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PARDEE CENTER **TASK FORCE REPORT**

A globe constructed from interlocking puzzle pieces, resting on a stack of Euro banknotes. The puzzle pieces are white with black outlines, and the globe is positioned over a stack of Euro banknotes, including a 10 Euro note and a 20 Euro note. The background is a blurred image of more Euro banknotes.

## Capital Account Regulations and the Trading System: A Compatibility Review

# Capital Account Regulations and the Trading System: A Compatibility Review

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Occasionally, the Pardee Center convenes groups of experts on specific policy questions to identify viable policy options for the longer-range future. This series of papers, *Pardee Center Task Force Reports*, presents the findings of these deliberations as a contribution of expert knowledge to discussions about important issues for which decisions made today will influence longer-range human development.

Report editor: Kevin P. Gallagher

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This report is a project of the Global Economic Governance Initiative (GEGI) coordinated by Pardee Faculty Fellow Kevin P. Gallagher. For more information, visit <http://tinyurl.com/Pardee-GEGI>.

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## **ACRONYMS AND ABBREVIATIONS**

**AB:** Appellate Body

**AML:** Anti-Money Laundering

**APTA:** Asia Pacific Trade Agreement

**ASEAN:** Association of Southeast Asian Nations

**BCB:** Central Bank of Brazil

**BIPA:** Bilateral Investment Promotion and Protection Agreement

**BIS:** Bank for International Settlements

**BIT:** Bilateral Investment Treaty

**BRICS:** Brazil, Russia, India, China, South Africa

**BRL:** Real (Brazilian currency)

**CAFTA-DR:** Dominican Republic-Central America Free Trade Agreement

**CAR:** Capital Account Regulation

**CECA:** Comprehensive Economic Cooperation Agreement

**CEDES:** Center for the Study of State and Society

**CEPA:** Comprehensive Economic Partnership Agreement

**CFT:** Countering Terrorist-Financing

**COOL:** Certain Country of Origin Labeling

**CTFS:** Committee on Trade in Financial Services (WTO)

**EFTA:** European Free Trade Association

**EMD:** Emerging Market and Developing Countries

**EME:** Emerging Market Economy

**FATCA:** Foreign Account Tax Compliance Act

**FDI:** Foreign Direct Investment

**FEMA:** Foreign Exchange Management Act

**FII:** Foreign Institutional Investors

**FSA:** GATS Annex on Financial Services

**FSB:** Financial Stability Board

**FTA:** Free Trade Agreement

**FTAA:** Free Trade Area of the Americas

**FX:** Foreign Exchange

**FXDR:** Foreign Exchange Derivatives Regulations

**GATS:** General Agreement on Trade in Services

**GATT:** General Agreement on Tariffs and Trade

**ICSID:** International Centre for Settlement of Investment Disputes

**IIA:** International Investment Agreement

**IMF:** International Monetary Fund

**IOF: Imposto de Operações Financeiras**  
**ISA: International Services Agreement**  
**LFT: Less Favorable Treatment**  
**MAI: Multilateral Agreement on Investment**  
**MERCOSUR: Member of the Southern Common Market**  
**MFN: Most Favored Nation**  
**MNC: Multinational Companies**  
**NAFTA: North American Free Trade Agreement**  
**ODI: Overseas Direct Investment**  
**OECD: Organization for Economic Cooperation and Development**  
**OTC: Over The Counter**  
**PBOC: People's Bank of China**  
**PIN: Public Information Notice**  
**PMD: Prudential Measures Defense**  
**PTA: Preferential Trade Agreements**  
**R-QDII: RMB Qualified Domestic Institutional Investors**  
**R-QFII: RMB Qualified Foreign Institutional Investors**  
**RBI: Reserve Bank of India**  
**RMB: Renminbi (Chinese currency)**  
**SENPLADES: Public Investment of Ecuador's Planning Secretariat**  
**TPP: Trans-Pacific Partnership**  
**UNCTAD: United Nations Conference on Trade and Development**  
**UNDESA: United Nations Department of Economic and Social Affairs**  
**Unicamp: Institute of Economics of the State University of Campinas**  
**USAID: United States Agency for International Development**  
**WIR: World Investment Report**  
**WTO: World Trade Organization**



# Executive Summary

## Capital Account Regulations and the Trading System: The Need for Reconciliation

Kevin P. Gallagher and Leonardo E. Stanley

The global financial crisis has re-confirmed the need to regulate cross-border finance. As this consensus has emerged, some policymakers and academics have expressed concern that many nations may not have the flexibility to adequately deploy such regulations because of trade and investment treaties they are party to. This report validates that such concerns are largely justified, and offers remedies to make the trading system more compatible with the proper regulation of global finance.

In June 2012, the Global Economic Governance Initiative at Boston University's Pardee Center for the Study of the Longer-Range Future—along with the Center for the Study of State and Society from Buenos Aires, Argentina, and the Global Development and Environment Institute from Tufts University, USA—convened a workshop of the Task Force on Regulating Global Capital Flows to perform a “compatibility review” of the regimes for regulating cross-border finance and for international trade and investment.

That process revealed that there may be a number of incompatibilities between the ability to regulate cross-border finance and disciplines under the World Trade Organization (WTO) and the myriad “free trade agreements” (FTAs) and bilateral investment treaties (BITs) that many nations have agreed to over the past decade. In general, the review found that FTAs and BITs are far more incompatible with the ability to regulate cross-border finance than is the WTO.

This effort builds on an initial workshop of the Task Force that resulted in a report titled *Regulating Global Capital Flows for Long-Run Development*. In that report the Task Force asserted that capital account regulations (CARs), traditionally referred to as “capital controls,” were an essential part of the macroeconomic toolkit for emerging market and developing countries. The Task Force

stressed that CARs on inflows and outflows of capital should be a permanent part of a series of counter-cyclical measures to smooth financial booms and busts in a nation in order to create the proper environment for long-run growth. The Task Force also noted that at times it may be necessary for nations to cooperate on “both ends” of capital flows in order to regulate cross-border finance in an efficient manner.

This brief introduction highlights the main incompatibilities between capital account regulations and the trading system that were identified by members of the Task Force, and offers concrete remedies to reconcile the ability to deploy capital account regulations with the trade and investment regime.

## **RESULTS OF COMPATIBILITY REVIEW BETWEEN CARs AND THE TRADING SYSTEM**

Members of the Task Force were asked to review agreements at the WTO and various FTAs and BITs to examine the extent to which the trading regime was

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### **A number of potential incompatibilities were found between the WTO and the ability to deploy CARs.**

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compatible with the ability to deploy effective capital account regulations. A number of potential incompatibilities were found between the

WTO and the ability to deploy CARs. Even more alarming is the lack of policy space to use CARs under a variety of FTAs and BITs—especially those involving the United States.

Box 1 shows the main features that contrast the WTO and BITs/FTAs with respect to CARs. On the whole, the WTO is more conducive to regulating finance than are FTAs and BITs, though there are some significant concerns. In terms of process, it is important to note that the WTO is a “one country, one vote” system that thus enables significant coalitions to emerge among emerging market and developing countries (EMDs). Moreover, negotiations at the WTO, for financial services, take a “positive list” approach whereby nations get to choose which sectors to liberalize and even put limitations or conditions on such liberalization. Indeed, Chile liberalized trade in cross-border financial services but reserved the right to deploy CARs when monetary authorities saw it as necessary (Saez 2006).

In contrast, FTAs and BITs are products of asymmetric bargaining power, often pitting a large country against a smaller one where market access to the larger is conditioned on large concessions by the smaller nation. This is accentuated by

the “negative list” approach to the negotiation where a nation has to liberalize all of its financial services except for those that a nation lists to protect. This is problematic because of the weaker negotiating position of EMDs and the lack of ability to anticipate future financial services and how they might be regulated.

**Box 1: WTO vs FTAs-BITs**

| <u>WTO</u>   | <u>FTAs/BITs</u>   |
|--|--|
| One country, one vote                                | Asymmetric bargaining power  |
| Positive list  | Negative list  |
| Narrow free transfers requirement                    | Expansive free transfers requirement   |
| Covers all financial services                        | Covers all financial services and investment   |
| Balance of payments safeguard & prudential carve out | Typically only includes either a balance of payments or a prudential defense, not both |
| State-to-state dispute settlement                    | Investor-state dispute settlement  |

Under the WTO, when nations choose to liberalize financial services—either through what is called “Mode 1” trade in financial services or “Mode 3” establishing a commercial presence (foreign direct investment (FDI)) for financial service providers under the General Agreement on Trade in Services (GATS)—they do have to open their capital account in order for those services to contract. FTAs and BITs, in contrast, require free transfers associated with all covered investments, which are defined broadly. This obligation requires, in effect, a full opening of the capital account among parties to the agreement.

The WTO also has a balance of payments safeguard (Article XII), general exception (Article XIV) and a prudential measures defense often referred to as a “carve out” (Article 2(a) of the Financial Services Agreement). FTAs and BITs typically only include one of the above.

Disputes at the WTO are conducted among nation-states and sometimes involve the International Monetary Fund (IMF) for expertise. FTAs and BITs almost never involve monetary authorities, and offer both state-state and investor-state dispute resolution. In these cases, private investors can directly file claims against nation-states for alleged violations to a treaty.

## The World Trade Organization

Although the WTO requires a more limited opening of the capital account and may have a broader level of safeguards, some of the Task Force members raised a number of concerns about the ability of nation-states to deploy CARs while maintaining their commitments under the GATS. Under the GATS, if a nation makes commitments under Mode 1, it is required to open the capital account to allow those services to transact and is not permitted to regulate capital flows. Second, it is not clear that the GATS safeguards give ample room for nations to deploy CARs.

If a nation does not make any GATS commitments in Modes 1 or 3, of course it is free to regulate cross-border finance as it sees appropriate. If a nation does list Mode 1 or Mode 3 commitments, some degree of capital account liberalization is required. The IMF (2010) notes the following:

WTO members must allow cross-border (inward and outward) movements of capital if these are an essential part of a service for which they have made liberalization commitments regarding its cross-border supply (without establishment). For example, international capital transactions are an integral part of accepting deposits from or making loans to nonresidents (Mode 1). International capital transactions are also usually associated with financial services such as securities trading on behalf of a customer residing in another country. The establishment of a commercial presence (Mode 3) in a host country by a foreign services supplier involves both trade in services and international capital transactions. In permitting the establishment of a commercial presence, WTO members must allow inward (but not outward) capital transfers related to the supply of the service committed.

However, the GATS has three safeguard provisions that may allow nations to derogate from their commitments. Box 2 presents the most relevant components of each safeguard.

With respect to the balance of payments safeguard, some members of the Task Force echo concerns from the legal literature about Article XII (see Viterbo 2012). It may be that the GATS balance of payments safeguard does not adequately guarantee that nations can use measures to regulate both the inflow and outflow of capital because there is no reference to derogations to maintain “financial stability.” Moreover, 2(c) in the balance of payments exception states that measures

## Box 2: Key Safeguards Relevant to CARs

### GATS Article XII: Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.
2. The restrictions referred to in paragraph 1:
  - (a) shall not discriminate among Members;
  - (b) shall be consistent with the Articles of Agreement of the International Monetary Fund;
  - (c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;
  - (d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;
  - (e) shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.
3. In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programmes. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

### Article 2(a) of the Financial Services Agreement

#### 2. Domestic Regulation

- (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

“shall not exceed those necessary” to deal with the circumstances that a measure is trying to prevent or mitigate. This amounts to what is called in WTO law as a “necessity test” and could give a dispute panel authority to rule that an alternative measure could have been used. Furthermore, some Task Force members expressed concern over 2(e). Requiring that measures be “temporary” may not give nations ample time to meet their stated goals.

Moreover, some members of the Task Force expressed concern that the procedures for use of the WTO's balance of payments procedures are overly cumbersome, especially for smaller developing countries. WTO rules require that nations file substantiating information to the WTO during the very crisis that a nation is working hard to mitigate. In a country like Ecuador, a recent example, this required the time and money of various regulators and trade negotiators—time and money perhaps better spent on crisis mitigation.

The GATS also has a provision often referred to as the “prudential carve out” (Article 2(a) of the Financial Services Agreement). This exception allows members to deviate from their commitments “for prudential reasons” to ensure the protection of investors or to “ensure the integrity of and stability of its financial system.” The GATS adds that if the prudential measures deviate from a nation’s GATS commitments “they shall not be used as a means of avoiding the Contracting Party’s commitments or obligations under the Agreement.” Some Task Force members echoed concerns in the legal literature that “prudential reasons,” while not defined, may not cover CARs and that the sentence stating that prudential measures should not breach a party’s commitments could be seen as “self-canceling.”

It should be stressed that there has not been a case where this language has been tested with respect to CARs. Some Task Force members believe that existing language will be sufficient. Indeed, Ecuador is leading an effort to clarify the extent to which nations looking to re-regulate their financial systems can do so under the “cover” of these safeguards. Their inquiry, for cautious reasons, was careful not to mention very specific measures or disciplines however. While a formal decision on this matter has thus far been blocked, Ecuador has received on-the-record assurances from many OECD countries, including the United States, that the GATS safeguards leave ample room to maneuver to prevent and mitigate financial crises (WTO 2011a).

### **Free Trade Agreements and Bilateral Investment Treaties**

While reviews are mixed on the WTO, Task Force members unanimously agreed that many FTAs and BITs may be significantly incompatible with the ability of nations to deploy CARs.

Most FTAs and BITs are wider in scope than the WTO. Whereas the GATS only covers capital transfers related to trade in financial services, FTAs and BITs often cover all transfers between parties. In addition, transfers are often broadly defined as any investment, including stocks, bonds, currencies, derivatives, direct investment,

and beyond. Thus a much broader number of investments must be allowed to be transferred “freely and without delay” among parties to an agreement.

Often, a developing country is at a disadvantage when negotiating an FTA or a BIT that uses a “negative list” approach whereby a nation is expected to liberalize all sectors except a handful where they still want to regulate. Thus if a nation wanted to regulate a new financial “innovation” in the future such as a new form of derivative, that nation would not be permitted to regulate the related investments because it hadn’t anticipated the innovation and reserved the right to regulate during the negotiation. Of course, such anticipation is impossible.

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Astonishingly, many FTAs and BITs do not have a balance of payments safeguard and/or a prudential carve out. Those that do have a balance of payments safeguard are often modeled after the GATS Article XII and thus have the same concerns described above (lack of clear scope for inflows and outflows, a necessity test, and restrictions of temporariness). Among the few agreements that have a prudential carve out are those with the United States (which generally do not have balance of payments safeguards). However, most U.S. treaties tie the definition of “prudential” more closely to policies pertaining to “individual financial institutions” and also include the potentially “self-canceling” language found in the GATS. Moreover, U.S. negotiators have repeatedly stressed that existing language does not pertain to the use of capital controls (Saez 2006; Taylor 2003; Geithner 2011). Indeed, a handful of U.S. treaties have annexes that note how capital account regulations are deviations from commitments but require an extended “cooling off” period before foreign investors may file claims for compensation. One treaty, the United States-South Korea FTA, allows South Korea to deploy regulations as specified under its law as long as such measures meet a number of limitations specified in the Annex.

The IMF has expressed concern that many FTAs and BITs lack the adequate safeguards to put in place CARs: “The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows” (IMF 2012, 8). The IMF has developed an institutional view on the use of CARs that defines CARs as

“measures affecting cross-border financial activity that discriminate on the basis of residency” (IMF 2011). Therefore forbidding nations to violate “national treatment” in treaties may thus constrain the ability of nations to use CARs in general and under IMF advice in particular. Some U.S. treaties allow nations to deploy price-based taxation measures on capital flows, or have an annex that allows a nation to deploy CARs as long as they meet national treatment requirements. Such limitation may nullify the ability to use CARs by definition. Moreover, such incompatibility may make it more difficult for nations to accept the IMF policy advice based on its new institutional view.

Finally the Task Force expressed serious concern about the use of “investor-state dispute resolution” in cases pertaining to CARs in FTAs and BITs. WTO disputes are settled “state-to-state” and therefore nation-states can negotiate on behalf of the well-being of entire nations and financial systems—looking for situations where the benefits to the majority outweigh losses to a minority. However, that cost-benefit analysis is tipped on its head under investor-state disputes. Under investor-state provisions, private firms and investors may directly file claims against governments that regulate capital. Therefore, those sectors that may bear the cost have the power to externalize the costs of financial instability to the broader public while profiting from awards in private tribunals.

## **MAKING THE TRADE REGIME COMPATIBLE WITH REGULATING FINANCIAL FLOWS**

Members of the Task Force discussed how a variety of procedures could yield substantive reform at the WTO and in FTAs and BITs. Box 3 outlines a range of reforms and clarifications that could be undertaken at the WTO and under FTAs and BITs.

While Task Force members agree that the WTO is likely more compatible with CARs than BITs and FTAs, there are a number of uncertainties that could be remedied. The Article XII balance of payments safeguard could be interpreted or amended to include measures to ensure “financial stability” and development, not be limited to temporary measures, and not be subject to a necessity test. Moreover, nations wishing to evoke Article XII should be able to register and notify the WTO after the fact, rather than in the midst of a crisis. This would allow nations to focus on the mitigation tasks at hand. In the prudential carve out the language pertaining to “prudential” would be clarified so as to include the use of CARs, and the language that has been interpreted by some as self-canceling would be deleted.

