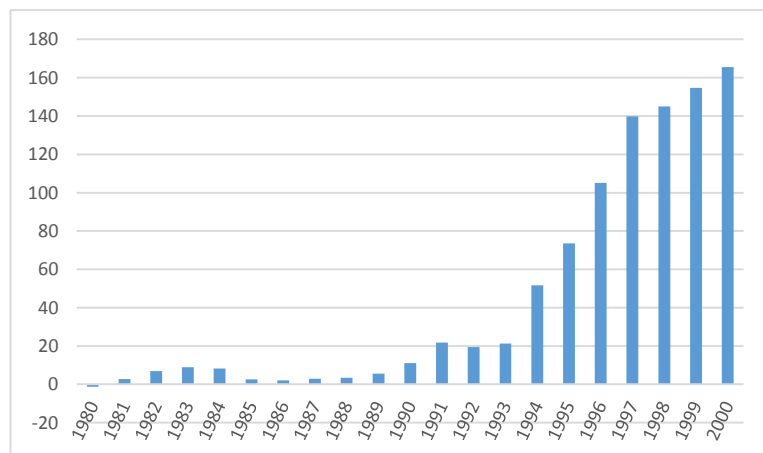
### 3. China's "Going Out" Strategy and the New Material Benefits of Legalized BITs

The most direct causes of the liberalization and legalization of China's BITs are China's new material interest in promoting its overseas investment and its new developmental strategy of "going out" [*zou chuqu*], as its foreign exchange reserves accumulate and its material power increases rapidly. When China had neither the intention nor the capabilities to invest overseas on a large scale in the early stages of its economic reform, delegating disputes to the ICSID and granting foreign investors national treatment would mainly impose high sovereignty costs without

bringing China any significant gains. Nevertheless, as China becomes a capital-surplus economy with the desire to invest in other countries, decision makers realize that legalized BITs can provide better protection for China's own investments and function as important legal instruments to facilitate the "going out" strategy. Although the material dimension of sovereignty costs from hard BITs—captured by the inherent values of the control rights being ceded—will inevitably rise, the increased material benefits of more liberal and legalized treaty provisions can offset some portions of the costs and directly lead to the change of China's BIT policies in the recent decade.

The most important structural force that contributes to the evolution of China's material interests and enables Chinese leaders to initiate the "going out" strategy is the rapid increase in its foreign exchange reserves. After experiencing nearly two decades of export-led economic growth in the early stage of the "reform and opening up," China has accumulated a large trove of foreign exchange reserves, evolving from a poor, capital-scarce state to a major capital-exporting economy in the world. As Figure 2.2 and 2.3 show, China's foreign exchange reserves reached 100 billion USD for the first time in 1996 and have since then maintained a strong momentum. The large amount of capital-surplus provides a solid financial foundation for Chinese firms to invest overseas and actively participate in market competition at the global level.

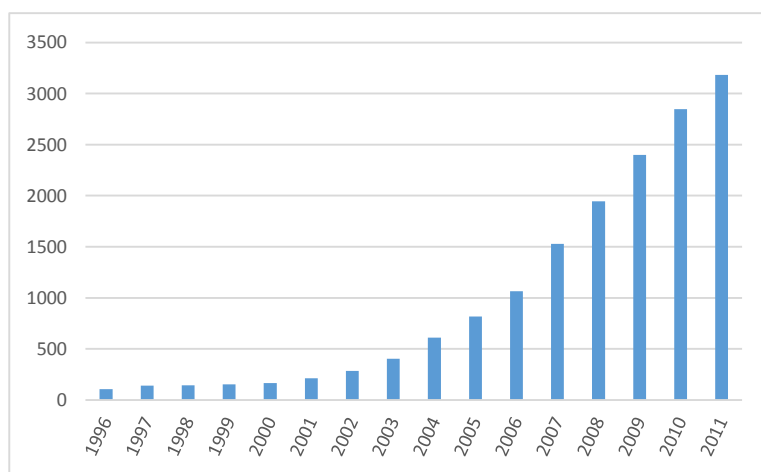
**Figure 2.2: China's Foreign Exchange Reserves from 1980-2000 (billion USD)**



Source: China's Administration of Foreign Exchange:

[http://www.safe.gov.cn/wps/portal/!ut/p/c4/04\\_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PQyNPI\\_2CbEdFAKLWUno!/?WCM\\_GLOBAL\\_CONTEXT=/wps/wcm/connect/safe\\_web\\_store/safe\\_web/tjsj/node\\_tjsj\\_whcb/node\\_tjsj\\_whcbs2\\_store/799fcb004818128e8fc7df84909d05cd](http://www.safe.gov.cn/wps/portal/!ut/p/c4/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PQyNPI_2CbEdFAKLWUno!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/tjsj/node_tjsj_whcb/node_tjsj_whcbs2_store/799fcb004818128e8fc7df84909d05cd)

**Figure 2.3: China's Foreign Exchange Reserves from 1996-2011 (billion USD)**



Source: China's Administration of Foreign Exchange:

[http://www.safe.gov.cn/wps/portal/!ut/p/c4/04\\_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PQyNPI\\_2CbEdFAKLWUno!/?WCM\\_GLOBAL\\_CONTEXT=/wps/wcm/connect/safe\\_web\\_store/safe\\_web/tjsj/node\\_tjsj\\_whcb/node\\_tjsj\\_whcbs2\\_store/799fcb004818128e8fc7df84909d05cd](http://www.safe.gov.cn/wps/portal/!ut/p/c4/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwMLE09nA09Pr0BXLy8PQyNPI_2CbEdFAKLWUno!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/tjsj/node_tjsj_whcb/node_tjsj_whcbs2_store/799fcb004818128e8fc7df84909d05cd)

Besides the large amount of foreign exchange reserves, the rapid growth of China's overall economy and material power has greatly boosted Chinese leaders' confidence in promoting the "going out" strategy and strengthening China's international competitiveness and global influence. As stated in an article by Shi Guangsheng, former head of the Ministry of Commerce (MOFCOM—the government agency in charge of negotiating and signing BITs),<sup>13</sup>

The rapid and continuous development of our national economy and the fruitful results gained from more than two decades of the "bringing in" practices<sup>14</sup> have provided important material foundations and experiences for us to implement the "going out" strategy. Nowadays, the scales of our economy, foreign trade, FDI, and foreign exchange reserves have reached the front rank of the world; several industries and products have gained significant comparative advantages by participating in global market competition and we have mastered many advanced and world-leading technologies; therefore, our capabilities to invest overseas have increased steadily (Shi 2002: 36).