### **Box 3: Potential Reforms to the Trading System**

#### **WTO Reforms**

- 1) The balance of payments exception should be broadened to allow nations to regulate capital inflows and outflows for financial stability and development
- 2) The process for activating balance of payments exceptions should be streamlined
- 3) Prudential carve out should clearly allow for the use of capital account regulations

#### **Reform of FTAs and BITs**

- 1) Negotiate commitments with a “positive list” approach
- 2) Consider excluding certain kinds of investments as beyond the scope of agreements
- 3) Include balance of payments safeguards that clearly allow for the use of CARs
- 4) Include a prudential carve out that clearly allows for the use of CARs
- 5) Ensure that disputes are resolved by nation-states and in collaboration with financial and monetary regulators

FTAs and BITs will require more significant reform. At the negotiating table, at least with emerging market and developing countries, financial services and transfers provisions could be conducted using a “positive list” approach as in the WTO. This would allow nations to liberalize specific sectors as they reach appropriate threshold levels of institutional development and not bar the possibility of future regulations that may be needed.

The definition of investments and investors could be narrowed to leave the most unstable types of investment (such as sovereign debt, short-term debt and equity, currency trade, and derivatives) to the realm of national and global regulators, not trade treaties. This has been recommended by some IMF officials and more recently listed as a possible option by the United Nations Conference on Trade and Development (UNCTAD) in a new set of guidelines it has issued on investment agreements (Hagan 2000; UNCTAD 2012).

Treaties should have balance of payments safeguards and prudential carve outs that allow for the use of CARs in a similar manner to the reforms we suggest for the GATS. Perhaps most importantly, where trade and investment treaties do overlap with financial regulatory reform they should be subject to state-to-state

dispute settlement and in consultation with appropriate monetary and economic policy authorities and experts.

There are a variety of processes and procedures that could lead to these reforms:

**1. Refrain from taking on new commitments in regimes incompatible with the ability to deploy CARs.** Nations could refrain from making Mode 1 and Mode 3 commitments under GATS altogether, and refrain from signing FTAs and BITs without proper safeguards and dispute settlement. Of course, in the current WTO negotiations many nations are essentially doing this by not further liberalizing current GATS commitments, and nations such as Brazil and others are not signing FTAs and BITs. However, that is not an option for the numerous nations that already have GATS commitments and are party to FTAs and BITs that lack the proper policy space for regulating capital flows. Though some nations, such as Bolivia and Ecuador, have begun withdrawing from their treaty obligations altogether.

**2. Adopt “interpretations” of existing treaty language.** Both the WTO and FTAs-BITs allow for “interpretive notes” or amendments that could clarify or change existing language in current treaties. Article IX: 2 of the Agreement Establishing the WTO allows the WTO Ministerial Conference or the General Council to adopt—with a three-quarters majority—official interpretations of the GATS on the basis of a recommendation of the Council for Trade in Services. Moreover, CARs could be included in “Recognition Agreements” among willing parties, as allowed by Article 3 of the GATS Annex on Financial Services. For example, an interpretive note could clarify that language under the GATS for the balance of payments exception and the prudential carve out cover the use of CARs in the manner that is recommended here. Ecuador has engaged with the Committee on Financial Services in a process that could lead to an interpretation of this kind. For FTAs and BITs such processes exist as well. U.S. Congresspersons Barney Frank and Sander Levin have together asked the United States Treasury to issue an interpretive note that would allow the proper flexibilities to deploy CARs under U.S. treaties.

**3. Amend existing treaties to reconcile current incompatibilities.** Another route to reform would be formal amendments to existing treaties. Amendments to the GATS can be submitted to the Ministerial Conference by a member or by the Council for Trade in Services, and be adopted by consensus or with a two-thirds majority vote. For an amendment to enter into

force it has to be ratified by two-thirds of WTO members. Nevertheless, a new set of guidelines for investment treaties that better balance investor protection and development suggest that amending existing treaties is an option for reform (UNCTAD 2012).

**4. Design new rules for future treaties.** Treaties currently under negotiation or those that may occur in the future could be designed to have a narrower definition of investment, negative list negotiations, adequate balance of payment and prudential carve out exceptions, special and differentiated treatment, and dispute settlement procedures that exhaust domestic remedies and have state-to-state dispute settlement in consultation with macroeconomic and monetary authorities and experts. The new UNCTAD guidelines make recommendations along these lines. Nations such as Australia have begun to negotiate trade deals without investor-state dispute settlement.

Each of these processes and procedures has its own costs, benefits, and level of political feasibility that will vary on a case-by-case basis. Some members of the Task Force prefer a preventative approach to clarify and amend existing agreements

now, before such language is tested in dispute settlement bodies. However, some expressed caution that certain procedures may open a Pandora's box and leave the trading system

even more incompatible with the adequate regulation of global finance. It is clear from the analyses conducted by the Task Force that there are a number of areas in the trading system that are potentially incompatible with the ability of nations to deploy capital account regulations for stability, growth, and development.

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# Section 1: The Compatibility between the WTO and Regulating Capital Flows

## 1. How to Make the GATS a Code of Conduct for Capital Controls

Annamaria Viterbo

This essay analyzes the extent to which provisions under the General Agreement on Trade in Services (GATS) make it more difficult for nations to deploy capital account regulations. Furthermore, it outlines processes and policies that could be undertaken at the WTO that would enable the GATS to become a model whereby nations could have the appropriate policy space to regulate capital flows.

### **CAPITAL ACCOUNT LIBERALIZATION UNDER THE GATS**

The GATS does not contain a general obligation to liberalize capital flows.

GATS Article XI (Payments and Transfers), in fact, sets forth only a “conditional obligation,” according to which when a State has undertaken to grant market access and national treatment to specific service sectors, it will be requested to liberalize also those current and capital movements in connection to those services.

Therefore, unless a Member of the GATS has voluntarily undertaken to be bound in its schedule of specific commitments, it remains free to adopt capital controls without violating any of the GATS rules.

Footnote 8 to Article XVI (Market Access) makes it even clearer that the pace of capital account liberalization is defined by the extent to which a State has committed itself to grant market access for cross-border supply of services (Mode 1) or for their supply through commercial presence (Mode 3).

For what concerns Mode 1, Footnote 8 stipulates that, if the cross-border movement of capital is an “essential part” of the service itself, the Member is required to liberalize the associated *inward* and *outward* capital flows.<sup>1</sup> The movement of

**Provision of financial services under Mode 1: controls on both capital inflows and outflows are prohibited**

capital becomes an “essential” component of the service transaction especially in the provision of financial services. While for instance the provision of cross-border engineering consultancy does not necessarily involve a capital flow, financial services will almost always generate a capital movement, the two being inextricably intertwined.<sup>2</sup>

As for services provided under Mode 3, Footnote 8 requires Members to allow the associated transfers of capital *into* their territory, thus liberalizing capital *inflows* both in the establishment and post-establishment phase of the investment. The obligation to liberalize capital inflows applies to all the sectors listed in a country’s schedule of commitments, and not only to financial services.

Besides, Members would not be allowed to make the establishment more burdensome by imposing unremunerated reserve

**All services sectors under Mode 3: controls on both capital inflows and outflows are prohibited**

requirements, by which non-residents would have to deposit with the central bank (or a commercial bank) a percentage of their capital inflows for a given period and at zero interest rate. Moreover, as the operation of a company will almost certainly involve the periodic transfer of financial resources, any restriction on the *outward* movements of capital necessary to provide

the service would be prohibited, since otherwise the commitment in question would be without value (for a different view, see Pasini 2012, 22).

In Footnote 8 there is no explicit obligation to liberalize capital movements related to Mode 2 (consumption abroad). However, for electronic transactions in financial services, the distinction between Mode 1 and Mode 2 of the GATS remains ambiguous since there is no clear criterion to establish when the service (Mode 1) or the consumer (Mode 2) crosses the border (WTO 2010, para. 47 ff.). The issue is of particular importance because many Member States have partly liberalized financial services under Mode 2, but not under Mode 1.

## **THE SCOPE OF THE GATS EXCEPTIONS: LIMITED ROOM FOR THE INTRODUCTION OF CAPITAL CONTROLS**

Member States wishing to deploy capital controls should therefore be aware of the fact that, once specific commitments have been undertaken under Mode 1 and Mode 3, measures on capital flows may be introduced only relying on GATS exceptions.

In particular, capital controls can be adopted to satisfy a request by the IMF (GATS Article XI:2), to deal with balance of payments difficulties (GATS Article XII), or to ensure the integrity and stability of the financial service sector (under the GATS prudential carve-out clause contained in Article 2(a) of the Annex on Financial Services).<sup>3</sup>

a) GATS Article XI prohibits Member States from applying restrictions on payments and transfers as well as on capital transactions non-consistent with their specific commitments. As emphasized by the WTO Panel in the 2004 *United States—Gambling* case, this provision is an indispensable complement to GATS rules on market access and national treatment (WTP 2004, para. 6.442).

The prohibition of Article XI, however, is not absolute in nature. In fact, paragraph 2 of the provision contains an “ex ante coordination clause” which prevents conflict between the GATS and the IMF treaties to arise in the first place (“Nothing in this Agreement shall affect the rights and obligations of the members of the IMF [..]”), provided that certain criteria are met.

**Under GATS Article XI:2 (Payments and Transfers), capital controls can be legitimately introduced only ‘at the request’ of the IMF, a prerogative the Fund has never exerted**

Accordingly, Members may introduce restrictions on capital movements (both *inwards* and *outwards*)—even when they are incompatible with their GATS specific commitments—“at the request of the Fund” (pursuant to IMF Article VI, Section 1).

Since the IMF has never exerted its right to request the introduction of capital controls, the exception set forth by GATS Article XI:2 would remain without effect if not interpreted in a broader sense, as to cover also capital controls introduced for conditionality or under an IMF lending program (like in the case of Iceland 2008).

Unfortunately, in the *Argentina—Textiles and Apparel* case, the Appellate Body found that a capital control measure can be considered consistent with WTO law only when applied as a result of a “legally binding obligation” arising from the IMF Articles (WTO 1998a, para. V). Under this interpretation, policy pledges made by an IMF Member in a letter of intent, or in a memorandum of economic policy, would not be covered by GATS Article XI:2 as they are implemented on a voluntary basis, following a mere recommendation by the Fund. The opposite standpoint would be more in line with the objective of preserving the rights of IMF Members and avoiding conflict of norms.

**It remains unsettled whether GATS Article XII:1 (Balance of Payments Safeguard Clause) covers controls on capital outflows as well as on inflows**

b) Pursuant to GATS Article XII:1, in times of balance of payments (BoP) problems or external financial difficulties, Members are allowed not only to impose temporary trade restrictions on service sectors for which they have undertaken specific commitments, but also to introduce exchange restrictions on service-related payments.

Besides, even if GATS Article XII makes no reference to the possibility of adopting capital controls, this option cannot be ruled out. The right to resort to capital measures can be inferred from the use of the word “including,” which clearly means that the drafters made an exemplification rather than a closed list of exceptions.<sup>4</sup>

It is worth mentioning that, during the negotiations of the Multilateral Agreement on Investment (MAI) within the OECD, a question arose on whether the GATS BoP clause covered restrictions just on capital *outflows* or if it applied also to *inflows*.<sup>5</sup> The issue remained unsettled: a number of delegations expressed the view that the BoP clause was applicable in both senses, while the IMF argued that serious balance of payments difficulties and the depletion of monetary reserves are caused mainly by excessive capital outflows.

In order to be consistent with WTO law, capital controls should also satisfy a number of requirements established by the GATS BoP clause: they cannot discriminate among Members; they have to be temporary and progressively phased out as soon as the situation starts improving; they have to avoid unnecessary damage to commercial, economic, and financial interests of other Members; they cannot exceed what is necessary to deal with the circumstances; and they have to be consistent with the IMF Articles.

It should be carefully assessed how these requirements can affect the design of new capital controls.

Non-discrimination, for instance, raises some concerns: in a recent staff paper on a new policy framework for the management of capital outflows (IMF 2012), the IMF suggested that priority should be given not to measures discriminating on the basis of residency (which would amount to a breach of national treatment), but to measures discriminating on the basis of currency (like currency-specific reserve requirements or limitations on foreign currency borrowings). It has to be pointed out, however, that it is in the nature of capital controls to discriminate

to some extent between residents and non-residents; secondly, the question remains unanswered on whether measures concerning currency would be consistent with the GATS BoP clause.

As for the “necessity test,” in dispute settlement proceedings the initial burden of proof is on the respondent party, which would have to represent that the measure under review was necessary (even if it does not have to prove that alternatives were not reasonably available) (WTO 2005, para. 308–311).<sup>6</sup>

On the subject of procedural requirements, capital controls should be notified to the WTO General Council and be followed by consultations with the Committee on Balance of Payments Restrictions. In particular, the Committee is entrusted with the task of determining whether the balance of payments situation of the Member concerned justifies the adoption of restrictions, verifying also whether the criteria established by GATS Article XII:2 have been complied with. The Committee can also make recommendations on the progressive withdrawal of the restrictions.

Besides, GATS Article XII:5(e) lays down a procedural link with the IMF regime, delegating to the IMF the assessment of a Member’s situation in terms of foreign exchange, monetary reserves, and balance of payments.

c) Article 2(a) of the GATS Annex on Financial Services (FSA) contains a carve-out clause that allows a country to adopt prudential measures regardless of its specific commitments on market access and national treatment. This exception applies only to the financial service sector and overrides the obligations arising from GATS Article VI (Domestic Regulation).

**It is still unclear whether the GATS prudential carve-out clause also covers controls on capital inflows**

The clause does not provide a definition of “prudential regulation.” Therefore, in the absence of case law, the question over whether capital controls (especially those on *inflows*) fall within the scope of the prudential carve-out clause remains unsettled. It has been argued that prudential measures do not include capital controls (even if they have a clear macro-prudential nature), but only Basel-type measures such as bank capital requirements and buffers.

According to recent IMF studies (Habermeier and Kokenye 2011; Korinek 2011), prudential measures consist of regulations aimed at limiting the systemic risk on financial institutions in relation to cross-border flows and have two features that

distinguish them from capital controls: a) they target financial institutions, while capital controls target directly capital account transactions; and b) they do not differentiate either by residency or currency.

However, the two sets of policies have been often employed jointly to contrast the risks associated with a surge of capital inflows. A precise classification is therefore not easy to draw, as capital flow management measures and macro-prudential policies overlap in many areas (G20 2011). The global financial crisis demonstrated that micro- and macro-prudential regulation and supervision have to complement each other, as they contribute synergically to the stability of the global financial system. The reference in the carve-out clause to the need of ensuring “the integrity and stability of the financial system” should therefore be read as encompassing macro-prudential regulations, to which capital controls belong.

In order to clarify the issue, a few years ago, it was suggested that the WTO Secretariat prepare a Note on the legal meaning and scope of the prudential carve-out clause, including examples of prudential regulations that Members could adopt. Unfortunately, consensus was not reached.

Another way to gradually build a common understanding of the meaning of “prudential” might be to conclude a recognition agreement in accordance with Article 3 of the GATS Annex on Financial Services. Recognition agreements might prove an effective way to promote convergence in regulatory practices and to include capital controls in the scope of the carve-out clause. These bilateral or multilateral agreements would gradually aggregate other countries.

Another issue may arise on the interpretation of the last sentence of the clause (prudential measures not conforming to the GATS obligations “shall not be used as a means for avoiding the Member’s commitments or obligations under the Agreement”). While some commentators argue that the last sentence makes the safeguard “self-canceling,” others consider that it operates in the same way as the *chapeau* of the general exception provisions (GATT Article XX and GATS Article XIV): accordingly, prudential measures should be introduced in good faith, without a disguised protectionist intent, or to purportedly avoid a country’s obligations or commitments under the agreement.

Besides, it is worth noticing that GATS Members introducing prudential regulations do not have to prove that they are “necessary” or “not more burdensome than necessary.”

Lastly, it is interesting to note that the prudential clause does not explicitly require prudential measures to be non-discriminatory.

## **HOW TO MAKE THE GATS A CODE OF CONDUCT FOR CAPITAL CONTROLS**

Given the current weak position of capital controls within the GATS legal framework, governments should advance proposals to protect their right to deploy capital account management measures to prevent and contrast a crisis. This could be achieved through an authoritative interpretation by the Ministerial Conference or the General Council,<sup>7</sup> or through an Amendment of relevant GATS provisions.<sup>8</sup> Agreement could be first reached within the Committee on Trade in Financial Services (CTFS).

It is worth noting that in 2011 both the delegation of Barbados and Ecuador presented communications to the CTFS to discuss possible GATS amendments to grant States sufficient room to maneuver to contrast the financial crisis.<sup>9</sup> They received support from many countries, but they are still under discussion.

Proposals going in the opposite direction have also been put on the table. Since the Doha Round has been stalled for more than a decade, a group of industrialized countries is considering how to further liberalize trade in services. At the beginning of 2012, preliminary talks were held in Geneva among the representatives of 16 industrialized and advanced developing countries on an International Services Agreement (ISA), a plurilateral agreement under which self-appointed WTO Members would further deregulate services and market access (Hufbauer 2012). Even if BRICS boycotted the initiative—on the grounds that it is against the principles of transparency, inclusiveness, and multilateralism—Chile is expected to submit a draft model agreement and identify new issues that should be targeted, including, hopefully, the structure and scope of safeguard clauses.

The following are amendments or clarifications that would help protect capital controls from being challenged before WTO panels:

—GATS Article XI:2 (Payments and Transfers): current and capital account restrictions are permitted only if a Member is requested to do so by the Fund.

The meaning of “at the request of the Fund” should be clarified as to include capital controls introduced in concomitance with a lending program or under IMF conditionality. This could be achieved also if the WTO Appellate Body overruled its 1998 decision in *Argentina—Textiles and Apparel*.

—GATS Article XII (BoP Safeguard Clause): Members are permitted to introduce restrictions on the movement of capital only in the event of serious balance of payments and external financial difficulties or when threatened by such difficulties.

Especially for controls on capital inflows, which have an intrinsic precautionary nature, there is a need to include other rationales for exceptions, like financial stability, high indebtedness, and severe fiscal imbalances. Countries should be allowed to counter hot money inflows even if a balance of payments crisis is not looming.

Proposals could be made for the introduction of a cooling-off period.

The mandate of the Committee on Balance of Payments Restrictions should not cover capital account measures, remaining limited to trade restrictions.

—GATS Annex on Financial Services, Article 2, let. 2 (Prudential Carve-out Clause) allows a country to adopt prudential measures.

There is a need to establish the scope of its application, clearly defining the meaning of “prudential” as to encompass capital controls and not just international financial standards.

The alternative would be to further investigate the role of recognition agreements, for instance, among developing countries.

The last sentence of the clause should be deleted or at least thoroughly clarified.

A special consultation procedure involving the financial authorities of the countries concerned should be introduced, with dispute settlement left as a last resort when the parties are unable to reach agreement.

Another solution would be to make the clause self-judging.

Language adding a necessity test or other requirements and limitations (as in the case of the BoP clause) should also be avoided.

In the short term, while changes are being negotiated a moratory period could be the solution to protect capital and current account regulations from GATS challenge, as in 1994 and 1997 when—awaiting the entry into force of the GATS Second Annex on Financial Services—countries were allowed to withdraw or modify their commitments on financial services.

## WHY DO WE NEED A REVISED GATS?

The IMF would be the natural forum to address the relationship between capital account liberalization and capital control measures, but proposals to amend the IMF Articles were set aside already at the end of the 1990s, in the aftermath of the Asian financial crisis. The amended IMF framework would have consisted of two key points: a general obligation to gradually liberalize capital movements and safeguard clauses similar to those applying to exchange restrictions. States would have been allowed to maintain capital controls over a transitional period or to introduce temporary Fund approved capital controls, when facing a serious crisis.

More recently, proposals have been formulated for the IMF to adopt an “institutional view” on capital account policies and, in particular, on the preconditions needed for the liberalization of capital movements as well as on the design of controls.

In 2011, the IMF delivered a first set of guidelines that recommended the use of capital controls only temporarily and as a last resort measure. Concerns about these guidelines were expressed by many emerging economies, which claimed they were too prescriptive. At the 2012 IMF/World Bank Spring Meetings, the Minister of Finance of Brazil expressed his opposition to any code of conduct constraining countries from responding to excessive and volatile capital inflows, thus limiting the rights contained in Article VI of the IMF.

In parallel, at the 2011 meeting of Cannes, the G20 Heads of State and Government endorsed the document “Coherent Conclusions for the Management of Capital Flows,” that cautiously supported the use of capital controls. Unlike the IMF, the document emphasizes that there should not be a one-size-fits-all approach or a rigid definition of conditions for the adoption of capital flow measures.

These developments—both at the IMF and the G20—shift away from the hard law proposals of the late 1990s, favoring a soft law approach that, however, does not seem entirely satisfactory.

In fact, a soft law approach would not solve the delicate issues of enforceability and conflict of norms, as capital controls consistent with the IMF (or G20) guidelines would still amount to illegitimate measures under the current patchwork of trade and investment treaties.

Besides, not even an amendment to the IMF Articles would be sufficient to establish hierarchical superiority over other treaties. In fact, in the absence of a carefully drafted *ex ante* coordination clause—that is a provision designed to pre-

vent conflicts of norms between two treaties—capital controls approved by the Fund would inevitably clash with the obligation to liberalize capital movements established by other international agreements.<sup>10</sup>

On the contrary, the GATS contains a provision that could be interpreted as giving the GATS safeguard clauses some authority over FTAs as well. Pursuant to Article V, GATS Members may enter economic integration agreements to further liberalize trade in services among themselves, without breaching MFN obligations. To qualify for Article V, an integration agreement has to meet a set of given requirements. First, it should have substantial sectoral coverage. Second, discriminations between domestic service providers and those of the other Members of the FTA have to be eliminated or prohibited. However, and this is the most interesting aspect, measures admitted by the GATS safeguard clauses (Articles XI, XII, XIII or XIV) may be maintained or introduced for the purposes of Article V, even if they are discriminatory in nature. It follows that, to a certain extent, this provision (usually replicated in the text of most FTAs) gives coverage to those restrictive regulations that are authorized by the GATS safeguard clauses—including capital controls—also in the context of FTAs.

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1. Pasini (2012), however, maintains that a Member is permitted to impose capital account restrictions to prohibit resident banks from accepting deposits from consumers located abroad, or from selling financial instruments to non-residents; in this case, there is no Mode 1 service because the provider is located within the jurisdiction of the Member. Following the same reasoning, a Member State is allowed also to impose a prohibition on resident banks to lend money to non-resident customers.

2. Financial services will almost always involve a capital movement, with the exclusion of the services listed in Article 5 of the Annex on Financial Services under letter (i) advisory, intermediation, and auxiliary services, and (ii) provision and transfer of financial information, and financial data processing.

3. Capital controls may be legitimately imposed in accordance with Article XIV bis to protect essential security interests and international peace to comply with the obligations arising from membership in the United Nations. For instance, the freezing of bank deposits in connection with terrorism financing will be covered by this exception.

4. This is further confirmed by the reference to the BoP clause contained in GATS Article XI:2, which also covers restrictions on capital transactions.

5. See Negotiating Group on the MAI, Expert Group No. 5 on Financial Services Matters, Note by the Chair, 'Balance-of-Payments Clause,' 14-27 February 1997, DAF/MAI/EG5(97)3 and WTO Working Group on the Relationship between Trade and Investment, Note by the Secretariat, 'Exceptions and Balance-of-Payments Safeguards,' WT/WGTI/W/137, 26 August 2002, at 16.

6. See WTO (2005), para. 308-311.

7. By the three-quarters majority rule of Article IX:2 of the WTO Agreement and following a recommendation of the Council for Trade in Services.

8. Pursuant to the procedure set forth in Article X:5 of the WTO Agreement, and following the submission of a proposal to the Ministerial Conference by a Member State or by the Council for Trade in Services.
9. Communication from Barbados, 'Unintended Consequences of Remedial Measures taken to correct the Global Financial Crisis: Possible Implications for WTO Compliance,' dated 16 February 2011, JOB/SERV/38. Communication from Ecuador, 'Proposal for Furthering Work on Regulatory Measures in Financial Services,' dated 7 October 2011, S/FIN/W/80; see also Committee on Trade in Financial Services, 'Report of the Meeting Held on 31 October 2011,' dated 4 November 2011, S/FIN/M/71.
10. See, for instance, the Temporary Safeguard clause of the Multilateral Agreement on Investment (MAI), Draft Consolidated Text, 22 April 1998.



## 2. The Looming GATS Conflict with Capital Controls

Todd Tucker

This chapter explores countries' obligations when they make specific commitments under the GATS, briefly explores the exceptions to those obligations, and offers some concluding thoughts.

### **OBLIGATIONS/COMMITMENTS**

WTO complainants could cite three grounds for a CAR violating a respondent's GATS commitments. A CAR could:

- 1) Violate national treatment rules under Article XVII, or most favored nation (MFN) obligations under Article II.
- 2) Take the form of a policy characteristic prohibited by Article XVI market access rules.
- 3) Violate some other GATS provision, such as Article VI.

### **Ground 1**

A national treatment violation can occur when a country has made a relevant commitment, has undertaken or introduced a measure "affecting trade in services," and when that measure accords "less favorable treatment" (LFT) to foreign services or suppliers relative to their like domestic counterparts.

The list of financial services in the GATS is comprehensive, and ranges from derivatives to deposits to credit cards. The agreement is presumed to encompass even new services (WTO 2009a, 396–397).

As the Appellate Body (AB) has noted: "[T]he term of 'affecting' reflects the intent of the drafters to give a broad reach of the GATS. The ordinary meaning of the word 'affecting' implies a measure that has 'an effect on,' which indicates a broad scope of application. This interpretation is further reinforced by the conclusions of previous panels that the term 'affecting' [in other contexts] is wider in scope than such terms as 'regulating' or 'governing'" (WTO 1997, para. 220). Thus, a

CAR could be challenged for its impact on service sectors other than the sector (say, banking) it is formally regulating, such as if it raised the costs to securities dealers or gas terminal operators.

The AB has offered limited guidance on “likeness” under the GATS, but a panel has stated that “to the extent that the service suppliers concerned supply the same services, they should be considered ‘like’...” (WTO 2000, para. 10.248). Another panel added that, “When origin is the only factor on which a measure bases a difference of treatment between domestic service suppliers and foreign suppliers, the ‘like service suppliers’ requirement is met, provided there will, or can, be domestic and foreign suppliers that under the measure are the same in all material respects except for origin” (WTO 2009b, para. 7.975). And a third panel found that, when a respondent’s firm supplies the same service and the complainant’s firms consider them competitors, that may be enough to establish likeness (WTO 2012a, paras. 7.702–7.704).

LFT can be “formally different or formally identical treatment which modifies the conditions of competition in favour of domestic services and service suppliers” (WTO 2000, para. 10.304). It can be *de jure* or *de facto*, and need not have the aim or effect of providing protection to domestic services or service suppliers (WTO 1997, paras. 234, 241). It appears to put an affirmative obligation on governments to level the costs of doing business for new foreign entrants as against domestic incumbent enterprises, even when new domestic entrants face the same alleged disadvantage (WTO 2012a, paras. 7.710–7.714).

In non-services contexts, the AB and panels have established tilted conditions of competition by examining any differential in the per-unit costs as between imports and domestic goods allegedly imposed by the regulation, including upstream or downstream from the precise sector upon which the regulation is applied (WTO 2012b, paras. 289–292). This analysis essentially takes separate snapshots of the domestic and foreign industries—largely abstracted from their histories of production processes, business models or market penetration.<sup>1</sup> There is no *de minimis* threshold for this test: even a tiny touch of “discrimination” is too much (WTO 2009b, para. 7.1537). Governments might protest that it is more difficult to regulate foreign lending services, and thus differential treatment may be merited. But WTO panels have rarely if ever given weight to such arguments (WTO 1996, paras. 6.11–6.13).

A complainant would likely be able to establish both likeness and LFT in a challenge to a CAR. Many CARs make regulatory distinctions on the basis of national origin of the capital flow or service supplier, and many CARs are (sometimes inadvertently) more onerous for foreign services or suppliers. Indeed, it is entirely possible that formally non-discriminatory CARs could impact foreign banks disproportionately: foreign banks might service importers or offshore clients to a greater degree than national banks, so formally equal limits on short-term overseas borrowing (say) could impact them disproportionately on a cost-per-transaction basis.

The MFN obligations are similar to the national treatment commitments. The primary difference is that Article II applies when there is LFT for services or suppliers of a given foreign country relative to those of another. Moreover, even countries with no specific commitments must comply with MFN obligations.

## **Ground 2**

There are several parts of Article XVI that have relevance for CARs. When a country makes full market access commitments, it commits to not employ four types of maximum quantitative limitations outlined in Article XVI(2)(a-d). This includes forms of policies such as bans or monopolies—even if applied to foreigners and nationals alike.<sup>2</sup> The AB has noted that measures can violate these commitments when they “are in form or in effect” a numerical cap (WTO 2005, para. 230).

The U.S. has successfully argued that a quantitative limitation on a mere slice (e.g., RMB-denominated payments processing for Chinese traveling in Macao) of a committed service sector (e.g., payments services) violates China’s market access commitments. The panel was even willing to consider that a measure that is not a market access limitation may be one in conjunction with other policies (WTO 2012a, paras. 7.624, 7.627). This shows that a claim could be brought that a CAR—when coupled with other domestic regulations—constitutes a prohibited quantitative cap. Alternatively, a country that took full market access commitments in securities trading but banned a narrow slice of risky activities could find such a CAR challenged. Indeed, the RMB offshore policy noted above bears resemblance to certain CARs (Tucker 2012).

There is a debate about whether Article XVI(1) imposes any additional obligation. The panels that have reviewed it said that it did not (WTO 2012a, paras. 7.628–7.630), but the AB has not given specific guidance. It does seem that the

Article XVI(1) footnote 8 imposes additional obligations, requiring members a) to “allow such movement of capital” when the “cross-border movement of capital is an essential part of the service itself” when a market access commitment is made for Mode 1 (for both capital inflows and outflows) or b) “allow related transfers of capital into its territory” when a market access commitment is made for Mode 3.<sup>3</sup> The word “essential” is key to understanding the scope of this Mode 1 obligation. In core financial service sectors, there is no service transaction (i.e., service fee) unaccompanied by a capital flow: it would be impossible to supply cross-border lending services if there were no cross-border loans (i.e., capital). The required nexus between the Mode 3 service provision and the capital flow is broader in one respect (all “related” capital flows are to be permitted, whether “essential” or not) and narrower in another (only those capital flows “into its territory” are required to be permitted).<sup>4</sup>

Undergirding Grounds 1 and 2 is GATS Article XI(2), which reads in part: “a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions.” As several panels have made clear, the word “restriction” is to be interpreted “broadly.” Its ordinary meaning is “a limitation on action, a limiting condition or regulation.” It “need not be a blanket prohibition or a precise numerical limit” and can merely be “a measure that has identifiable negative consequences on” imports. It may include measures that only allow imports “under certain conditions which make the importation more onerous than if the condition had not existed, thus generating a disincentive to import.”<sup>5</sup>

So, are the only disallowed Mode 1 “restrictions” those that do not “allow... movement of capital” at all (i.e., a prohibition on capital flows), or could a broader range of “restrictions” be prohibited? WTO members know the words “prohibition” and “ban,” and could have used those had they intended that scope.<sup>6</sup> A dispute panelist might conclude that a “restriction” on Mode 1 services trade must be something more than “a disincentive to import” (since “allow” suggests a more restrictive counterfactual) but is up to and including a “blanket prohibition.” In contrast, because the Mode 3-specific disciplines in footnote 8 have a looser nexus, the types of GATS-inconsistent “restrictions” for that mode of supply would likely include CARs that cause a mere “disincentive to import” but would also range up to and include “blanket prohibitions.”

Finally, it is worth noting that panels have been willing to scrutinize Article XVI and XVII obligations across modes of supply. For instance, Canadian automakers

received certain benefits based on their “Canadian value added,” which could include expenditures on services like Canadian-produced insurance. A panel ruled that this benefit disadvantaged foreign insurance services and service providers, whose Modes 1 and 2 services and suppliers should not have been treated less favorably than their domestic and Mode 3 counterparts (WTO 2000, para. 10.307). Another panel found that China’s full Mode 3 commitment obligates a member to allow firms to set up shop in its territory to export services out of its territory (WTO 2012a, para. 7.619). Neither Canada nor China made deep Mode 1 commitments. But their deep Mode 3 commitments were interpreted as a requirement to treat offshore service suppliers no less favorably, or to allow firms interested in serving the offshore markets to establish a commercial presence. Either policy could put substantial pressure on the capital account.

### **Ground 3**

There are additional bases for claims. For instance, GATS Article VI(4) created a mandate for ongoing negotiations to ensure that domestic regulations “do not constitute unnecessary barriers to trade in services,” be “based on objective and transparent criteria,” and be “not more burdensome than necessary to ensure the quality of the service.” Draft texts of the disciplines proposed pursuant to this mandate include a requirement that regulations be “pre-established.” Any newly announced CAR might violate this requirement. Article VI could also subject CARs to a standard of review that goes far beyond the relatively lenient standard under domestic law (Stumberg 2010). For instance, U.S. courts typically only require that agency action be reasonable, and not arbitrary, capricious, an abuse of discretion, or illegal. Under Article VI, in contrast, a WTO panel could put itself in the shoes of the regulator, and add additional requirements that legitimate regulations minimize their trade impacts.