Chinese leaders began to deliberate the "going out" strategy as early as the mid and late 1990s. After a trip to Africa in 1996, former President Jiang Zemin first raised the possibility of policies to promote China's overseas investment in Africa (Jiang 2006 vol. 2: 94). In a meeting with government officials in charge of foreign investment in 1997, Jiang stated that China needed not only to attract foreign capital, but also to encourage domestic firms to set up businesses and utilize the markets and resources in other countries. Moreover, Chinese firms should not focus solely on developed countries in West Europe and North America, but also need to pay attention to the markets in developing countries (2006 vol. 2: 92).

The "going out" strategy was an important part of China's grand strategy. First publicly announced by President Jiang Zemin in the Third Session of the Ninth National Congress of the Chinese Communist Party (CCP) in March 2000, it was later written into the 10<sup>th</sup>, 11<sup>th</sup>, and 12<sup>th</sup>

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<sup>13</sup> Minister Shi Guangsheng's tenure in MOFCOM from 1998 to 2003 was the critical transformation period of China's BITs: China's first legalized BIT with Barbados was signed in 1998, and the first renegotiated one with the Netherlands was signed in 2001.

<sup>14</sup> This refers to China's policies on attracting FDI.

Five-Year Plans for National Economic and Social Development<sup>15</sup> in 2001, 2006, and 2011 respectively. This new developmental strategy intended to achieve two major strategic aims: to strengthen the competitiveness of large state-owned enterprises (SOEs), and to facilitate the sustainable growth of China's economy in the long run. As Jiang said,

'Bringing in' [*yin jinlai*] and 'going out' [*zou chuqu*], are two closely related and indispensable parts of the fundamental national policy of 'reform and opening-up'. This guideline must be set up. Nowadays, international competition has been so keen that we have to do this in order to invigorate our state-owned-enterprises and to sustain the long-term economic development. We need to speed up our research, policy-making, and policy implementation, so as to have significant achievements in two or three years. The key point is to guide and support a group of large and middle sized SOEs to 'go out', setting up the tone of overseas investment and exploring the potential global market. *This is a grand strategy—an important strategy of 'reform and opening-up' as well as an economic developmental strategy* (Jiang 2006 vol. 2: 92; Italics mine).

Although Chinese leaders are enthusiastic about promoting China's overseas investment, the implementation of the new national developmental strategy is not without obstacles. Chinese policymakers especially worry about the high risks and uncertainties their firms and investors encounter in developing countries. Because many of those countries lack effective legal and administrative institutions, many potential Chinese firms and individuals have been deterred from conducting business there. The lack of institutional protection in the third world has become the biggest barrier for China to implement its "going out" strategy. For example, former Premier Zhu Rongji explicitly expressed this concern in response to a reporter's question about the potential difficulties Chinese firms faced in the process of "going out" in 2002:

The problem is that investment environment in some developing countries is not good enough. They do not have investment-related laws and many things do not have formal rules to follow. *Our businessmen often shake heads when talking about these issue and do not want to go there. If he does not want to go, even if I use a whip to beat him from behind, it will not work.* There should be some institutions and we need to help

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<sup>15</sup> The Five-Year Plans are a series of national developmental initiatives, which periodically set up the goals and directions and lay out concrete plans for China's economic development. The first Five-Year Plan was initiated in 1953, and the most current 12<sup>th</sup> one was passed in 2011 (People's Net: <http://dangshi.people.com.cn/GB/151935/204121/index.html>).

developing and friendly countries to improve their investment laws and regulations, so that we can ‘go out’ (Zhu 2009: 429; italics mine).

In order to implement the “going out” strategy and lower the risks for Chinese firms to invest in developing countries, the MOFCOM has changed its long time practices of signing only soft treaties and begun to advocate more liberal and legalized BITs since the late 1990s. Although the sovereignty costs of hard BITs will increase significantly, decision makers seem confident that the expected benefits can offset large portions of the costs. The potentially high sovereignty costs originate mainly from legalized BITs China has renegotiated and signed with developed countries. Because China is still a capital-importing state vis-à-vis developed countries, accepting more boundary-transgressing obligations in new BITs will constrain the policy autonomy of the state and increase the risks that the Chinese government will be brought to international arbitration by private foreign investors.

Nevertheless, protecting China’s overseas investments in developing countries has become an ever more important aim for Chinese policymakers. They expect to make use of legalized BITs to bind the governments of capital-importing developing countries and lower the risks for Chinese investments overseas. For example, Shang Ming, former Director of the Department of Treaties and Laws of the MOFCOM<sup>16</sup>, explains in a journal article the main purpose for China to sign legalized BITs as follows:

Nowadays, our overseas investments mainly concentrate in developing countries. The legal environments of those countries vary significantly and the environments for foreign investments have not yet been perfect. By signing BITs, we can make sure that host countries’ obligations of protecting our investors and their commitments to our investors have international legal effects. BITs can, to a certain degree, reduce the possibility that our overseas investments are harmed or cannot get adequate protections due to the unsound domestic legislations of host states, and thus increase the predictability for our investors to invest in those countries (Shang 2005: 32).

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<sup>16</sup> The MOFCOM’s Department of Treaties and Laws has been directly in charge of negotiating and signing BITs since the early 1980s.



Shang Ming further emphasizes that in the process of “going out”, Chinese firms should fully understand and make use of the treaty provisions of the BITs; they should learn to use legal methods to solve disputes with host states and better protect their legitimate rights (Shang 2005: 32).