### **EXCEPTIONS/DEFENSES**

There are four potentially applicable defenses if a CAR is found to violate a GATS commitment:

1. If the IMF requests a CAR;
2. If a CAR qualifies for the exceptions in Article XIV;
3. If it qualifies for the prudential measures defense (PMD); and
4. If Article XII permits a CAR.<sup>7</sup>

The defenses are quite weak: the IMF has never triggered Defense 1 (Siegel 2002, 598); and Article XIV-type exceptions have only been adequate in one out of 27 cases (Tucker 2011b).<sup>8</sup>

As for the PMD, there is a debate about whether CARs are even prudential (Viterbo 2012, at 159),<sup>9</sup> and the existence of a CAR-specific Defense 4 may limit a respondent's ability to prevail on Defenses 2 and 3.<sup>10</sup>

Indeed, there are several steep hurdles to utilization of the PMD. First, a respondent must meet the hurdle of the first sentence, which lays out five "prudential" objectives. The first four objectives relate to principal-agent problems typically associated with regulation of individual banks. There is no specified minimum degree of achievement associated with these first four objectives. A final objective—"to ensure the integrity and stability of the financial system"—is broader (and could encompass CARs), but carries with it a much more demanding degree of achievement of the objective. CARs may contribute to stability, but they rarely "ensure" it on their own.

Second, a respondent must show that the prudential policy is not being used as a means of avoiding their GATS commitments or obligations (i.e., at least the first two grounds). Some have suggested that this is simply a good faith or anti-abuse requirement. However, WTO members have long known how to craft such language, as reflected in the chapeau of GATS Article XIV and GATT Article XX. Panelists would have to give effect to the PMD's differently worded provisions (Tucker et al. 2011).<sup>11</sup> Some have expressed concern that a self-canceling construction of the PMD would render it without effect. But the PMD's title—"Domestic Regulation"—provides an indication that it could be used as an alternative to the obligation of the eponymous Article VI. This construction could give effect to the PMD, and also give effect to its difference with Article XIV (Tucker 2011d).

Moreover, prudential measures cannot be scheduled as limitations to market access or national treatment obligations (WTO 2001, para. 20). But several forward-looking developing country members have inserted CAR-type policies as limitations in their schedules anyway. The AB has found that the schedules of other members are "context" for the purpose of informing what GATS rules mean (WTO 2005, para. 178). In this sense, developing countries with strong limitations may be undermining the policy space of developing countries with

deeper commitments, by contributing to an interpretation that CARs are not “prudential.”

This leaves respondents with Defense 4. Under Article XII(1), “a Member may adopt or maintain restrictions on trade in services”—but only “in the event of serious balance-of-payments and external financial difficulties or threat thereof.” This would appear to limit usable restrictions to outflows only (Viterbo 2012, 222). Articles XII(2-5(a)) establish 10 additional limitations on countries’ ability to use CARs in balance-of-payments crises, including an anti-discrimination requirement, a “necessity test” and a requirement that CARs be temporary (which eliminates space for long-term prophylactic regimes) (Tucker 2010).

CARs, as opposed to other macroprudential tools, almost definitionally make distinctions on the basis of capital, service, or supplier origin (Jeanne et al. 2012, 30–33), so would be unlikely to pass anti-discrimination muster. “Necessity tests” for a CAR would involve, first, an analysis of its contribution to its goal, of the importance of the goal, and of its trade-restrictiveness. If the CAR is less effective, if its goal is less important, or if it is especially trade restrictive, this will all count against the respondent in a panel’s weighing and balancing. Second, a complainant may propose alternative measures that are less trade restrictive, and a panel would be allowed to second-guess the regulator as to whether that option was reasonably available to the respondent (or more effective, etc.) (WTO 2007, paras. 139–183). There is ample room for panel discretion at each interpretative phase.

## CONCLUDING THOUGHTS

In the U.S., the federal government has control over such imminently national concerns as currency and interstate and foreign commerce. Meanwhile, state governments have broad police powers to regulate matters not exclusively in federal jurisdiction, provided (under Dormant Commerce Clause doctrine) that such regulations do not unduly burden interstate commerce. The GATS effectively subjects imminently federal issues like control of international capital flows to a level of scrutiny reserved in domestic law for regulations by sub-federal entities (who for good reasons do not regulate such matters).

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One way to craft a better defense against the range of grounds for attacking a CAR explored in this paper is to expand the PMD to ensure that it applies to CARs, and to remove its arguably self-canceling language.<sup>12</sup> While most developing nations are on the record as supporting this conversation, the U.S. and other developed nations have thus far largely resisted.

One parting thought: Fewer concerns have been expressed about the regulation/GATS conflict than with the regulation/FTA conflict. This appears to be based on several considerations: 1) the GATS uses a positive list approach and therefore countries are only committed to the sectors and modes of their choice; 2) there are more exceptions to the GATS rules; and 3) there is only state-state dispute settlement at the WTO.

But these considerations may obscure more than they illuminate. Many countries—who were unfortunate enough to have neoliberal, under-informed, or over-pressured governments in the 1990s—actually did make deep specific commitments.<sup>13</sup> In the absence of an amendment to the GATS or a grace period to withdraw commitments without triggering compensation obligations (as occurred in the 1995–97 period), the 1990s commitments may be locked in forever. Moreover, many of the exceptions that are cited as support for the superiority of the GATS are included almost verbatim in the bilateral deals. Either the exceptions are sufficient in both, or deficient in both.

Also, financial services represent a large share of many national economies—of tax haven nations in particular. State-state disputes over trade disputes of much lower relative economic weight have dragged on for decades, and nations like the U.S. and Panama have been willing to challenge policies with strong resemblance to CARs (Tucker 2012, Tucker 2011a, WTO 2009c). Diplomatic restraint can be overstated, especially since investors must (at least initially) internalize the costs of their arbitration decisions, while government bureaucrats may not.

It is worth noting that the GATS likeness and LFT tests are less forgiving than the standard formulation used in FTAs, which require that investors be “in like circumstances.” Generally speaking, investment panels hew more to a “discriminatory aim and/or effect” approach than do trade panels (ICSID 2007, paras. 320–321). In contrast, WTO panels have held that service providers could be in very different contexts (i.e., one could be providing services within the country, and another outside), and still, government regulations must afford them similar competitive opportunities.

Indeed, the “GATS good/FTA bad” meme seems to rest on the dubious proposition that FTA free transfers articles that have never been successfully invoked (and which are poorly understood)<sup>14</sup> are somehow more likely to interfere with CARs than the simple national treatment article in the GATS—which has been successfully invoked on numerous occasions and which is well understood. Clearly both rules are problematic, although the latter is more of a known quantity.

Finally, WTO rules and decisions are accorded great weight globally. Negotiators often import problematic WTO rules into the bilateral context, since these carry a certain imprimatur—and since nations are already bound by these rules anyway (so the marginal decrease in policy space by signing FTAs is low to nil). Investment arbitrators often cite problematic WTO jurisprudence in their awards, on the view that this is a type of gold standard of adjudication. Accordingly, policymakers can only be complacent about WTO rules at great risk to their policy space and in dismissal of the pivotal role that the multilateral body plays in a system of obscure but rapidly consolidating global governance.

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1. The AB has ruled that U.S. dolphin-safe tuna labels were “detrimental” to Mexico because U.S. tuna tended to qualify for the label, while Mexican tuna did not, giving little weight to the reasonableness of the underlying regulatory distinction (based on fishing practices that were more or less harmful to dolphins), or the fact that other nations like Ecuador had adapted their practices to take advantage of the label (WTO 2012c, paras. 234-235).
  2. There is a debate about how Article XVI(2)(e) affects sensitive areas of financial services regulation (Tucker 2011c), while Article XVI(2)(f) applies to foreign shareholding limits.
  3. Mode 1 refers to cross-border trade, 2 to consumption abroad, 3 to establishment by commercial presence, and 4 through movement of natural persons.
  4. It is possible that there are also some residual obligations for CARs under Modes 2 and 4 (Viterbo 2012, 217). In any case, the distinction between Modes 1 and 2 has collapsed with the emergence of online banking, as it is not clear whether the consumer or the service crosses the border.
  5. For this discussion of relevant GATT cases, see (WTO 2009c, paras. 7.233-7.246).
  6. Moreover, if the only prohibited form a “restriction” could take were an absolute refusal to allow capital to flow, the defense provision in GATS Article XII (see below) would have been couched more narrowly.
  7. Additionally, the first part of Article XI(2) subjects the rights under the IMF Articles of Agreement to a requirement to not impose capital restrictions inconsistently with specific commitments.
  8. Article XIV(d) appears to offer a substantial taxation carve-out, but this is only for direct taxes, not “event” or indirect taxes like CARs or financial transaction taxes.
  9. Other analysts suggest that prudential measures apply to inflows, while balance of payments measures correspond to outflows (Jeanne et al. 2012, at 24).
  10. See Trachtman (2011) for a conversation about similar provisions in NAFTA, and also Kaufmann (2008, 424).
  11. See also the tortured effort to give distinct effect to the seemingly identical phrases “monopoly” and “exclusive service provider” at WTO (2012a, para. 7.587).
  12. For textual suggestions, see Tucker et al. (2009).
  13. See Tucker (2010) for an estimate.
  14. See the difficulty one panel had attempting to tie a transfer to a covered investment at ICSID (2008, para. 244).

### 3. Capital Controls Can Smoothen Trade Tensions

Héctor R. Torres<sup>1</sup>

Reserve currencies are being massively created to stimulate domestic growth in advanced economies where families, banks, and sovereigns are prompted to save more and spend less.<sup>2</sup> Meanwhile in Emerging Market Economies (EMEs) growth and macroeconomic fundamentals are much stronger, but their capacities to absorb short-term capital are reduced as financial markets are shallow. The IMF is advising them to manage capital flows by letting their currencies float, adjust their policy interest rates, and use counter-cyclical fiscal policies, but this cannot be done overnight.<sup>3</sup> Capital controls are now admitted in their tool-boxes, but according to the IMF they should only be used “temporarily” and “without compromising the overall process of liberalization” (IMF 2012d, para.4).

So far the spillover effects of monetary decisions in major advanced economies have been relatively offset by an increase in demand for reserve currencies due to deleveraging and money hoarding. However, the crisis will eventually recede and central banks may not rush to mop up the excess of liquidity for fear of crushing growth or for interest in kindling inflation. Governments, even those that find that capital controls are distasteful, may need to enforce them. In this chapter, we will address the question of whether WTO rules provide sufficient policy space to countries willing to regulate or limit capital inflows (and outflows).

#### **CAPITAL CONTROLS: ONLY A LAST RESORT MEASURE?**

The abundance of short-term capital and its intrinsic volatility has been prompting EMEs to continue accumulating foreign-currency reserves as a reliable self-insurance mechanism.<sup>4</sup> EMEs' appetite for additional reserves is understandable, but also troubling. Accumulating reserves can shelter an economy from sudden capital outflows and allow governments to implement counter-cyclical policies, but the downside is that it requires export-led growth and trading partners willing to run trade deficits. This is not a minor point at a time when in advanced economies families and banks need to deleverage and governments must close their fiscal deficits (Torres 2011).

Given the current economic troubles in advanced economies, export-led growth is no longer an option, at least not for large EMEs. Going down that road could exacerbate trade tensions (particularly “South-South” tensions<sup>5</sup>) and challenge the multilateral trading system.

The problem is not just theoretical. Volatility has increased since early 2011 and investments in the form of capital portfolios are predominant in financially integrated EMEs (IMF 2011c). Short-term capital can transmit the reverberations of the crisis into their economies, and calls for protection of domestic industries could easily turn “currency wars” into “trade wars”<sup>6</sup>—a risk that is compounded by the virtual paralysis of the Doha Development Round.

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Capital controls fall in this sub-optimal category. Beyond reducing access to credit, capital controls are not necessarily watertight and could eventually be outsmarted by financial markets. However, they may create policy space, buy time

to introduce macro-economic policy adjustments and prudential regulations, and avoid options with worse spillover effects, as trade protectionism.

## **ARE TRADE RULES LIMITING THE POLICY SPACE TO IMPOSE CAPITAL CONTROLS?**

Financial services are primarily governed by the disciplines of the General Agreement on Trade in Services (GATS); however, certain measures “could be found to fall within the scope of both the GATT 1994 and the GATS.”<sup>7</sup> In the GATT 1994 Article XV.9 (a) states that nothing in that agreement could preclude Members from using “exchange controls or exchange restrictions in accordance” with the IMF’s charter.

According to Article VI, Section 3 of the IMF Charter, Members are free “to exercise (...) controls (on capital transactions) as are necessary to regulate international capital movements” with the limitation that “no member may

exercise these controls in a manner which will restrict payments for *current transactions* (...)" (emphasis added).

Article XV.9 (a) of GATT 1994 has not yet been interpreted by a Panel or the Appellate Body but arguably "exchange restrictions" may include both exchange rate restrictions and restrictions in access and use of foreign exchange. The latter may be used to enforce capital controls but they could also affect current payments.<sup>8</sup> In turn, controls on capital transactions could be used to enforce restrictions on current transactions that could affect exchange rates. In such cases capital controls could be inconsistent with the obligation in Article IV, Section 1 (iii) of the Articles of Agreement (this is the IMF Charter, hereafter AoA) if they allowed for "manipulation" of the exchange rate in order to prevent balance-of-payment adjustments or to gain an unfair competitive advantage (IMF 2010).<sup>9</sup>

Do you find this confusing? Indeed, the borderline is not clear and the terms of Article XV.9 (a) of GATT 1994 are broad. Siegel (2002) argues that they create an exception to GATT obligations for any measure that, in the view of the IMF (Executive Board), is an exchange control or an exchange restriction applied consistently with the IMF AoA.<sup>10</sup>

As Siegel (2002) notes, the IMF requires Members to remove restrictions affecting current transactions *regardless* of whether another Member has submitted a complaint requesting the removal.<sup>11</sup> This contrasts with the WTO where Members are required to withdraw a measure only after it is found to be a breach of its obligations, following the adoption (by the Dispute Settlement Body) of a report produced by a Panel or by the Appellate Body.<sup>12</sup>

In sum, IMF Members **can restrict** capital transactions, as when imposing capital controls or regulations that limit portfolio investment, **but not if** they result in restricting payments due to imports of goods or services. And, according to Article XV.9 (a) of the GATT 1994, a measure restricting capital transactions that is consistent with IMF obligations should not<sup>13</sup> lead to a finding of breach of GATT/WTO provisions.<sup>14</sup>

## WHAT IS THE ACTUAL DIFFERENCE BETWEEN CAPITAL AND CURRENT TRANSACTIONS?

The IMF does not provide a definition of the concept of "capital transactions" but Article XXX(d) of its AoA clarifies that payments for current transactions are

those “which are not for the purpose of transferring capital, and [this] includes, without limitation:

- 1) all payments due in connection with foreign trade, other current business, including services, and normal short term banking and credit facilities;
- 2) payments due as interest on loans and as net income from other investments;
- 3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and
- 4) moderate remittances for family living expenses.”

This leaves us with a grey zone<sup>15</sup> as some measures could be difficult to categorize, for instance, limiting access to foreign exchange for investment purposes could also affect the settlement of trade. Furthermore, IMF Decision 955-(59/45) establishes that “a direct governmental limitation on the availability or use of [foreign] exchange as such” should be considered “a restriction on payments and transfers (to settle) *current transactions*”; hence, by implication, not a restriction on capital transaction.<sup>16</sup>

In sum, international payments for current transactions do require capital transfers but not just for the purpose of transferring capital but rather to settle trade transactions<sup>17</sup>. The IMF only bans restrictions on capital transfers that are for the purpose of settling current transactions. Transfers of capital that are not for that purpose can be restricted and, according to Article XV.9 (a) of GATT 1994, WTO Members imposing measures restricting capital transfers that are not IMF inconsistent are—in principle—not in breach of their trade obligations.<sup>18</sup>

### **THE GATS AND ITS “PRUDENTIAL EXCEPTION”**

As noted above, financial services are governed by the disciplines of the General Agreement on Trade in Services (GATS).<sup>19</sup> Article XI.1 provides that Members “shall not apply restrictions on international transfers and payments for current transactions relating to specific commitments.”<sup>20</sup> Article XI.2 echoes Article XV.9 (a) of GATT 1994 by establishing that “provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions” nothing in the GATS shall affect its rights and obligations under the IMF AoA.

Footnote 8 to Article XVI goes a step further, clearly outlawing restrictions to certain capital transactions. If a WTO Member undertakes commitment to supply a service in Mode 1 (cross-border) then cross-border movement of capital (inflows and outflows) may be an essential part of the service itself and the Member cannot restrict it.<sup>21</sup> In the same logic, if a WTO Member undertook commitment in Mode 3 (commercial presence) then the Member “is thereby committed to allow related transfers of capital *into* its territory” (emphasis added).<sup>22</sup>

Some commentators read this as a derivation of the principle of good-faith (Leroux 2002). Indeed, when a WTO Member undertakes commitments to open its market for cross-border supply (Mode 1) or for supply through commercial presence (Mode 3) this presupposes that the Member will allow capital flows associated with the provision of this service.<sup>23</sup> It is important to note that the GATS does not oblige any country to make across-the-board commitments to liberalize financial services and the associated capital flows, let alone “spontaneous” capital flows not associated with scheduled commitments.<sup>24</sup> Under the GATS all scheduled commitments are made under the mechanism of “positive lists,”<sup>25</sup> therefore WTO Members only undertake commitments in the areas and in the Modes enumerated in their lists, which may also frequently include limitations on each commitment.<sup>26</sup>

Moreover, the GATS include provisions that allow Members to derogate their liberalization commitments on capital flows. The principal derogation is the so-called “prudential carve-out,” which establishes that “notwithstanding *any* other provisions of the GATS” (emphasis added) a WTO Member is not prevented from “taking measures for prudential reasons.” Measures taken for “prudential reasons” are not predefined<sup>27</sup> but they could include measures taken for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. The single limitation is that “they shall not be used as *a means of avoiding* the Member’s commitments or obligations” under the GATS (emphasis added). As Marchetti (2010) explains, the prudential carve-out does not need to be invoked before taking a measure for prudential reasons. Only if such a measure was legally challenged in the context of a dispute brought to the WTO, the country may want to use the carve-out to justify the measure.<sup>28</sup> In such case the defendant would bear the burden of proof.<sup>29</sup>

The “prudential carve-out” has not yet been interpreted by a Panel (or by the Appellate Body) but as Kireyev (2002, 15) puts it, “prudential measures are left completely outside the scope of the financial sector commitments under GATS, they do not

need to be scheduled (or included amongst the reservations on market access).” Moreover, as Leroux (2002) argues, the words “notwithstanding *any* other provisions of (the GATS)” indicate that measures covered by the “prudential carve-out” may, *a priori*, appear as inconsistent with any obligation under the GATS, including liberalization commitments<sup>30</sup>; Marchetti (2010) argues that measures taken for prudential reasons for the purpose of ensuring “the integrity and stability of the financial system” may be part of preventive, containment, and remedial policies.

In sum, limitations to impose capital controls in the GATS are only derived from voluntary commitments on market access adopted by countries mostly in Mode 1 and Mode 3 (only for outflows) in (some<sup>31</sup>) financial services where cross-border movement of capital is an essential part of the service itself. And even then, notwithstanding *any* provision of the GATS (which includes the schedules of specific commitments<sup>32</sup>), WTO Members preserve policy space to take measures for prudential reasons or to ensure the integrity and stability of *the* financial system.<sup>33</sup> The only limitation to a Member’s policy space is that, when measures adopted for these two purposes depart from the GATS provisions, they should not be *used as a means* of avoiding the Member’s commitments or obligations under the Agreement.<sup>34</sup> Leroux (2002, 88) notes that this caveat is “but an expression of the principle of good faith, which is at once a general principle of law and a general principle of international law.”

## **WTO REGULATIONS: THE WRONG TREE TO BARK UP**

The above does not mean that policy space for WTO Members to impose capital control measures is unlimited. Several developing countries and EMEs have undertaken substantial unilateral liberalization in trade in financial services, outside of the WTO (Kireyev 2002).

Indeed, most WTO Members are part of Preferential Trade Agreements (PTAs), many of which include provisions on investment that “contain largely blanket prohibitions on capital controls even in times of economic crisis” (Siegel 2012, p. 5). Also, several WTO Members are bound by Bilateral Investment Treaties (BITs), which, as the IMF notes, normally include obligations to liberalize capital flows and restrict policy space to impose capital controls<sup>35</sup> (IMF 2012).

Furthermore, BITs and PTAs with investment obligations are frequently negotiated on the basis of “negative lists”<sup>36</sup> and do not contemplate “appropriate safeguards or proper sequencing of liberalization” (IMF 2012, p. 8). As a consequence “many PTAs and BITs provide only limited flexibility for the management of

capital flows” and “they often do not provide for prudential carve-outs” (IMF 2012, para. 34). In this respect, the IMF has recently shown concern for the undercutting of policy space by PTAs and BITs, as it may restrict the possibility of imposing capital controls during macroeconomic and financial distress (IMF 2010, p. 11).<sup>37</sup>

A few years ago, investment was still perceived as a North-South issue.<sup>38</sup> Then the “North” was rich and the “South” thirsty for capital. Nowadays, almost 80 percent of economic growth is authored by the “developing” world; Europe is begging for investments; the average fiscal deficit in advanced economies (6.7 percent of GDP) is three fold that in “developing” economies (2.6 percent of GDP) and their total financing needs (maturing debt + budget deficit) in 2012 is four times that of EMEs (27.7 percent of GDP vs. only 7.7 percent).

Today capital is flowing in every possible direction with a strong predominance of portfolio investments. In the current “hyper-liquid” environment, governments—even those that would prefer not to use capital controls—may

need to regulate financial capital movements. Their policy space to implement such regulations is not challenged by WTO provisions. Conversely some BITs and PTAs contain lax definitions of “investment” that could undercut policy space to regulate short-term capital flows. Moreover, such BITs or PTAs could extend investment protection to investors that acquired government bonds in the secondary market. As the IMF notes this could interfere with the capacity of a government to restructure sovereign debt.<sup>39</sup>

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We are witnessing important geopolitical changes that call for cooperative policies. Investment is no longer a North-South issue<sup>40</sup> and the world leading economies (“advanced” and EMEs) need to achieve greater coherence in their economic policy-making. This may require a new multilateral framework to harmonize interpretations of “preferential” investment rules (those included in the myriad of PTAs and BITs).

A few years ago the intent to negotiate multilateral rules for investment met stiff opposition from the “developing world.” We live now in a different world.

1. Héctor R. Torres, a former Executive Director of the IMF, is currently with the World Trade Organization. The author is grateful to Alejandro Jara and Gabrielle Marceau for their comments and observations and to Juan Marchetti for his extremely useful insights; also to Luan Aggersberg and Debora Ponce for their assistance on research and editing. Any errors are those of the author who could be contacted at hector.torres@wto.org. The opinions expressed are solely those of the author and do not represent in any way those of the WTO Secretariat or Members.
2. Between 2007 and 2011 the U.S., the UK, and the EURO zone nearly doubled their monetary base (measured as a percentage of their GDP, IMF, 2012 a, p. 22).
3. As Batista (2012) argues, “fiscal policy is a slow, heavy and clumsy instrument to deploy against fast-moving and fickle capital flows” (p. 94).
4. The more financially integrated the more reserves an EME would need to self-insure. Torres, Héctor (2010).
5. Mattoo and Subramanian (2011) note that developing countries are increasingly resorting to trade restrictive measures against Chinese exports and that their use of antidumping against China (as a share of their total actions) increased from 19 percent in 2002 to 34 percent in 2009, whereas the corresponding figures for advanced economies were 11 and 27 percent.
6. Mattoo and Subramanian (2011) note that when the Brazilian Finance Minister warned that “currency wars” could turn into “trade wars” it equated the effects of quantitative easing in the United States with China’s alleged policy of repressing appreciation of the RMB.
7. According to the Appellate Body “[t]hese are measures that involve a service relating to a particular good or service supplied in conjunction with a particular good. In all such cases (...), the measure in question could be scrutinized under both the GATT 1994 and the GATS.” Appellate Body Report, EC—Bananas III, para. 221 (WT/DS27/AB/R).
8. Wei and Zhang (2007) have calculated that increase in controls on trade payments could have negative effects on trade (equivalent to an increase in tariff rates of 14 percentage points). According to the authors, increases in controls of foreign exchange by one standard deviation could reduce trade by the same amount as an increase in tariffs of 11 percentage points (p. 12).
9. Other IMF provisions could also be relevant in interpreting the scope of Article XV.9 (a) of GATT 1994. Article VI, Section I of the AoA prohibits the use of the IMF’s general resources to meet a large or sustained outflow of capital and allows the Fund to require the imposition of controls on capital movements in order to prevent such use (IMF 2012, d.). Also, Article VIII.2 (a) (Avoidance of restrictions on current payments): requires IMF members to refrain from imposing restrictions on the making of payments and transfers for current international transactions (unless they have the approval of the Fund).
10. However, it is conceivable that an exchange control (or an exchange restriction), even if consistent with IMF obligations, could “frustrate the intent of the provisions” of GATT/WTO (Article XV.4 of GATT) or nullify or impair benefits that a WTO Member could reasonably have expected from a commitment under the GATS (Article XXIII.3) or under a WTO agreement of trade in goods (Article XXIII.1 (b) of GATT 1994). The analysis of this legal question goes beyond the scope of this shortened note.
11. In the Fund a breach of compliance can be brought by staff, management (or by any executive director) to the attention of the Executive Board.
12. WTO staff cannot act de officio to raise apparent violations to the attention of the General Council or the relevant political body monitoring the agreement in question. The single occasion in which WTO staff is called to express opinion on Members’ policies is during the Trade Policy Review process and staff stays clear from categorizing a measure as inconsistent with WTO obligations.
13. Provided that it is not inconsistent with another WTO provision.
14. As this provision has not yet been interpreted, I am not in a position to assert what is the legal extent of this presumption.
15. Art XXX (d) of the AoA authorizes the Fund to establish ad hoc limits by consulting with the Members concerned, to determine whether certain specific transactions are to be considered current transactions or capital transactions.
16. This definition was echoed in the GATT by the panel in “Dominican Republic – Import and Sale of Cigarettes” (Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes. Report of the Panel, p. 144; 7.144, 7.145).

17. As well as interests on loans, net income from investment, payments of “moderate” amount for amortization of loans of FDI, and “moderate” remittances for family expenses.

18. Capital controls could be used to enforce multiple currency practices. According to Note to Article VI paragraphs 2 and 3, 2 of the GATT, “Multiple currency practices” (practices by governments or sanctioned by governments) “can in certain circumstances constitute a subsidy to exports” which may be met by countervailing duties under paragraph 3 or can constitute a form of dumping by means of a partial depreciation of a country’s currency which may be met by action under paragraph 2. “Multiple currency practices” means “practices by governments or sanctioned by governments.” At the IMF, Multicurrency practices (outlawed, except when authorized) arise when, due to government action, there are two or more exchange rates for spot foreign exchange transactions prevailing in the country that deviate by more than 2 percent (see Policy on Multiple Currency Practices, Decision No. 649-(57/33), June 26, 1957). Article VIII, Section 3 of the AoA establishes that “no member shall engage in, or permit any of its fiscal agencies (...) to engage in, any discriminatory currency arrangements or multiple currency practices.”

19. The Multilateral rules and disciplines applicable to trade in financial services are contained in three legal instruments: the GATS; the Annex (to the GATS) on Financial Services; and the Understanding on Commitments in Financial Services; WTO (2012). As discussed above measures related to the supply of a financial service could also fall within the scope of the GATT 1994 and/or WTO agreements on trade in goods (see footnote 9).

20. Except when justified to safeguard the Balance of Payments, see Article XII of the GATS.

21. Lending on “Mode 1” would be such a case, as cross-border movement of capital would be essential to supply the service. To the extent that a WTO commitment includes a financial service transaction which involves an international capital transaction, then the capital account needs to be opened for the former to take place (Kireyev 2002).

22. GATS does not require free cross-border movement of capital (inflows and outflows) for commitments undertaken under Modes 2 and 4, nor liberalization of capital outflows for commitments undertaken under Mode 3.

23. Financial flows may be originated in financial services, but whereas financial services are a category in the current account, financial flows are included in the capital account of the balance of payments. As Kireyev (2002) notes, “(F)inancial services only include fees and charges associated with financial flows (...) For example, deposit-taking between resident and non-resident is an item of the capital account, whereas financial service charges for such transactions (...) is an item of the current account. Within the WTO framework, only financial services which can be associated, or not associated, with financial flows, but *not the financial flows themselves* - are the subject of negotiation and liberalization” (emphasis added, *Ibid*, p. 8).

24. As Marchetti (2010) notes, not all financial service transactions are associated with cross-border financial flows (financial services as consultancy and information services do not require trans-border capital movements—other than the payment for the current transaction).

25. “Positive lists” opposed to the modality of “negative lists” in which only exceptions to trade liberalization are enumerated. As discussed below, negative lists are frequently used in Bilateral Investment Agreements (BITs) and in Preferential Trade Agreements (PTAs). Negative lists are used in other WTO agreements that regulate trade in goods (e.g., see Article 3.3 of the Agreement on Agriculture).

26. Commitments to liberalize financial services associated with financial flows does not imply that the financial service in question will be “de-regulated” but rather that the applicable regulation will grant national treatment to foreign providers (on top of which countries may include limitations in their country schedules).

27. Leroux (2002) notes that the concept of prudential reasons may evolve as it is “not frozen in time.”

28. As Marchetti (2010) explains, measures covered by the prudential carve-out are not subject to a “necessity test” (proving the contribution it brings to the achievement of its objective and whether the same objective could be achieved by a less trade-restrictive measure). Conversely those in which the defendant invokes the General Exceptions to the obligations under the GATS it may need to prove that the measure in question was “necessary” to pursue some of the objectives enunciated in Article XIV of GATS.

29. Marchetti (2010) notes that measures taken for “prudential reasons” need not be limited to measures categorized as “prudential regulation.”

30. The sheer existence of the “prudential carve out” may discourage legal challenges to capital controls even where countries have commitments on financial services that may require capital transfers. Indeed, capital controls have been implemented on several occasions but they have never been legally challenged.

31. "Some financial service transactions are not accompanied by capital movements, such as financial consultancy and information services." Marchetti (2010).
32. Article XX.3 of GATS.
33. The wording of the carve-out suggests that in using it WTO Members are not limited to preserving the integrity and stability of "their" financial system.
34. This provision has not yet been interpreted. However, it is interesting to note that the prudential carve-out does not require that measures adopted for the purpose of prudential reasons or to ensure the integrity and stability of the financial system have no effect on Members' commitments or obligations; but rather that, in implementing them, Members should not use them as means to depart from their obligations.
35. According to UNCTAD's International Investment Agreements database, G20 countries are part of 1,824 IIAs (OECD and UNCTAD Seventh Report on G20 Investment Measures, May 31st, Table 2).
36. Countries are required to list all nonconforming measures. Measures not specifically listed or areas in which no measures were listed need to be fully liberalized.
37. Limitations to impose capital controls included in PTAs and BITs could conflict with two IMF provisions. Article VI, Section 1 establishes that the Fund's general resources cannot be used to meet "large or sustained outflow of capital"; however, in the absence of a safeguard provision in the PTA or the BIT, a Fund Member may feel legally bound to use IMF resources to transfer capital to its PTA/BIT partner. On the other hand, obligations under PTAs/ BITs may conflict with Article VIII, Section 2 (a) of the IMF charter. According to this provision a Member may, with the approval of the Fund, impose restrictions on payments and transfers for current international transactions. In the event of a financial crisis, problems of discrimination among Fund Members could arise if a party were to impose controls on nonparties to the PTA/BIT (IMF 2010, para. 27).
38. Mattoo and Subramanian (2008) argue that the resistance to multilateral regulation of FDI is based on the—now false—perception that developing countries allow FDI as a trade-off for industrial countries easing restrictions on goods and labor.
39. IMF 2010, p. 7.
40. Yet many developing countries, particularly those with small economies, are still prompted to "compete" for capital by using their limited fiscal space.

## 4. Ecuador's Efforts to Review GATS Rules on Monetary and Financial Regulations and New Paradigms on Ways Around Them<sup>1</sup>

Andrés Arauz G.

In this essay, I explain Ecuador's approach to reviewing GATS rules in the midst of the global financial crisis and its pursuit of treaty-abiding alternatives to fulfill policy objectives. First, I will argue that the principles on which the GATS rules were designed responded to a geopolitical juncture and did not provide ample enough policy space for developing countries' monetary and financial policy. Second, I will present the process Ecuador followed at the WTO and its intended results. Finally, guidelines are presented for heterodox capital account regulations in conformity with current international law.

### **THE DEREGULATION PARADIGM IS IN CRISIS BUT THE GATS IS STUCK IN THE 1990s**

When the Uruguay Round was being negotiated and the WTO was created in the mid-1990s, the paradigm of financial deregulation and liberalization was the consensus among mainstream academia, international organizations, and global policymakers. About 100 countries committed to profound liberalization of financial services, including the free flow of capital (GATS Article XI). However, these rules on commitments purposefully ignored the prevalent structural tendency of capital to flow to reserve currency issuing countries (Table 1) and to offshore centers (tax havens and secrecy jurisdictions) (Table 2). Strongly influenced by IMF structural adjustment programs in the 1990s, the principle of liberalization was implemented even in domestic legislation throughout the developing world.

It should thus come as no surprise that the most liquid form of capital (the financial sector) and the net recipient countries (reserve currency issuers and offshore centers) pressure the most for the liberalization of financial services and particularly for the free movement of capital. Recently, one can witness the pressure<sup>2</sup> on Korea to disband its capital account regulations and the insistence that China fully liberalize its capital account.

**Table 1: External Liabilities by Bank Nationality**

| Jurisdiction of banks (dec 2011) | Liabilities by bank residency (USD billion) | Liabilities by bank nationality (USD billion) | Proportion (residency / nationality) (%) |
|----------------------------------|---|---|--|
| <b>United States</b>             | 3,943                                       | 5,122   | 130%                                     |
| <b>United Kingdom</b>            | 6,031                                       | 4,650   | 77%                                      |
| <b>France</b>                    | 2,124                                       | 3,492   | 164%                                     |
| <b>Germany</b>                   | 1,644                                       | 3,277   | 199%                                     |
| <i>Switzerland</i>               | 834   | 2,675   | 321%                                     |
| <b>Japan</b>                     | 1,237                                       | 2,379   | 192%                                     |
| Netherlands                      | 1,406                                       | 1,623   | 115%                                     |
| Sweden                           | 527   | 1,236   | 234%                                     |
| Spain                            | 717   | 919   | 128%                                     |
| Australia                        | 676   | 914   | 135%                                     |
| Canada                           | 376   | 907   | 241%                                     |
| Italy                            | 827   | 828   | 100%                                     |
| <i>Hong Kong SAR</i>             | 688   | 526   | 76%                                      |
| Belgium                          | 581   | 526   | 91%                                      |
| Denmark                          | 282   | 369   | 131%                                     |
| Chinese Taipei                   | 118   | 326   | 275%                                     |

**Bold** = pre-euro Special Drawing Rights (SDR) members. *Italics* = offshore centers.

Source: Bank for International Settlements (2012).