The evolution of China’s material and strategic interests has enabled Chinese leaders to think not only as a capital-importing, but also as a capital-exporting state. Although soft BITs allow China to maintain more policy autonomy as a host state, they could not provide adequate protection for its increasing investment in the third world. When negotiating and signing BITs, policymakers have balanced China’s dual roles as both a capital-importer and -exporter, believing that the increased material benefits of protecting China’s investments in developing countries can partially offset the rising sovereignty costs of signing legalized BITs with developed countries. As Ma Yuchi, a government official in the Department of Treaties and Laws of the MOFCOM, wrote in a book chapter,

China has become an important capital exporting state because of the implementation of the ‘going out’ strategy. Most of our investments go to developing countries... *China used to think from the perspective of a host state, and tended to have reservations towards investment treatment and dispute resolutions... Since these reservations will be similarly applied to China’s own overseas investments (mainly in developing countries), if we still holds traditional stance when negotiating BITs with potential host states, it may not be good for the protection of our interests. We should have new thinking about how to protect overseas investment through international investment treaties and law* (Ma 2007: 267-268, Italics mine).

Therefore, if China’s “going-out” aim is taken as given, legalized BITs are effective means to achieve the end, and thus the material benefits of accepting more liberal and legalized treaty provisions increase. However, China’s signing and renegotiating of new BITs should not be viewed solely from this static perspective, as the policy of promoting China’s overseas investment does not result only from the rise of China’s material power, but also from a profound change in

Chinese leaders' beliefs. Once decision makers accept the legitimacy of globalization and liberalization, the sense of necessity to follow the trend itself dwarfs the costs of participation: it not only makes Chinese leaders actively promote China's overseas investments, but also lowers the normative costs of loosening state control over all types of economic activities within its territory, including inward FDI.

#### **4. Economic Globalization and Reduced Normative Costs of Signing Legalized BITs**

Besides material interests, the decrease in the normative costs of ceding economic control rights over time made the overall sovereignty costs of legalized BITs more bearable in the late 1990s than before. The weakening of the Westphalian norm in economic issue areas is mainly due to the strengthening of a boundary-transgressing belief that economic globalization is an inevitable trend independent of men's will, and that following the liberalization trend is a necessity rather than a choice. Such a historicist belief has great impacts on decision makers' perceptions of the benefits and costs of participating in globalization and market competition, and thus leads to a comprehensive set of foreign economic policies to further internationalize and liberalize China's economy in both trade and investment areas.

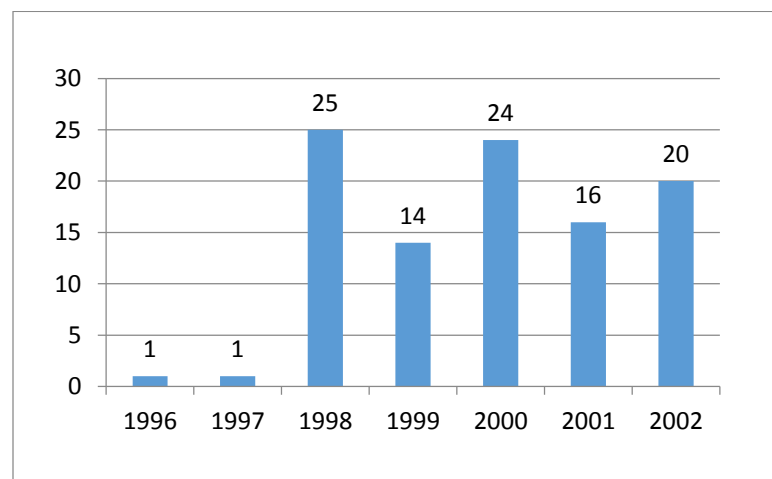
##### ***4.1 The Legitimacy of Globalization and the Liberal Economic Order***

A historicist belief in the inevitability of a norm or trend generates a strong sense of legitimacy, as states derive historicist and determinist meanings of a social trend from rapid and forceful changes in their external environments and from the common practices of most states in the international society. Since the late 1970s, when China started the "reform and opening" process, Chinese elites' stances towards economic sovereignty have been softened and their beliefs in the market force and economic interdependence strengthened step by step; but it was not until the late 1990s that the top leaders started to accept the legitimacy of globalization and embrace the liberal

international economic order.

The concept of globalization began to take off in Chinese top leaders' discourses in 1998. As Figure 2.4 shows, in the three volumes of *Selected Works of Jiang Zemin*, “globalization” appears only once in Jiang Zemin’s selected speeches, in 1996 and 1997 respectively—when Chinese leaders started to pick up the term and consider the implications of the trend on China. However, the concept jumped to 25 times in Jiang’s 1998 works, and maintained an average frequency of about 20 times per year from 1998 to 2002 during his second term as president. The peak of the concept of “globalization” in Jiang Zemin’s speeches coincides with the critical time that China finalized its WTO negotiations, promoted the “going out” strategy, and started to sign legalized BITs.

**Figure 2.4: Number of Times “Globalization” Appears in *Selected Works of Jiang Zemin***



Jiang Zemin comprehensively elaborated the meaning of economic globalization for the first time in 1998, in the article titled “The Current International Situation and Our Diplomatic Works”, which references the concept 21 times. As he said, “the most basic features of economic globalization are the free mobility and allocation of commodity, technology, information, and especially capital at the global level, as well as the consequent complex phenomenon of ‘I

integrating with you and you integrating with me' [*ni zhong you wo, wo zhong you ni*] among every developed and developing country". (Jiang 2006, vol. 2: 201). The idiom clearly demonstrates Chinese top leaders' recognition that the global market had connected every country and obscured the economic boundaries between nation states.

The most important reason for Chinese leaders to accept the legitimacy of the boundary-transgressing power and the integrating effects of the global market is their belief that economic globalization is an "objective trend [*keguan qushi*] of the world economic development" and "reflects the development of productive forces and technologies of the society" (Jiang 2006, vol. 2: 201, 199). Because Marxism, the orthodox ideology in China, posits materialist "productive forces" and technology as the ultimate driving forces of history and as the "economic foundation" of all types of "superstructures" (such as social relations, norms and cultures), a social trend that is driven by the development of productive forces has innate legitimacy and represents the correct direction of history.

Accepting the legitimacy of globalization and the liberal international economic order means that Chinese top leaders have recognized that the market, rather than the state, can better reflect the "objective demands" of productive forces, and that the free mobility and allocation of resources beyond national boundaries is the innate demand of a market economy. Although a state has the authority and autonomy to make economic policies and regulate economic activities within its own territory, its intervention should follow the rules of the market economy. If a state's economic control rights are weakened by the market forces that reflect the "objective" development of productive forces, it represents a historical necessity. Therefore, when facing the inevitable trend of economic globalization, state sovereignty is not absolute, and market forces may triumph over the Westphalian norm.

The sense of necessity to follow the inevitable trend not only reduces the normative costs of ceding economic control rights, but also allows Chinese leaders to develop a dynamic and dialectic benefit-cost view towards globalization and market competition. Although they perceive the consequences and normative meanings of globalization as twofold—on the one hand, representing the objective development of productive forces, and on the other hand, reflecting the interests of developed more than developing countries (Jiang 2006, vol. 2: 199-200)—they believe that China’s own efforts will determine whether the benefits of opening up China’s economy and participating in global competition can eventually outweigh the costs. If China takes actions and makes reforms to meet the requirements of the market economy, it can turn challenges into opportunities.

Therefore, Chinese leaders believed that in order to meet the challenges of globalization, China should not hold an absolutist view on state sovereignty and use economic nationalism as developmental strategy, but continue integrating with the liberal economic order and making use of market competition to accelerate its economic reform. Only by forcing Chinese firms, especially large SOEs, to compete with successful foreign MNCs in both domestic and international markets would inefficient domestic firms take pro-market reforms, learn from their Western counterparts, and eventually win the competition. As Jiang Zemin confidently presented,

*Economic globalization as an objective trend of the global economic development is independent of men’s will; no country can avoid it. As today’s world is an open world, no one can develop its own economy outside the world. We must steadfastly carry on the “reform and opening-up” policy, adapt to the trend of globalization, actively participate in international cooperation and competition, and make full use of all kinds of positive conditions and opportunities of economic globalization. We cannot be scared away from participating, because of the risks and negative effects, just as “we cannot give up eating because of the risks of choking” [yin ye fei shi]<sup>17</sup> (Jiang 2006 vol. 2: italics mine).*

#### **4.2 Policy Implications of the Belief in Economic Globalization**

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<sup>17</sup> This is a Chinese idiom.

Chinese leaders' historicist belief in the inevitability of economic globalization means that they perceive market competition as a *necessary* way for Chinese firms and the nation as a whole to gain competitiveness, and thus rely more on liberalization and internationalization than on economic nationalism as national developmental strategies. The period of the late 1990s and early 2000s was the critical juncture when the globalization idea gained great momentum in shaping China's foreign economic policies. China adopted a comprehensive set of pro-globalization strategies, such as participating in the WTO, promoting overseas investment, and negotiating legalized BITs, to liberalize China's economy and internationalize its large SOEs. These approaches not only encouraged domestic firms to "go out," but also further opened up its own market to bring in more competition.

Legalized BITs play both functions, facilitating China's overseas investment and strengthening the inflow of foreign investment. The new BIT policies were initiated and implemented by the pro-globalization MOFCOM as the top leaders vigorously advocated the "going out" strategy and China's accession to the WTO in the late 1990s. Both "going out" and participating in the WTO are China's national developmental strategies reflecting a boundary-transgressing belief in the inevitability of globalization and the liberal international economic order. Promoting China's overseas investment increases the material benefits and partially offsets the sovereignty costs of hard BITs; while the WTO negotiation and accession strengthens the momentum and the legitimacy of the globalization norm, sets a precedent for China to delegate disputes and make boundary-transgressing commitments in hard economic treaties, and thus lowers the normative costs of signing legalized BITs.

#### *4.2.1 WTO Decision Making and the Rising Legitimacy of Economic Globalization*

In contrast to the "going out" strategy, which imposes no significant sovereignty costs on

China, WTO Agreements require China to make sweeping boundary-transgressing and binding commitments to open up its domestic market. Those unprecedented international obligations not only weaken states' economic control rights, but also increase competition and exert pressures on a variety of domestic economic sectors. Given the high sovereignty and adjustment costs of WTO membership, the negotiation process required complex bargaining among bureaucratic agencies, industries, and other domestic actors. The globalization norm did not naturally "diffuse" and gain legitimacy across the nation. When the WTO decision making was more pluralized and exhibited features of "fragmented authoritarianism" before the late 1990s, reform-oriented negotiators and officials often faced strong domestic ideational and institutional obstacles to making meaningful concessions and reaching agreements (Jackson and Oksenberg 1990; Pearson 2001; Feng 2006; Liang 2007).

It was only after the direct intervention of the highest leadership in the final stage of the negotiation that the globalization norm reached the tipping point in shaping China's foreign economic policies, including the BIT policies. Although top decision makers had long been enthusiastic about joining this "economic United Nations", viewing WTO membership as the recognition of China's social and great power status by the international community, they did not perceive participation as a *necessity* until they saw that economic globalization was an inevitable trend and that only market competition could further China's economic reform in the late 1990s (Interviews BJ080322; BJ080412). Scholars of China's WTO decision making almost unanimously agree that the pro-globalization leadership at the highest level, especially former President Jiang Zemin and Premier Zhu Rongji, played deterministic roles in finalizing China's WTO Agreements (for example, Fewsmith 2000; Lardy 2002; Pearson 2001; Feng 2006; Liang 2007). Once they set up the WTO accession as a national grand strategy, they became more

actively involved in the negotiation and swept away all domestic obstacles for China to make concessions.

Chinese top leaders' historicist belief in economic globalization and its strong consciousness of market competition served as a "roadmap" for them to navigate through the uncertainties and lowered the normative costs of accepting boundary-transgressing treaty provisions. One prominent example that exhibits the deterministic role of the highest leadership was the last round of negotiations with the United States. When the talks reached an impasse, Premier Zhu Rongji arrived at the site and personally spoke with American delegates. He broke the deadlock by accepting most of American's bargaining terms and reached a bilateral agreement with the US.<sup>18</sup> Some Chinese WTO experts at Peking University and Remin University described the final decision on WTO concessions as a "big political gamble" for top leaders (Interviews BJ080224; BJ080305). However, "what enabled them to make the final call and take huge risks at that time," as a government official in the MOFCOM said, "was that they all realized that economic globalization was an inevitable trend. If China would eventually join the WTO, it would be better for us to participate earlier than later" (Interview BJ080415).