**Table 2: External Liabilities by Bank Residency**

| Jurisdiction of banks (dec 2011) | Liabilities by bank residency (USD billion) | Liabilities by bank nationality (USD billion) | Proportion (residency / nationality) (%) |
|----------------------------------|---|---|--|
| <b>United Kingdom</b>            | 6,031                                       | 4,650   | 77%                                      |
| <b>United States</b>             | 3,943                                       | 5,122   | 130%                                     |
| <b>France</b>                    | 2,124                                       | 3,492   | 164%                                     |
| <b>Germany</b>                   | 1,644                                       | 3,277   | 199%                                     |
| <i>Cayman Islands</i>            | 1,585                                       | 14  | 1%                                       |
| Netherlands                      | 1,406                                       | 1,623   | 115%                                     |
| <b>Japan</b>                     | 1,237                                       | 2,379   | 192%                                     |
| <i>Singapore</i>                 | 905   | 235   | 26%                                      |
| <i>Switzerland</i>               | 834   | 2,675   | 321%                                     |
| Italy                            | 827   | 828   | 100%                                     |
| Spain                            | 717   | 919   | 128%                                     |
| <i>Hong Kong SAR</i>             | 688   | 526   | 76%                                      |
| Australia                        | 676   | 914   | 135%                                     |
| <i>Bahamas</i>                   | 589   | 16  | 3%                                       |
| Belgium                          | 581   | 526   | 91%                                      |
| <i>Luxembourg</i>                | 540   | 63  | 12%                                      |

**Bold** = pre-euro Special Drawing Rights (SDR) members. *Italics* = offshore centers.

Source: Bank for International Settlements (2012).

As we have seen in the introduction in Chapter 1, GATS poses contradictions as to whether the member country is able or not to pursue exchange capital account regulations.

Capital account regulations (CARs) are useful for crisis management and for crisis prevention, but they are also a valuable instrument for economic development beyond financial stability. I will expand on the benefits of CARs to protect monetary policy autonomy, from Ecuador's recent (dollarized) perspective and I will briefly examine the role of CARs in aiding administrative enforcement of development policies.

As the diverse and dynamic response to the global financial crisis has widely demonstrated,<sup>3</sup> capital account regulations are and should be part of the policy toolkit but, unfortunately, GATS rules limit this necessary policy space. But CARs must not only be available to policymakers in times of crisis to avert capital flight and liquidity drains; they should be available to be used expediently and with certainty, without fear of a legal

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**Capital account regulations (CARs) are useful for crisis management and for crisis prevention, but they are also a valuable instrument for economic development beyond financial stability.**

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backlash. It is important to recognize that, even though countries must follow a lengthy and obstacle-ridden procedure, the GATS does provide for the possibility to use CARs for crisis management purposes, mainly by invoking Article XII.

However, CARs are not only useful for crisis management, they are also valuable macro-prudential instruments for crisis prevention. Because of structural geopolitical asymmetries between developed reserve currency issuing countries and developing nations, the latter need CARs as macro-prudential instruments to have adequate governance of their financial systems and safeguard financial stability as a pre-condition of growth.<sup>4</sup> The main effect of successfully designed CARs as macro-prudential instruments has been to alter the term structure of capital flows, as a preventative measure to minimize effects of sudden stops of "hot" capital and to deter speculative attacks against national currencies or particular financial institutions. Furthermore, having CARs in place or readily available in the policy toolkit in "crisis prevention mode" allows for quicker responses via fine-tuning or closing loopholes if contagion effects of a foreign crisis do take place. Implementing CARs at the moment of crisis without preventative measures in place could be considered desperate and until their implementation has been perfected, the

expectation of their implementation will cause heavily pro-cyclical outflows and massive capital flight will be self-fulfilling. Conversely, there is a risk of contagion from within: “If a country exposed to systemic risks that accompany capital flows is not able to adopt proper macro-prudential measures, its financial and economic stability could be put at risk. Given the current environment of financial globalization and the resulting interconnectedness worldwide, economic uncertainty at the national level could spill over to the global economy” (OECD 2012). I consider the policy space for these types of preventative macro-prudential measures ambiguous given the current GATS language.<sup>5</sup>

After the series of financial crises in the 1990s, developing countries in South America have tended to accumulate costly reserves (Rodrik 2006; Aizenmann 2009). Besides the orthodox credit risk criteria, some of these countries are reluctant to invest in longer-term assets within the region because they could face sudden outflows of capital. Moderate CARs can minimize this risk and liberate hundreds of billions of dollars in reserves for the region’s development strategy. Coordinated, cooperative, and complementary CARs, rather than competitive race-to-the-bottom CARs, would have even greater effects.

Even though GATS Article XII “recognizes that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its program of economic development or economic transition,” and even if the term “recognizes” has a binding effect (which has not been tested), it seems impossible in practice because it requires following the Balance of Payment (BoP) crisis procedure with the IMF.

Because the regional objective of establishing a common reserve fund<sup>6</sup> has not yet been fulfilled, as part of its development program the Central Bank of Ecuador has invested part of its (dollarized) portfolio in long-term domestic assets and, consequently, has covered its liquidity risk with non-discriminatory CARs.

Developing countries can also find it very useful to limit the capital account convertibility of their domestic means of payment as part of their national development strategy in order to gain monetary policy autonomy (Epstein 2012). Notice that countries can also regulate domestic means of payment (even domestic non legal tender units of account) and their degree of convertibility without breaching any international commitment. Ecuador’s Central Bank has already created

such policy space for publicly issued electronic currency. Recall the *State Theory of Money*: a country can issue non-convertible sovereign credit to finance its (domestically available) development needs (Wray 2012).

Regarding administrative enforcement, CARs are a very powerful instrument in generating administrative records with valuable quantitative transactional data that can be easily interconnected with other government entities.<sup>7</sup> According to Epstein (2012), these records can be used to prevent corruption (outflows and inflows of Politically Exposed Persons—PEPs), tax evasion (particularly transfer pricing), money laundering, terrorist financing, and other illegal activities that involve capital flight. They can also be used to enforce performance criteria in state-investor contracts. None of these issues were discussed in the public sphere in the early 1990s. In the conclusion I will propose a design of CARs that primarily fulfills this role in a manner that complies with the current trade regime.

## **ECUADOR AT THE WTO**

Ecuador is a small, middle-income, very open economy. At the end of the last century, it suffered a systemic financial crisis, which caused a sudden capital outflow, the collapse of the financial system, the loss of the country's monetary sovereignty, and the expulsion of millions of nationals through migration. If the country is to prevent a repeat of a crisis of such magnitude and regressive distributional impacts, it needs to ensure ample and sufficient regulatory space for its monetary, financial, and economic policy. Ecuador has since been re-regulating<sup>8</sup> its monetary and financial system to serve as a tool for development (WTO 2011a).

After a symposium on July 1, 2011 with other multilateral organizations, Ecuador joined efforts with India, Argentina, and South Africa in a request to study the effects of the crisis and whether subsequent behind-the-border measures taken by developed countries were in compliance of GATS commitments. A series of related asymmetries were detected between developed and developing countries: behind-the-border transparency and monitoring; fiscal endowments; quantitative easing—linked to reserve currency issuance (currency of denomination of its debt); exchange rate effects; and competition of systemically important financial institutions.

In the subsequent Committee on Trade in Financial Services (CTFS), Ecuador presented the need to study the effects of the financial crisis and its implications for the WTO.

At the WTO's Public Forum in September 2011, Ecuador concluded the following: Director-General Lamy was correct in supporting<sup>9</sup> the need for more and better regulation. For this re-regulation to be successful there must be much bet-

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**Crises can be avoided with adequate regulation, and avoiding crises helps to avoid trade distorting measures.**

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ter communication and coordination between regulators and trade negotiators. Crises can be avoided with adequate regulation, and avoiding crises

helps to avoid trade distorting measures. Therefore Ecuador suggested that the WTO should monitor the impacts of the crisis and measures taken and ensure the public policy space for regulation (WTO 2011b).

Ecuador's proposal at the WTO Committee on Financial Services in October 2011 was preceded by a series of bilateral meetings and supported by a series of non-governmental organizations. It consisted of requesting an interpretation by the Ministerial Conference to continue reviewing the GATS' rules on financial services in order to ensure ample policy space for CARs and domestic regulations. This request was in light of recent developments, including the reform of the international monetary system (role of reserve currencies, global imbalances, Triffin dilemma), domestic regulation ("too-big-to-fail" institutions, Glass-Steagall, "shadow" banking system), and cross-border regulatory arbitrage (particularly via offshore centers). Argentina, Barbados, Bolivia, Brazil, China, Cuba, the Dominican Republic, India, and South Africa supported the proposal (WTO 2011a).

Australia said the GATS and the Annex on Financial Services already afforded Members a high level of discretion and, at the same time, did not allow measures that were purely protectionist in effect. Chinese Taipei, the European Union, South Korea, Norway, and the United States considered that the GATS already provided for the appropriate policy space, in particular through the prudential carve-out. Canada gave the view that the GATS prudential carve-out had functioned quite well and had provided Members with the flexibility to safeguard their domestic financial systems and reform their regulatory regimes (WTO 2011a). The responses by the developed economies (who harbor the largest and most powerful financial sectors) may be beneficial to Ecuador. These official statements remarking on the flexibility of the prudential carve-out can be used as arguments in potential disputes in the future.

In the CTFS in March 2012, Ecuador highlighted that preservation of policy space for financial regulation was supported by many members. It requested

the Secretariat prepare a Note on the scope of the GATS and gave examples of prudential measures that members might adopt. This proposal was not accepted by the members of the Committee (WTO 2012e).

It is clearly understood that a series of examples as to what constitutes prudential or not, or avoids commitments or not, would be counterproductive for Ecuador's and other developing countries' interests. However, Ecuador should attempt to include an interpretation of **the term prudential that encompasses micro-prudential as well as macro-prudential**. This seems like a viable consensus, and may be already explicit in Article 2(a) of the GATS Annex on Financial Services.

Furthermore, Ecuador should intend to ensure that CARs be considered macro-prudential regulations. This point seems to pose a level of conflict: both, the Bank for International Settlements (BIS) and the IMF have published papers<sup>10</sup> that, depending on the authors, have mutually exclusive positions on this issue. However, there exists a political definition by G-20 Leaders who "called on the FSB, IMF, and BIS to do further work on macro-prudential policy frameworks, including tools to mitigate the impact of excessive capital flows" (FSB, IMF, and BIS 2011). According to this definition, CARs are part of macro-prudential policy. On the other hand, **the scope of macro-prudential could be left for each member to decide**,<sup>11</sup> which would precisely fit with an approach taken by Claire Jones (2011) at the *Financial Times*: "Countries' priorities will differ on what the most important sources of financial stress are, so macro-prudential policy will differ from jurisdiction to jurisdiction." An alternative approach is to define these terms as broadly as possible in recognition agreements allowed by Article 3 of the GATS Annex on Financial Services (Viterbo 2012).

Ecuador should also seek clarification on the phrase "used as a means of avoiding,"<sup>12</sup> when referring to domestic prudential regulation. There is a lively debate on this topic (UNCTAD 2011a), without this clause actually having been tested.<sup>13</sup> In principle, that is already a good sign for Ecuador's interests. If the measure passes the "prudence" test, it can be safely assumed that the regulation is not used as a means of avoiding commitments. Because if it is prudential, then it is already being used as a means of protecting investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or as a means of ensuring the integrity and stability of the financial system.

On June 26, 2012, in a nonbinding workshop coordinated by the CTFS Chair (China), Ecuador insisted on the need for the WTO to update its paradigms in light of the greatest financial crisis since the Great Depression and to act on the asymmetries described above.

On June 27, 2012, Ecuador presented a proposal (WTO 2012f) to the Financial Services Committee, requesting the Secretariat to prepare a background paper for a discussion within the CTFS on international advances on macroprudential regulation (including CARs) and GATS rules. The debate questions proposed touch on new macroprudential regulations, their relationship to trade in financial services, coherence between WTO rules and IMF standards on macroprudential regulations, coordination between regulators and negotiators, and specific characteristics of capital flows in relation to GATS rules. As on other occasions, it was decided that members would consult with their capitals and have a response for the next meeting of the Committee.

### **HETERODOX CARs**

Despite its efforts given its size and resources, Ecuador cannot necessarily wait for the international trade regime to adapt itself to the present circumstances.<sup>14</sup> Therefore, there are alternative measures that can be taken, with similar effects as CARs. The first group of measures relates to tax-avoidance preventative transactional regulations. The second group relates to anti-money laundering and countering terrorist-financing (AML/CFT). The third group relates to central bank micro-prudential domestic regulations.

Regarding the tax avoidance of measures, the idea is to part from the sovereign right<sup>15</sup> of any state to establish its tax system. Even at the level of the European Union Treaty, Article 65 expressly exempts<sup>16</sup> tax matters from the free circulation of capital mandate. The most aggressive tax-avoidance preventative transactional regulation was signed into law in the United States: Foreign Account Tax Compliance Act (FATCA). It establishes strong *ex ante* administrative controls for foreign transactions and associated quantitative restrictions via withholding taxes (IRS 2012). Even though it has not been fully implemented, it appears it has been successful in curtailing “capital flight” from the United States (Der Spiegel 2011). FATCA may violate the non-discrimination provisions within the North American Free Trade Agreement (NAFTA) as well as the GATS (Cockfield 2012).

The specific types of measures could be *ex ante* price transfer administrative controls, anti-fraud solvency-tests for cross-border transactions, differentiated

withholding taxes for cross-border transactions, Tobin taxes, compliance with domestic taxes, and transparency (beneficial owner) requirements for the transfer recipient, among others.

International pressure has been surging regarding enforcement of AML/CFT standards. Countries can establish internal regulations that, while directly confronting these issues, can also serve as alternative CARs. It has been accepted<sup>17</sup> that capital controls reduce money laundering through the banking system. Developed countries are aware of the multiple uses of AML/CFT instruments as CARs. At the onset of the FTA negotiations between the U.S. and Colombia, USAID and the U.S. Embassy in Bogota reportedly made the following diagnosis: "The Government of Colombia may argue it needs tight controls on international financial transactions to control money laundering and capital flight. The Government of Colombia may accept additional U.S. technical assistance in fighting money laundering as an alternative" (Wikileaks 2004). Argentina's National Securities Commission has already implemented capital account restrictions based on AML/CFT non-cooperative jurisdictions lists (CNV 2011).

The measures that could be implemented include beneficial owner transparency; restrictions (administrative or price-based) on transactions for non-cooperative jurisdictions; administrative restrictions based on size of the transaction; further administrative requirements for cross-border transactions; lowering the threshold for unusual transaction reports; know your customer's customer regulations; among others. These measures can safely be included in the "national security" exceptions that are present in virtually all treaties.

There has been little analysis regarding the "microprudential" indicators that a Central Bank must comply with. A Central Bank's micro-indicators are its economy's overall (liquidity) situation. Depending on the institutional arrangement in every country, the Financial Services Authority or Banking Superintendency, or even the Supervisory wing of the Central Bank itself, could set (creative micro-macro) regulations for the Central Bank that force it to establish contract-rules and due-diligence for its customers regarding cross-border transactions. Those regulations would be domestic in nature, would not be in breach of international agreements, and would have the effect of regulating the country's capital account. Apparently, though, the legal success of implementing controls will be determined by their degree of discriminatory nature (Brockmeijer et al. 2012).