#### *4.2.2 The Impacts of Economic Globalization and WTO Decision Making on Legalized BITs*

Because of the top-down decision-making approach in the final stage of WTO negotiations,

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<sup>18</sup> Zhu Rongji's 1999 visit to the United States represents direct involvement of the highest leadership in WTO decision making. During this trip, Zhu brought with him a list of comprehensive concessions China could make and tried to reach a deal with the US. Nevertheless, President Clinton rejected the offer—a decision he regretted almost immediately—and also posted the full list of China's commitments online, intending to see domestic reactions towards China's offer. Zhu's failed trip was perceived as a big humiliation by conservatives in China. The publication of China's concessions also strengthened the voices of anti-WTO forces for a short period, as Zhu's offer was approved only by a small number of top leaders, and even Ministers who were in charge of the most impacted industries were not informed. Some conservative officials and intellectuals even accused Zhu of "selling China." Moreover, the NATO bombing of China's Embassy in Belgrade in 1999 aroused another wave of nationalism and forced China to temporarily suspend the negotiations. Nevertheless, these two events only slightly delayed the pace of China's WTO accession. As the top leadership held a strong globalization belief and were determined to bring China into the WTO during their tenure, China restored negotiations with the US in late 1999.



the globalization norm has gained widespread legitimacy and become the dominant economic idea in China. This has further lowered the normative costs for China to make boundary-transgressing commitments in subsequent international treaties that reflect the globalization trend. Therefore, in contrast to the first norm-shaking event that required intervention from the highest leadership, negotiating and signing legalized BITs has become a routine practice undertaken by the pro-globalization MOFCOM.

China's WTO negotiation and accession as well as the increased legitimacy of the globalization norm have had two major specific impacts on its BIT policies since the late 1990s. First, the WTO Agreements have set a precedent for China to make boundary-transgressing commitments and delegate disputes in legalized economic treaties. This has lowered the normative costs of loosening state control over all types of economic activities and eased the way for China to change relevant BIT provisions to keep them in line with the "spirit of the WTO."

In the WTO Agreements, China promised to greatly open up its domestic market and liberalize its foreign trade and investment regime, accepting major investment-related obligations on both substantive and rule-based issues. Substantive issues refer to market access to FDI in service industries: China promised to open up many long-closed sectors to foreign investment and significantly lift restrictions for foreign firms to conduct business in China. Those previously closed industries include telecommunications and financial (banking, insurance, and securities) sectors, which have long been considered as critical to China's national security, as well as distribution, audiovisual, and a variety of professional (legal, accounting, consulting, engineering, medical, etc.) services (Lardy 2002: 66-72). The most important rule-based commitments regarding investment are stipulated in the Agreement on Trade-Related Investment Measures (TRIMs). The TRIMs Agreement confirms one of the most fundamental principles of the WTO,

the nondiscrimination and national treatment principle, and requires states to eliminate several investment measures that discriminate against foreign firms and result in trade distortions. Those prohibited measures include local content, trade balancing, and foreign exchange balancing requirements (Lardy 2002: 100). All of the commitments are binding and enforceable through the legalized WTO DSM, which set up a permanent and independent tribunal to solve disputes among state parties.<sup>19</sup>

Although the investment-specific provisions of the WTO Agreements are not as comprehensive as the trade-related ones, they have particular impacts on subsequent policy—and on rule-making regarding foreign investment. As a MOFCOM official said in an interview, the new BITs China has signed since the 2000s indeed limit state sovereignty more than the old ones did, especially when considering China as a capital-importing state vis-à-vis developed countries; but the new changes reflected the “inherent demands of the market economy and globalization.” Moreover, China did not suddenly change its positions on major BIT provisions; some of the new BIT obligations, especially the national treatment commitment, had already been made in and were “consistent with the spirit” of the WTO Agreements. “If we have already agreed to do these things in the WTO Agreements, we have no reason to reject them in the BITs” (Interview BJ080511).

Another MOFCOM official, Ma Yuchi, also points out in an article that the old treaties could not meet the requirements of strengthening the protection of foreign investment in the post-WTO era. “China’s politics, economy, as well as regulations and laws regarding foreign investment have experienced great changes in the past decade and especially since the accession to the WTO...

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<sup>19</sup> In fact, investment-specific obligations are just a small portion of the overall boundary-transgressing commitments China made. In addition to “normal” WTO requirements for most new members, China also agreed to accept many discriminatory treatments that apply only to China, especially in trade related safeguards and anti-dumping areas. The so-called “WTO-plus” requirements enable other countries to use lower than WTO-required standards to impose safeguards and anti-dumping measures on imports from China, but restrict China’s rights of retaliation as permitted by the WTO rules in the early stage of its accession. For detailed elaborations of major WTO commitments China made, see Lardy 2002: 63-106.

Because most previous BITs did not include the important clause of national treatment, and other clauses, such as expropriation, transfer of foreign currency, and dispute resolution between the host state and private investors, also had many restrictions, old BITs provided relative weak protections for investment” (Ma 2007: 262). According to Ma, Germany, the Netherlands, and Finland were among the earliest developed countries to raise the requests for renegotiation. As China’s BITs with developed countries were signed in the 1980s when China was in the early stage of its economic reform, the protection for investment in those treaties was the weakest among all the BITs China signed. Therefore, since 2003, China has started a series of renegotiations and updated its treaties with those countries to adapt to the new situations in the post-WTO era (Ma 2007: 262-263).

Second, the globalization norm and the WTO negotiation process have aroused Chinese elites’ “legal consciousness” [*falv yishi*] and greatly strengthened their belief that “market economy is an economy of the rule of the law.” Participating in economic globalization requires China to integrate with relevant legal regimes and keep up with the legalization trend of international economic laws. Therefore, the normative costs for China to delegate disputes to the ICSID and use binding legal instruments to protect foreign investment have decreased gradually.

The WTO Agreements themselves constitute a complicated legal system. Throughout the long journey of China’s WTO negotiation, many Chinese government officials have gradually realized that economic globalization will naturally restrict the power of the state, and that law rather than the government should govern the market economy. For example, Long Yongtu, former chief WTO negotiator and Vice Minister of the MOFCOM, characterized the “spirit of the WTO” as “rules and openness” (Long 2006). As he said, “the WTO accession represents a new stage of China’s ‘open-up’ policy... *Because China has committed to follow the rules of the WTO, it will*

*help us to build a socialist market economy based on the rule of the law... We have to follow international common rules to examine and review our current laws and regulations so that they can keep in line with international rules”* (Long 2002: 7; Italics mine).

The compulsory DSM is arguably the most important WTO legal mechanism that arouses the “consciousness of rules” [*guize yishi*] of Chinese elites. Many government officials have developed a very positive view on mandatory dispute resolution, perceiving enforceable hard laws as representing a rising trend of the rule of law in international economic spheres. As stated by Yang Guohua, current Vice Director of the Department of Treaties and Laws in the MOFCOM, the WTO DSM represents that “international law has been implemented so well for the first time in human history, and has also exhibited a sign of changing from the so-called ‘soft law’ to ‘hard law’; therefore, the WTO is a very good example of the rule of the law in the international society” (Chinalawinfor Net 2011a). Moreover, many Chinese elites accept the view that economic disputes should be adjudicated or arbitrated according to legal principles without being influenced by political factors. For example, Zhang Yuqing, former Director of the Department of Treaties and Laws in the MOFCOM, highly praised the legalized WTO DSM as “an important development of international law in men’s civilization”—in large part because “both expert group and appeal tribunal make decisions completely according to the WTO rules without considering any political and other factors” (Chinalawinfor Net 2011b).

These new perceptions on legalized DSM differ from the traditional sovereignty-centered belief that disputes are better solved by flexible political means than by legal methods. Before the WTO accession, China mainly attracted FDI via policy instruments or administrative measures (such as preferential tax rates and other preferential policies in Special Economic Zones [SEZs]), rather than binding legal commitments, because the former is more flexible and imposes less

sovereignty costs on the state. Accordingly, all of the BITs China signed at that time were soft law in nature.

As Chinese leaders' beliefs in economic globalization and in the rule of the law were greatly strengthened throughout the WTO negotiations, the normative costs for China to delegate dispute resolution to international legal authorities gradually decreased. Many policymakers came to see the advantages of legal means over political approaches to solving economic disputes, accepting that it was time for China to use more binding BIT provisions to signal its commitment to the protection of foreign investment. As the MOFCOM official Ma Yuchi says, "the broadening of disputed issues that can be submitted to international arbitration reflects the international trend of strengthening the protection of foreign investment. *This change will help avoid politicizing economic conflicts, and also shows that China has more confidence on its own investment environment and on the international arbitration regime*" (Ma 2007: 265; italics mine).

Another MOFCOM official also stated in an interview that strengthening the protection of foreign investment and delegating disputes to the ICSID in BITs have become common practices of the international society in the past two decades. He especially emphasized that he and his colleagues began to realize when negotiating BITs with developing countries, that those countries as capital importers often required more liberal treaty provisions than China did. Some Latin American states that had signed BITs with the United States even required China to use the most liberal American model as the base for negotiation. Given that ever more developing countries have enthusiastically embraced the globalization and legalization trend, "*the problem is not whether we should accept the mandatory DSM, but how to improve it so as to keep balance between state sovereignty and investors' rights when signing those treaties*" (Interview BJ080521).

As China's WTO negotiation and accession greatly strengthened Chinese leaders' belief in the inevitability of globalization and liberalization and aroused their legal consciousness, decision makers have taken for granted certain degrees of restrictions on state autonomy by commonly accepted international rules and become more open to the liberalization and legalization trends in international economic affairs. Therefore, the increased legitimacy of globalization and the liberal international order has gradually lowered the normative costs of ceding economic control rights and contributed to the changes in China's BIT practices since the late 1990s.

### **5. Sovereignty Costs and China's Reservations to Legalized BITs**

Because of the increased material benefits of protecting its overseas investment as well as its leaders' new belief in the globalization and the liberal international order, the BITs China signed in the last decade have become more liberal and legalized and imposed much higher sovereignty costs than previous ones. However, China does not stand at the forefront of the globalization trend, and its new BITs do not reach the highest degree of liberalization and legalization. When negotiating BITs, China has cautiously guarded its state sovereignty and tried to minimize the sovereignty costs by making reservations to major boundary-transgressing treaty obligations. China's conditional acceptance of the national treatment and DSM clauses demonstrates that state sovereignty has still played a very important role in determining China's national interests and BIT practices, even if the normative costs of deviating from the Westphalian norm have decreased in the economic issue areas.

The boundary-transgressing globalization norm cannot replace Westphalian sovereignty as the dominant ideational force in shaping China's foreign economic policies for two main reasons. First, as the metaphysical foundation for Chinese leaders to accept the legitimacy of globalization is materialism, they do not view the trend per se as having innate moral meanings, and thus do not

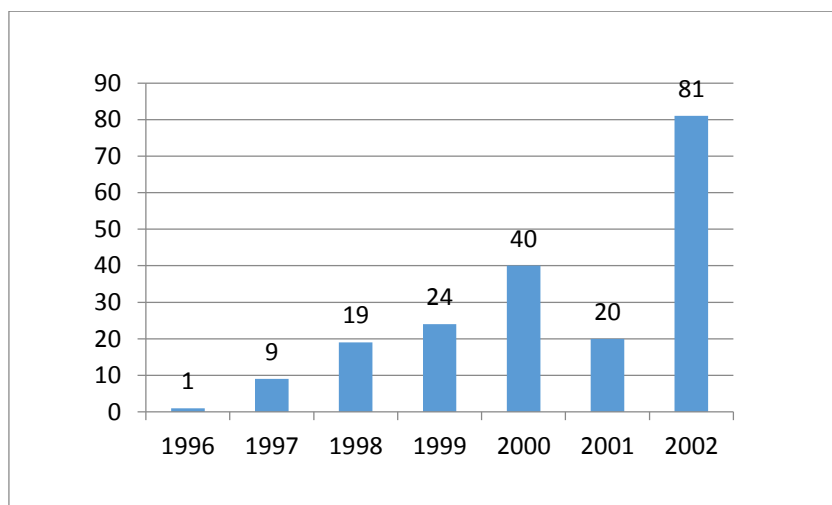
accept the normative legitimacy of globalization. And second, Chinese leaders still perceive that globalization is unfair in nature. Because Western developed countries determine the direction of the trend, they benefit the most from the “rules of the game,” with resulting negative impacts on developing countries and on China.