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1. Disclaimer: This paper is an academic effort to guide, primarily, developing countries' efforts to preserve ample policy space regarding monetary and financial regulations in the midst of the continuing global financial crisis. This is not an official document, it is non-binding and it is not for use in judicial cases, arbitration, or any other controversy or dispute in any jurisdiction. The views of the author do not necessarily reflect the views of the institutions he participates in.
  2. "Secretary Paulson explained... he was particularly interested in investor-state dispute settlement and capital controls. ... As for financial safeguards, this was important to Korea because of the memories of the financial crisis of 1997-98, but Kim thought both sides could find 'some way around that problem.'" Wikileaks (2007).
  3. See, for example, the paradigmatic experience in Malaysia in the late 1990s and the most recent case in Iceland.
  4. The recent exemplary case being the quantitative easing "liquidity tsunami" countermeasures implemented by Brazil. Other successful paradigmatic cases have been Colombia, Chile, and Argentina.
  5. Korea finds that "countries are restricted in employing effective policy tools and choosing appropriate times of implementation" when referring to the similarly principled OECD Codes of Liberalization (OECD, 2012).
  6. For more on Ecuador's new regional financial architecture proposals, see CBE 2011.
  7. See, for example, Russia's Central Bank Remote Transactional Monitor, Wikileaks (2010).
  8. These efforts of re-regulation have been challenged by Colombia (2009) and Peru (2012) at the Andean Community Secretariat, and by Panama at the WTO (2010).
  9. "The financial crisis had been triggered [...] because of the inability of supervisory authorities to properly regulate the financial system domestically and internationally. [...] The restoration of public confidence in banks and other financial intermediaries is contingent on macro-prudential reforms involving the regulation and supervision of the financial sector. A 'business-as-usual' approach is not an option. [...] It is important that re-regulation be applied in a non-discriminatory manner, avoiding any form of 're-nationalization' of lending." (WTO 2009).
  10. According to BIS (2011) and IMF (2012), capital controls are macroprudential instruments. A footnote on IMF (2012e) says, "Macroprudential instruments should not be confused with capital controls."
  11. Some WTO members scheduled CARs as non-conforming measures. In a context examination by a panel, this could undermine members that didn't schedule CARs: there are fewer chances to claim CARs as prudential measures.
  12. However, there is an additional twist. The Spanish version uses the term "eludir," different from the English "avoid," literally "evitar." "Eludir" carries intention to avoid. For Ecuador's interests, the English version should be preferred.
  13. Similar clauses in BITs and FTAs have been tested, but not at the WTO. FTAs have no bearings of interpretation at the WTO. One could consider Iceland's recent implementation of capital controls without a WTO challenge as a 'soft' test, considering that they have been challenged under EFTA.
  14. Ecuador has denounced the ICSID and 11 BITs. Ecuador's Constitutional Court has qualified 11 other BITs as unconstitutional; their denunciation is in process. Also, Ecuador has filed arbitration against the United States regarding an arbitral award that interprets the U.S.-Ecuador BIT. Ecuador has proposed an alternative conflict resolution mechanism at the Union of South American Nations (UNASUR). The Andean Community rejected one of the suits (Colombia) filed against Ecuador for its capital outflow tax, the second one (Peru) is pending.
  15. BITs are probably the only threat to sovereign right to tax, as some of these BITs consider new or raising taxes as "indirect expropriation." The costly but quick alternative to confront these is to denounce the BITs and the ICSID (as Ecuador and Bolivia have done). The savvy alternative is to ensure that compensation mechanisms for arbitral awards follow a domestic exequatur procedure (such as Argentina has done) and that major decisions exploit the exceptions language allowed in these BITs (as the U.S. has done).
  16. Albeit it mentions that tax-related measures cannot be used to disguise CARs. For example, the European Courts have recently interpreted this article in favor of freedom of movement of capital. (European Union 2012).
  17. For the case of Argentina, see Wikileaks (2008). For Iceland, see Wikileaks (2009). For Colombia, see Wikileaks (2004).

## 5. Capital Account Regulation, Trade and Investment Treaties, and Policy Space in Brazil

Luiz Fernando de Paula and Daniela Magalhães Prates

Since the second quarter of 2009, there has been increasing volatility of capital flows due to quantitative easing policy and loose monetary policy at the U.S. Federal Reserve, historical low interest rates in advanced countries, the double-speed recovery, and the Eurozone crisis. Brazil was one of the emerging countries that experienced significant currency appreciation through February 2012, due to the combination of huge capital inflows, the commodities boom, and high domestic interest rates. Perhaps most important for Brazil was the existence of a sophisticated and deep Foreign Exchange (FX) derivatives market completely open to foreign investors that provides room for speculation on the exchange rate. In an attempt to mitigate these massive capital inflows, Brazil implemented a number of CARs such as taxes on inflows and foreign exchange derivatives regulations (FXDR).

Brazil deployed these measures with full knowledge that it maintains the policy space to regulate capital flows under its international trade and investment agreements. As this essay will outline, Brazil has not committed to significant GATS obligations that would curtail its ability to use CARs. Moreover, Brazil has signed very few Free Trade Agreements and Bilateral Investment Treaties, and those that Brazil has signed allow ample room to regulate financial flows. Indeed, it is noted in this essay that many of the measures that Brazil has recently taken would not be permitted if Brazil had treaties with many nations, particularly one with the United States.

### **TRADE AND INVESTMENT TREATIES: THE CASE OF BRAZIL**

As an active member of the World Trade Organization (WTO), Brazil took part in the GATS negotiations that concluded in December 1997. Regarding financial services, the specific commitments undertaken by the Brazilian government in the Fifth Protocol on Financial Services of GATS ensured a degree of liberalization equivalent to the conditions prevailing in the domestic financial market,

which only allow increased foreign access through commercial presence. This means that Brazil only made some slight commitments under Mode 3 (commercial presence), one of the four services modes discussed in the GATS.<sup>1</sup> The Brazilian list of services initially included insurance services and banking in the 1995 supplement of its GATS, but in Brazil's 1998 supplement to its GATS schedule there is only a sparse commitment related to foreign bank entry in the domestic

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**Brazil failed to adopt all the relevant protocols of GATS, and therefore preserved its autonomy related to policy space, likely more than its Latin American peers.**

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banking sector, with the following inscription: "The establishment of new branches and subsidiaries of foreign financial institutions...is only permitted when subject to a

case by case authorization by the Executive Branch, by means of a Presidential decree. Applying investors may be required to fulfill specific conditions. Foreign persons may participate in the privatization program of public sector financial institutions and in each case commercial presence will be granted, also by means of a Presidential decree. Otherwise, commercial presence is not allowed" (WTO 1998). Summing up, Brazil chose not to adopt all the relevant protocols of GATS, and therefore preserved its autonomy related to policy space, unlike its Latin American peers.

One distinguishing feature of the trade of services is that it does not involve tariffs but rather norms and laws that are not restricted to the international dimension, but to domestic ones. In the case of the Brazilian banking sector, commercial presence of foreign entities is restricted in financial services, in accordance with Article 192 of the Federal Constitution and Article 52 of the Temporary Constitutional Provisions Act. However, the Constitution kept open the possibility of foreign financial institutions having access to the domestic market through special congressional or presidential decisions made in the interest of Brazil. Within this legal context, Legislative Intent ("Exposição de Motivos") no. 311 of 1995 allowed the President to exceptionally authorize the entrance of foreign banks in domestic market, in order to take part of the program of privatization of state-owned banks that had already begun and in a few cases to buy some troubled domestic banks.<sup>2</sup> In other words, the entry of foreign banks into the domestic banking sector was carried out on a case-by-case basis. For this reason, compared to Argentina and Mexico, the opening up of the banking sector was less dramatic in Brazil.<sup>3</sup>

As pointed out by Gallagher (2010, 7), “to the extent that a financial services transaction involved an international capital transaction, the capital account needs to be opened for the former to take place freely.” Therefore, as Brazil made only a few commitments under Mode 3, the unique international capital account transaction that should be taking place freely due to these commitments is FDI between the parent foreign institution and their subsidiaries. Moreover, these commitments took into account the domestic legislation concerning the entry of foreign banks (case by case, depending on President’s authorization). It is worth noting that the liberalization on Mode 1 (cross-border services) would result in a correspondent liberalization of the capital flows, which are an essential part of the service itself. The second round of negotiations under the GATS was opened in 2000, with the launch of the Doha Round. So far, the Brazilian government has not provided any financial services offers in these negotiations. Brazil’s GATS schedule had sparse commitments, and therefore continues to maintain more policy space than its Latin American peers (Cintra 1999, 2004; Marconini 2004).

Regarding Free Trade Agreements (FTAs), Brazil is a full Member of the Southern Common Market (Mercosur), by far Brazil’s most important preferential agreement in terms of value of trade. The Common Market was established in November 1991 by the Treaty of Asunción; the Protocol of Ouro Preto, signed in December 1994, provides the institutional structure. In December 1997, the Brazilian government signed the Protocol of Montevideo on Trade in Services of Mercosur, which establishes principles for promoting trade in services among member countries, based on the GATS’ principles, including universal sectorial coverage, non-discrimination principle, adoption of mechanisms of progressive liberalization by the use of positive lists, and so on. However, Brazil was the only country of Mercosur when it signed the Montevideo Protocol that established restricted access to its market, while the other members made very comprehensive offers under the GATS and gave no preference to Mercosur. Therefore, the Brazilian offer (the same offer presented at GATS) conditioned the agreement within Mercosur in order to prevent preferential access to financial services in Argentina, Paraguay, and Uruguay (off-shore financial center) from being turned into platforms to launch into the Brazilian market. Montevideo Protocol began to be formally in force in December 7, 2005 in Argentina, Brazil, and Uruguay, with the commitment of implementing a free trade zone of services within ten years, although the advances up to now have been slow.

Regarding trade negotiations between Mercosur and the European Union—based on the EU-MERCOSUR Interregional Framework Co-operation Agreement, signed in December 1995 and formally launched in 1999—market offers exchanged in September 2004 included goods, services, government purchases, and investment, but were not deemed enough for an agreement. In the services sector, one of the main demands of the European Union was the cessation of the requirement of presidential authorization for the entrance of foreign banks into the domestic market and the possibility for foreign banks to operate freely with foreign currencies in the domestic banking sector (Cintra 2004). In any case, since 2004 when there was supposed to have been an agreement, there have been a number of ministerial and senior official contacts but no formal resumption of negotiations.

Finally, unlike many emerging countries, Brazil did not participate in any Bilateral Investment Treaty (BITs) or Foreign Trade Agreement (FTAs) with the U.S., which would likely result in some restrictions for the use of capital controls on inflows or outflows.<sup>4</sup> Regarding the Free Trade Area of the Americas (FTAA), proposed by President George W. Bush in 1994, the failure of the Mar del Plata summit (December 2005) to set out a comprehensive agenda to keep FTAA alive has meant that there is little chance for a comprehensive trade agreement in the foreseeable future. During the negotiation of the FTAA in the services sector the U.S. pressed for the inclusion of some elements, including expansion of cross-border liberalization of services, the negotiation of investments in services (commercial presence) to take place in the chapter on investment instead of the chapter on services, and the adoption of a style of negotiation based on a “negative list” (all the sectors are liberalized except if there is some reservation or restriction for some specific sector). The Brazilian and Mercosur proposal was in favor of adopting the same modalities and procedures adopted in the GATS, including the implementation of a “positive list” (whatever sector excluded of the negotiation is excluded from any commitment or obligation).

Besides the policy space granted by the cautious approach of Brazil in Trade and Investment Treaties, domestic norms on foreign exchange transactions allow the implementation of capital controls at any time—there is no formal restriction on this concern. Law 4,321/1961, which allows the adoption of controls on capital outflows by foreign investors and transnational enterprises, has not been repealed.

However, the degree of financial openness of the Brazilian economy is high, as Brazil has ample and deep experience with external financial liberalization. This

liberalization began in the 1990s and was expanded over time, marked by key decisions that, given their strong impact on capital inflows and outflows, can be considered landmarks. This was the case with the approval, in 1991, of Annex IV of Central Bank of Brazil Resolution no. 1,289, permitting foreign institutional investors to participate directly in the Brazilian capital market and, in 1992, the redesign of CC5 accounts, permitting residents and non-residents to make capital transfers abroad from Brazil. So, both capital inflows and capital outflows were liberalized in Brazil. The process of financial opening gained momentum in January 2000, when the Resolution CMN no. 2,689 allowed the unrestricted access of non-resident (i.e., foreign) investors to all the segments of the domestic financial market, including the derivatives market. Afterwards, during the 2000s there was in course a process of consolidation of the foreign exchange rules (Paula 2011).

In the post-global 2007–08 financial crisis context, the Brazilian government implemented some slight capital controls in 2009 and 2010, and more comprehensive regulation after January 2011 (when the first prudential financial regulation was implemented) and, mainly, after July 2011 (adoption of FX derivatives operations), encompassing both capital controls, prudential financial regulation and FX derivatives market regulation.

## **CAPITAL ACCOUNT REGULATION AND FOREIGN EXCHANGE DERIVATIVES REGULATION**

Before detailing CARs and FXDRs in Brazil after the global financial crisis, it is important to explain the importance of the latter type of regulation in Brazil. This importance is due to the central role of the FX derivatives operations in Brazilian currency markets (BRL) (predominantly a built-in tendency for appreciation, i.e., a fall of the BRL/USD exchange rate, which is the price of USD), as well as to the specificities of the FX derivative market in Brazil. This central role stems from the much higher liquidity and depth of the FX futures market, in comparison with the FX spot market in Brazil. The predominance of the organized segment in the FX derivatives markets (i.e., futures traded in BM&F Bovespa) is a specificity of Brazil's currency market. According to Avdjiev et al. (2010), the BRL was the second most traded currency worldwide in the organized derivatives markets in 2010.

A major distinction of the Brazilian FX derivatives (futures and over the counter) market is that these operations are non-deliverable. This means that gains or losses in these operations are liquidated in domestic currency (BRL—Brazilian *real*), and not in foreign currency (USD). Due to their non-deliverable legislation,

the margin requirements of FX futures transactions can be fulfilled in BRL. Along with the unrestricted access of non-residents to the FX futures market in the context of financial liberalization, this specific norm has contributed to its higher liquidity in comparison with the FX spot market, as FX futures operations can be carried out without any effective foreign currency flows.

Both before (2003 to mid-2008) and after (since 2009) the global financial crisis, during periods of low risk aversion, foreign institutional investors have become the most important investor group in Brazil's FX futures market, fostering a real appreciation trend through derivative carry trade. This is a different kind of currency speculation strategy, compared to the canonical carry trade through spot market operations—when an investor borrows money in a currency with a low interest rate and uses it to take long positions in currencies backed by high interest rate (Gagnon and Chaboud 2007). This strategy presents advantages because of its inherent high degree of leverage (as in order to be carried out, financial derivatives operations require only the payment of a margin requirement).

In derivatives markets, the carry trade expresses itself as a bet that results in a short position in the funding currency and a long position in the target currency (Gagnon and Chaboud 2007). In the case of Brazil, due to the huge differential between the internal and external interest rates, since 2003 foreign investors have taken, predominantly, one-way bets on the Brazilian currency appreciation through short positions in the FX futures market (selling USD and buying BRL), which has resulted in downward pressure on the USD price and, thus, upward pressure on the BRL price.

FX futures and spot markets are linked by the arbitrage carried out mainly by banks as the dealers in the FX spot market. In front of the downward trend of the USD futures price, these agents took the contrary position of foreign investors in the FX futures market (long position in USD and short in BRL). With this strategy, banks have earned arbitrage profits and, at the same time, caused additional appreciation of the Brazilian currency.

The derivatives carry trade turns out to be even more attractive in Brazil due to the non-deliverable trait of the FX futures market. In the case of Brazil, until October 2010, foreign and domestic agents could engage in derivatives carry trade without even investing on the margin, as is usual with derivatives operations, but without disbursing one USD. In addition, this carry trade strategy could also be performed without the expenditure of one single BRL because

investors could meet their margin requirements in BRL via domestically borrowed securities or guarantees from local banks. Despite the leadership of foreign investors, profit-seeking domestic agents, such as institutional investors and companies, have also engaged in derivatives carry trade.

Therefore, while other countries only face a problem of low efficacy of capital controls to deal with FX derivatives operations (due to its high degree of leverage), Brazilian authorities are dealing with an even greater challenge, as these operations could simulate the impact of capital flows on the exchange rate without any effective foreign currency flows. Consequently, CARs focused only on foreign capital flows have proven to be ineffective in restraining them, while at the same time prudential financial regulation also is insufficient in this case as it does not reach foreign investors and non-bank resident agents.

The Brazilian regulatory authorities after some time realized this constraint. Since October 2010, they have launched, along with CARs, specific measures to tap these operations, the already mentioned “FX Derivatives Regulation” (thereby FXDR). This new kind of regulation has been revealed to be key in restraining the BRL appreciation trend and, in turn, mitigating the economic policy dilemma faced by the Brazilian government; mainly, that is containing inflationary pressures without reinforcing the exchange rate misalignment (Figure 1).

**Figure 1: BRL/USD Exchange Rate**



Source: Authors' elaboration on data from the Central Bank of Brazil (BCB).

In October 2010, a price-based capital control (a financial tax on inflows, called *Imposto de Operações Financeiras* (IOF)), already adopted at a low level in 2009, was increased to curb the undesirable effects on financial and macroeconomic stability of one important kind of capital flows outside the scope of prudential financial regulation: portfolio investment in equity and fixed income. A few days later the Brazilian government also closed a loophole that allowed foreign investors to avoid the higher tax on fixed income investments established before. Moreover, the first FXDR was implemented: the IOF on margin requirements on FX derivatives transactions was increased from 0.38 percent to 6 percent and some loopholes for IOF on margin requirements were closed (Table 1).

However, the first rounds of CAR and FXDR proved to be insufficient, as the IOF was too low to stem the derivatives carry trade due to its high leverage degree. Moreover, private agents found loopholes to circumvent the regulations (Figure 1). One of the main channels of circumvention after October 2010 was the increase in bank's short dollar positions in the spot currency market. In fact, the IOF on portfolio inflows encouraged the build-up of long real/short dollar positions in the on-shore derivatives market; that is, the derivatives carry trade supported by resident banks.