Because Chinese leaders perceive economic globalization as representing the “objective” demands of materialist productive forces, what the globalization norm changes is not the developmentalist national goal, but mainly the means for China to achieve the end. The ultimate aim for decision makers to further open up China’s economy and liberalize its trade and investment is to sustain rapid economic development and improve China’s national competitiveness vis-à-vis developed countries. Since the collapse of the Soviet Union and East European socialist states, Chinese ruling elites have felt the need to demonstrate to the people that China under the CCP’s leadership can exceed the achievements of the Western democracies. Slow economic growth will not only lead to undesirable economic and social consequences, but will also threaten the CCP’s domestic legitimacy. As the previous leader Deng Xiaoping trenchantly pointed out in the early 1990s, “If we have five years of non-development or low rate, such as 4 or 5%, or even 2 or 3% rate of growth, what would be the impacts? *This is not only an economic problem, but actually a political problem*” (Deng 1993 vol. 3: 354; italics mine).

The post-Deng leaders have experienced even greater pressures to keep the momentum of China’s economic development, because they perceive the world as full of competition, and the major competitors as the developed countries. Although economic cooperation and policy coordination are considered as necessary and inevitable in the globalization era, Chinese leaders believe that the competitive nature between states does not change, but is further strengthened by the globalization trend. They are not satisfied with improving the overall living standards of the

people, but aim to increase China's *relative* position in the international system and win the competition with Western democracies. A theme that Jiang Zemin constantly emphasized during his presidency was to “take initiative/become invincible in fierce international competition” [*zai jilie de guoji jingzheng zhong zhangwo zhudong/liyu bubai zhidi*] (for example, Jiang 2006 vol. 1: 282, 370, 441; vol. 2: 202, 281, 379, 421, 434; vol. 3: 7, 34, 44, 289, 418, 442-460, 470). As Figure 2.5 shows, the frequency of the term “competition”—specifically referring to market competition or international competition among states—increased significantly in the *Selected Works of Jiang Zemin* from 1998 to 2002.<sup>20</sup>

**Figure 2.5: Number of Times “Competition” Appears in *Selected Works of Jiang Zemin***



Because Chinese leaders do not accept the inherent liberal values of the globalization and market norms, they believe that the state should play an indispensable role in governing economic

<sup>20</sup> The frequency of the concept “competition” reached its peak in 2002, with three articles heavily referencing the concept. “Taking Initiative in Fierce International Competition” is an article discussing China’s WTO accession and mentioning the term 35 times. “The Guideline and Main Tasks of Financial Works” discusses the impacts of financial globalization on China and the necessity for China to reform its financial system; it references the concept of competition 12 times. “Building a Well-Off Society, and Creating a New Prospect of Socialism with Chinese Characteristics” is the report of the 16<sup>th</sup> National Congress of the CCP—the most important national conference of the Party, which takes place every five years. The report analyzes the domestic and international situations and sets up the goals for the CCP in the next five years. The term “competition” appears 13 times in this report.



activities, albeit in a more limited manner in the globalization era. The “going out” strategy is a state-led national developmental strategy; the purpose of economic reform is not to privatize large SOEs at micro-level, but to maintain the state-owned nature and improve performance through macro-level internationalization and liberalization strategies, so as to increase the competitiveness and material power of the state as a whole. As Jiang Zemin emphasized, “the facts that our country can have such a strong comprehensive national power and important international status nowadays and that our economy can steadily and continuously develop in fierce international competition demonstrate the great and indispensable roles of SOEs”; “we must not pursue privatization; this is a fundamental principle and shall not be deviated even slightly” (Jiang 2006 vol. 2: 378; 389). Therefore, the rising belief of economic globalization does not fundamentally change the statist view or significantly weaken the sovereignty belief of Chinese leaders.

In addition to the materialist and competitive nature of Chinese leaders’ globalization belief, they still perceive that globalization has unfair features and negative impacts. On one hand, the legitimacy and positive effects of globalization originate from its reflection of the “objective” development of productive forces. On the other hand, “the trend of economic globalization is evolving and developing under the situation that the old unfair international economic order has not substantively changed” (Jiang 2006, vol. 2: 200). As Jiang Zemin points out, “the rules of the game’ of the international economy were established mainly under the leadership of Western countries and all international economic and financial organizations are under the control of the US and other developed countries; they would always make use of those advantages to pursue economic hegemonism and to maximize their own benefits” (Jiang 2006, vol. 2: 201).

The “double-edged-sword” effects of economic globalization will inevitably bring costs to China alongside potential benefits, with the major sources of risk stemming from the “economic

hegemonism” of Western countries. Although believing in the inevitability of globalization enables Chinese elites to develop a dynamic and dialectic view on the benefit-cost calculation, this does not mean that they pay less attention to the risks than to the opportunities when integrating with the global economy. When Chinese leaders emphasize that China has to “take initiative in fierce international competition” and “adapt to the globalization trend”, they mean that China should not only steadfastly uphold the “reform and opening-up” policy and actively seek opportunities, but also “be aware of the possible risks of economic globalization, maintain independence, be vigilant, and enhance the capability of countering the risks, so as to solidly safeguard [its] national economic security and better develop and strengthen [itself]” (Jiang 2006 vol. 2: 201). Given that Chinese leaders perceive Western developed countries as potential competitors and as the sources of injustice in the international economic order, they have always been cautious about state sovereignty when opening up China’s market to the outside world.

As the legitimacy of economic globalization cannot unlimitedly weaken Chinese leaders’ sovereignty belief and thus significantly lower the normative costs of ceding economic control rights, the Westphalian sovereignty has played an indispensable role in determining China’s national interests and influencing its foreign economic policies. The contents of China’s new BITs clearly exhibit Chinese decision makers’ attempts to minimize the sovereignty costs of boundary-transgressing obligations and to balance its mixed interests of a capital-importer and -exporter. As Li Chenggang, current Director of the Department of Treaties and Laws in the MOFCOM, explicitly states,

Nowadays, China is not only a capital-importing, but also a capital-exporting great power. *As a capital-importer, we emphasize more on keeping rights in hands [liu quan zai shou]; while as a capital-exporter, we emphasize more on market openness and rights protection.* Because of our mixed roles, we have mixed demands when negotiating and designing investment rules. *In this new situation, we should not pay attention to only one and neglect the other aspects, but should balance China’s dual roles as a capital-*

*importer and -exporter* (Li, C. 2012:4).

Although implementing the “going out” strategy increases the material benefits for China to sign legalized treaties with developing countries, and the globalization trend lowers the normative costs of loosening its control over foreign investment to a certain extent, the concerns about state sovereignty when negotiating with developed countries have limited the degree of liberalization of China’s new BITs. As a MOFCOM official said in an interview, because China perceived itself as a capital-importer vis-à-vis developed states, the major concern when negotiating with those countries was state sovereignty; if developed countries did not request renegotiation, China would not take the initiative to ask them to do so (Interview BJ080523). His words indicate that on the one hand, the globalization norm has indeed lowered the normative costs of ceding economic control rights, as China would not reject signing legalized treaties with developed countries; on the other hand, because deviating from the Westphalian norm in the economic area still imposes sovereignty costs on China, it is actually reluctant to update the old treaties and will not do so except under pressure from its Western counterparts.

Moreover, once China starts renegotiation with developed countries, it will try to minimize sovereignty costs by making reservations to boundary-transgressing provisions in treaty protocols. For example, although the formal treaty texts of China’s new BITs grant private investors national treatment at the post-establishment stage, the protocols state that with regard to China, the treatment clauses do not apply to the following situations: “(a) any existing non-conforming measures maintained within its territory; (b) the continuation of any such non-conforming measures; (c) any amendment to any such non-conforming measure to the extent that the amendment does not increase the non-conformity of these measures” (e.g. BIT with Germany in 2003). That means that China has the right to maintain any inconsistencies between its practices

and treaty provisions that existed before the entry into force of the new BITs. Nevertheless, China promises that it “will take all appropriate steps in order to progressively remove the non-conforming measures.” Chinese officials call these reservations a “stand still” clause [*dongjie tiaokuan*], which is not compulsory and functions as “soft obligations” [*ruan yiwu*] (Interview 080412; Ma 2007: 264). This reservation provides China with an unspecified transition period and allows it gradually to narrow the gap between its practices and the national treatment commitments without being punished for the continuation of nonconformities.

As for the delegation mechanism, Chinese government officials indeed recognize the increasingly important role of the ICSID in solving investment disputes and would like to follow the international trend of legalization. Yet they are not completely satisfied with the ICSID regime, considering the arbitration procedures “expensive and time-consuming” and many of ICSID’s previous decisions “controversial” (Ma 2007: 266, 267). Especially given that some private investors may abuse the mechanism and exert unnecessarily high sovereignty costs on host states, they believe that it is proper to maintain as much policy autonomy as possible and require investors to seek domestic remedies before resorting to international arbitration (Interview BJ080425).

Therefore, in order to lower the sovereignty costs of the mandatory DSM, China has made unilateral reservations in renegotiated BITs with developed countries. Most treaty protocols recognize that China may require investors to exhaust its domestic administrative review procedures before the submission of any dispute to international arbitration. Meanwhile, China promises that the administrative review process shall not exceed three months. The combination of the “exhaustion of local remedy” principle and the time limit for domestic procedure indicates China’s efforts to balance between state sovereignty and the compulsory DSM. Although China tries to keep dispute resolution within domestic terrain and use administrative rather than legal

means to solve disputes, the three-month limit ensures that the reservation clause cannot indefinitely delay or prevent investors from resorting to international arbitration.

The reservations that China has made in its new BITs enable it to maintain certain degrees of policy autonomy and minimize the sovereignty costs of legalized BITs. Although Chinese leaders believe that the new treaties can help protect China's overseas investment and that China should follow the globalization trend, the sovereignty norm determines that they could accept only the lower-bound of boundary-transgressing obligations in legalized BITs. As stated in an interview with a MOFCOM official, "because of the concern of sovereignty, our BIT template follows the relatively conservative German type, not the more liberal American type; moreover, we also insert the 'stand still' clause and require investors to exhaust domestic administrative review, so that we can maintain as much sovereignty as possible when signing treaties with developed countries" (Interview BJ080425).

## **6. Conclusion**

This paper examines why China has changed its long-time conservative stance toward legalized BITs, being willing to grant national treatment to foreign investors and delegate dispute settlements to the ICSID since the late 1990s. It suggests that the primary driving force for China to deepen its integration with the liberal international economic order is the evolution of its new strategic interests, which increases the material benefits and partially offsets the sovereignty costs of signing and ratifying hard laws; meanwhile, China's acceptance of the legitimacy of a sweeping social force or the inevitability of the boundary-transgressing globalization trend *incrementally* lowers the normative costs of delegation and complements the material factors in driving changes.

However, the new material interest and boundary-transgressing belief cannot completely replace the traditional sovereignty norm in shaping China's BIT policies. Despite the significant

changes in China's BIT practices in the most recent decade, China does not accept the national treatment and compulsory DSM clauses unconditionally, and its new BITs do not reach the highest degrees of liberalization and legalization. The reservations China has made to the boundary-transgressing obligations indicate that Chinese leaders have tried to reconcile its material interests, the globalization belief and the sovereignty norm, and to maintain a delicate balance between its dual roles as a capital-importer and -exporter at the same time. Thus, China is still in a weak socialization process and has not fully internalized or accepted the liberal values of international economic norms. The normative costs of deviating from Westphalian sovereignty cannot be significantly reduced, and China cannot accept highly legalized treaties without making reservations to minimize the sovereignty costs.

China's approach to sovereignty and legalization shows that in a weak socialization process, both material incentives and international social forces are effective mechanisms for China to keep up with ongoing international institutional and normative developments and to deepen its integration with the world. Although the sovereignty norm still plays an important role in shaping China's interests and China has not been able to fully internalize liberal international norms, it nonetheless willing to follow the mainstream and moving along with international social trends in major economic issue areas.

In fact, a robust and legitimate international order should be able to provide material benefits for a rising power and accommodate its strategic interests to a certain extent. If an international order can only benefit established great powers and denies the legitimate demands of a rising power, such an order is exclusive and unstable in nature and may easily turn a rising power into a revisionist state. In contrast, the BITs case indicates that when China's relative power increases, it sees more congruence between its strategic interests and the established international order and is

Jing Tao

more willing to participate in international institutions with binding obligations and high sovereignty costs. That means that the current liberal international economic order can well accommodate the interests of a rising power, making China more likely to recognize its legitimacy and become a status quo state as its power increases.

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