To close this loophole, the Central Bank of Brazil (BCB) adopted a non-interest reserve requirement on these positions in January 2010, which is a prudential financial regulation tool. Nevertheless, banks found another channel of regulatory arbitrage by switching to short-term foreign borrowings, which also allow them to obtain arbitrage gains between the internal and external interest rates. The regulatory response was the IOF on this kind of capital flows adopted in March 2011. However, private agents were able to make longer-term loans given the excess of liquidity and search for yields in the international financial market. Then, in April the government extended the IOF to these loans. Consequently, until the first quarter of 2011, the impact of the CAR was mainly on the composition of inflows rather than on their volume.

Regarding the currency appreciation trend, this could be curbed only after the launch of a broader FXDR in the end of July 2011. At that time, the government imposed a financial tax of 1 percent on excessive long positions on BRL in the FX derivatives market. These measures at least had a longer-lasting effect as they reached not only the marginal requirements, but the notional value of the carry trade operations of the FX derivatives market. The exchange rate BRL/USD increased from 1.70 on February 28, 2012 to 2.00 on May 18, 2012, a

**Table 1: Brazil: Capital Account Regulation (Capital Controls and Prudential Financial Regulation) and Foreign Exchange Derivatives Regulation after the Global Financial Crisis**

| Period    | Kind                            | Measure  | Agents   |
|-----------|---------------------------------|--|--|
| Oct. 2009 | Capital controls                | The Ministry of Finance implemented a 2% financial transaction tax (IOF) on non-resident equity and fixed income portfolio inflows   | Non-resident investors   |
| Oct. 2010 | Capital controls                | (i) IOF increased from 2% to 4% for fixed income portfolio investments and equity funds<br>(ii) IOF increased 6% for fixed income investments<br>(iii) Limitations were also introduced on the ability of foreign investors to shift investment from equity to fixed income investment   | Non-resident investors   |
| Oct. 2010 | Derivatives market regulation   | (i) IOF on margin requirements on FX derivatives transactions increased from 0.38% to 6%<br>(ii) Loopholes for IOF on margin requirements were closed: foreign investors in the futures markets were no longer allowed to meet their margin requirements via locally borrowed securities or guarantees from local banks, which allowed them to avoid payment of the tax  | Resident banks, institutional investors and companies and non-resident investors |
| Jan. 2011 | Prudential financial regulation | Non-interest reserve requirement equivalent to 60% of bank's short dollar positions in the FX spot market that exceed USD 3 billion or their capital base, whichever is smaller (to be implemented over 90 days).  | Resident banks   |
| Mar. 2011 | Capital controls                | Increased to 6% the IOF on new foreign loans (banking loans and securities issued abroad) with maturities of up to a year. Companies and banks previously only paid a 5.38% IOF on loans up to 90 days.  | Resident banks and companies   |
| Apr. 2011 | Capital controls                | (i) 6% IOF extended for the renewal of foreign loans with maturities of up to a year<br>(ii) 6% IOF extended for both new and renewed foreign loans with maturities of up to 2 years   | Resident banks and companies   |
| July 2011 | Prudential financial regulation | The non-interest reserve requirement became mandatory for amounts over USD 1 billion or their capital base (whichever is smaller).   | Resident banks   |
| July 2011 | Derivatives market regulation   | (i) The Monetary Council of the Brazilian Central Bank (CMN) became the agency responsible for regulating the derivatives market<br>(ii) All FX must be priced according to the same method<br>(iii) All FX derivatives must be registered in clearing houses<br>(iv) The PX exposure of all agents must be consolidated (liquid position)<br>(v) Excessive long positions on BRL off all agents pay a financial tax of 1%. This tax can be increased up to 25%. | Resident banks, institutional investors and companies and non-resident investors |

Source: Authors' elaboration based on BCB's and Minister of Finance's websites.

nominal devaluation of 17.6 percent (see Figure 1). An additional reason for such exchange rate behavior is some reduction in the net capital flows to Brazil since mid-2011 due to both the BCB policy determination to reduce short-term interest rates and the increase of risk aversion of foreign investors due to the higher likelihood of the imminence of a euro crisis (see Table 1).

## SOME LESSONS FROM THE BRAZILIAN EXPERIENCE

Some lessons can be learned from the recent Brazilian experience in dealing with capital flows and agents' FX positions, and with trade and investment treaties:

- Emerging countries should not make any commitment under GATS or sign any BITs or FTAs that can reduce the policy space for deploying CARs and FXDRs on a permanent or temporary basis. Although most treaties liberalizing trade in services employ a "positive list" approach with respect to trade in financial services, capital controls eventually can be inconsistent with obligations if they intervene in cross-border move-

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ments of capital related to the services that have been committed to liberalization. The same concern can be applied to FXDR, as non-residents' positions in the FX derivatives market

involve a safety margin and can result in gains that will be converted to USD and then will be transferred abroad. While some of these measures would appear to be permitted under the "taxation" components of some treaties, many treaties (such as the U.S.-South Korea FTA) often require taxation measures to adhere to national treatment. Thus, many of Brazil's measures would not be permitted if Brazil had signed such a treaty. In this particular regard, Brazil has been very careful avoiding to make any commitments under GATS and signing any BITs or FTAs that can reduce the country's freedom in terms of policy space, including the freedom to implement at any moment some sort of CAR. This was particularly the case of the negotiation of Brazil with NAFTA and the European Union, where in terms of the services sector there was a clear demand for financial liberalization of Brazil.

- In countries with open, deep, and non-deliverable FX derivatives markets, a third type of regulation, the FX derivatives regulation, needs to be adopted along with capital controls and prudential financial regulation. While other countries faced only a problem of low efficacy of these two regulations due to the high leverage degree of derivatives operations, in Brazil they turned out to be ineffective as these operations are liquidated in Brazilian currency. This means that they are likely to

have an impact on the exchange rate with very low or even without any foreign capital inflows or outflows taking place.

- A wider interest rate differential stimulates regulatory arbitrage, mainly in cases of countries with sophisticated financial markets. In this context, CAR and FXDR have to be even more dynamic, flexible, and adjustable, involving a steady “fine-tuning” to close the loopholes found by private agents through spot and FX derivatives transactions. Only when Brazilian government adopted all of the three kinds of techniques simultaneously (capital controls, prudential financial regulation, and FX derivatives regulation), the policy effectiveness increased in terms of protecting the exchange rate from upward pressures. Therefore, Brazilian experience shows that it cannot be possible to establish a clear-cut triple hierarchy between instruments to manage capital flows as supported by the current IMF approach (Ostry et al. 2010); that is, first using “appropriate” macroeconomic policies until exhaustion, then implementing prudential regulations on the domestic banking sector, and finally, if it is the case, capital controls.

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1. For more details on these four services modes, see Gallagher (2010).
  2. In 1995 Brazil was suffering banking distress as a consequence of the Mexican crisis contagion.
  3. According to Bank for International Settlements (2005, 72), the market share of foreign banks (in terms of total assets) was 27 percent, 48 percent, and 27 percent, in Brazil, Argentina, and Mexico, respectively.
  4. For a detailed analysis of some policy constraints related to GATS, BITs, and FTAs, see Gallagher (2010).

## Section 2: The Compatibility between FTAs-BITs and Regulating Capital Flows

### 6. Capital Account Restrictions, Trade Agreements, and the IMF

Deborah E. Siegel<sup>1</sup>

#### INTRODUCTION

Policymakers who negotiate Free Trade Agreements (FTAs) are potentially on a collision course with the work of the International Monetary Fund (IMF) because of how the FTAs investment chapters deal with capital transactions. This issue (first discussed in a 2004 note on which this report chapter is based) is more visible and pressing now that the IMF has been discussing an institutional view designed to advise members on “capital flow management measures” (CFMs) under specified circumstances.

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FTAs increase commercial entities’ access to markets within signatory countries and protect investors, without taking into account the global effect of capital flows that are an increasingly important means of allocating savings, promoting growth, and facilitating balance of payments adjustment. Some recent FTAs (particularly by the U.S.) include sweeping provisions against capital controls on the covered investments even in times of economic stress. Importantly, investors may challenge governments directly through investor-state dispute resolution, eliminating governments’ choice to filter disputes based on broader political concerns. This may impose significant liability on governments for making responsible macroeconomic decisions that could involve reasonable capital controls.

Thoughtful writers have expressed the importance of evaluating how these features of FTAs compare with the need for international oversight of capital flows that is conducive to crisis prevention and management (e.g., Gallagher 2010, United Nations Commission of Experts on Reform of the International Monetary and Financial System 2008, and Anderson 2011). This comment argues further that future FTAs should be written with safeguards that allow countries policy space for appropriate measures that may be chosen in conjunction with the advice of the IMF given its legal authority as the institution charged with overseeing the international monetary system and assuring global financial and economic security. As for existing FTAs, amendment or waiver provisions may be necessary to allow for this policy space.

## **IMF MANDATE**

The IMF's mandate on capital transactions is grounded in several provisions in the IMF's Articles of Agreement that establish different forms of legal authority for the IMF's different functions. The provision often mentioned against such a mandate is the statement that "members may exercise such controls as are necessary to regulate international capital movements..." (Article VI ("6"), Section 3), cited as members' "right" to impose capital controls. That provision from the original Articles reflected the then post-war negative view of capital flows and the fact that almost all members maintained capital controls. But it must be understood in light of other provisions in the Articles that involve the capital account; these provisions involve its jurisdiction, its financing function, and the 1978 Second Amendment of the Articles creating the surveillance function as well as the Executive Board's decisions related to surveillance. Several papers by the IMF's Legal Department in recent years clearly explain this complex topic (e.g., June 2006, Feb. 2010, Nov. 2010 ); a very brief overview follows.

### **Jurisdiction**

Besides the better-known financing and surveillance functions, the IMF has jurisdiction to liberalize exchange restrictions on current international transactions—its so-called "regulatory" powers. Members may not impose restrictions on the making of payments and transfers for current international transactions without the approval of the IMF (Article VIII, Section 2(a)). The Executive Board may approve exchange restrictions if they are necessary for balance of payments (BoP) purposes, refrain from discriminating among IMF members, and are temporary (usually for one year). Members have the right to maintain exchange restrictions that have been approved or that already existed when the country

joined the IMF (Article XIV) or those exchange measures that are not restrictive. The Articles contemplate sanctions for exchange restrictions that fail to meet these requirements.

One reason that FTA provisions on capital transactions often overlap with the IMF's Articles is that the definition of current international transactions for purposes of this jurisdiction (Article XXX(d)) includes some transactions that are considered "capital" by economists. These transactions must also be liberalized, unless they are approved or otherwise consistent with the Articles in the sense just mentioned. They include moderate amounts for amortization of principal on debt instruments and for depreciation of direct investments, as well as normal short-term credit and banking facilities. When current or capital restrictions are approved under IMF policies, or are applied consistently with the IMF's Articles, they could conflict with FTA rules that do not allow restrictions even in cases of a BoP crisis.

## **Financing**

The IMF Articles allow the IMF to request capital controls in the context of its financing function, although its legal status differs from the regulatory jurisdiction just described.

A key purpose of the IMF is to make available financing in times of BoP difficulties and in support of programs of macroeconomic stabilization and structural reform (Article I, paragraph (v)). IMF resources normally play a catalytic role for financing from the rest of the international community. At the same time, recent cases have highlighted (e.g., Iceland) how financing alone is rarely a solution. Although the IMF's policies reflect an overall priority for fundamental policy adjustments (including appropriate macroeconomic, structural, and financial sector policies), exchange or capital restrictions may need to supplement these policies.

Balancing this role with the need to safeguard IMF resources, the Articles state that a "member may not use the IMF's general resources to meet a 'large or sustained outflow' of capital. ..." (Article VI, Section 1) and they allow the IMF to "request" a member using IMF resources to impose capital account restrictions on a temporary basis. In practice, the IMF has not made a request under this provision.

Nonetheless, capital account matters may also figure in the IMF conditionality because the Articles require the IMF to adopt policies on the use of its resources

that will assist members to solve their BoP problems in a manner consistent with its Articles and to establish adequate safeguards for the temporary use of its resources (Article V, Section 3(a)). However, since capital account liberalization is not one of the IMF's purposes and the Articles recognize the right of members to restrict capital movements, the IMF may not establish conditionality which would require members receiving financial assistance to remove particular capital account restrictions. However, members using IMF resources cannot apply capital controls in a manner that will give rise to external payments arrears.

Neither conditionality, nor a request under Article VI, Section 1 constitute international obligations. They are conditions for using IMF resources. In other words, the member is not faced with breach of obligation for failure to impose the controls; rather, it would not receive scheduled financing or could be declared ineligible to use IMF resources.

### **Surveillance**

The introduction of the IMF's surveillance function through the Second Amendment to the Articles in 1978, following the collapse of the Par Value system, created a new code of conduct for exchange arrangements (IMF 2006) and provides a different form of authority for the IMF to address capital flow matters. In light of the IMF's oversight functions, the revised Article IV ("4") effectively modified the seemingly unqualified "right" to impose capital controls, even though Article VI ("6"), Section 3 was not deleted.

The revised Article IV recognized that the overall functioning of the international monetary system was impacted by a growth in international capital movements and liberalization of controls by some members. It imposed obligations on both the IMF and members—the IMF has responsibility to oversee the international monetary system and the members are required to adhere to the surveillance obligations relating to a stable system of exchange rates.

The surveillance function under Article IV differs from regulatory authority involving particular measures targeted for liberalization and thus is more difficult to express concretely. The 2006 Legal Department paper captured well the core principle that Article IV covers the conduct of members' economic policies because "if exchange rates reflected underlying conditions, the overall system would be more stable, even if this resulted in fluctuations in members' exchange rates." In brief, members must generally "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable sys-

tem of exchange rates." There are also four specific obligations relating to members' conduct regarding their economic policies. The first two obligations, which are often called "soft" obligations, are expressed in terms of undertakings relating to economic policies, given the important relationship between a member's domestic policies and its exchange rate. The second two obligations are "hard" obligations relating to specific actions respecting a member's external policies.

Surveillance is approached largely collaboratively between members and the IMF, but it should be recognized that it is grounded in the legal authority of Article IV. This authority is implemented by the IMF's Executive Board (EB). EB decisions express how capital flows fall under surveillance obligations. Over time, the EB recognized that capital flows are increasingly important means of allocating savings, promoting growth, and facilitating balance of payments adjustment, as reflected in decisions in 1977 and 2007. For example, capital account restrictions also figure in surveillance if a country uses them towards attempting to support an inappropriate exchange rate. Under the 2007 decision, the IMF must evaluate the size and sustainability of capital flows, including financial sector policies that give rise to capital transactions, as part of assessing BoP developments.

On July 30, 2012, the EB adopted a new decision covering both bilateral and multilateral surveillance, further articulating the IMF's role on the capital account from the point of view of helping countries to ensure their own domestic and external stability, as well as the stability of the exchange rate system. The inclusion of multilateral surveillance function shows that the IMF can discuss with its members their capital account policies and provide policy recommendations to the extent that these policies may significantly affect global economic and financial stability. Legally, Article IV is broader in scope than the current decisions and would permit the EB to go further in implementing the surveillance mandate, including how it is impacted by capital flows, but there is no political will to do so at this time.

Importantly overall, the IMF's surveillance discussions are not merely "advice," even though some aspects go beyond matters that have been articulated as obligations under the surveillance decisions. The consultations necessarily include related macroeconomic policies in the comprehensive discussions on the members' economic policies, as well as their exchange and payments system, especially with a view to the effect on its exchange rate. The oft-used expression "policy advice" for these related matters is unfortunate, as even these

matters are grounded in Article IV's scope for bilateral surveillance as well as the more general mandate to oversee the international monetary system from a multilateral perspective. And the IMF monitors Members' compliance with these policy discussions.

### **"Institutional View" on Capital Account Matters**

The IMF's recent discussions on an "institutional view" on capital flow matters could be better understood from a legal perspective on four key points: First, as of this writing, the discussions are not final. This paper is based on a series of interim papers from the fall of 2010 to the summer of 2012 on the IMF's institutional role, managing inflows, multilateral effects of capital flows, and managing outflows and capital account liberalization and sequencing, each with an Executive Board discussion. Based on those discussions, the IMF published a final cumulative paper in December 2012 that consolidates the comments and analysis that these discussions have generated.

Second, an institutional approach by the IMF is well grounded in its legal mandate under provisions of the Articles taken together and the legal authority underpinning its various functions, as described above. One popular concern was whether the institutional view would newly constrain countries' policy space to impose controls as they deem necessary. This concern no doubt developed the vacuum seen in recent decades in multilateral oversight of capital controls. Contributing to this vacuum was the IMF's own inaction to date (and the members' disinclination to accept the 1990s proposals to amend the Articles to cover capital transactions), the failure of the negotiations on the Multilateral Agreement on Investment, and the World Trade Organization's limited coverage of capital controls through scheduled commitments under the GATS (General Agreement on Trade in Services).

Third, legally, the "institutional view" is essentially a set of guidelines, and thus does not establish a binding, "one size fits all" approach—another concern reported. There has not been a new assertion of legal authority, but rather a crystallization of ideas on CFMs as they are appropriate in the current global economy. The word "framework" has been used for convenience. The EB summaries (as expressed in the Public Information Notices (PINs)) clarify that the "framework" is not intended to have a legally binding status and the PINs state the intention to retain sufficient room for country-specific circumstances, acknowledging the difference between countries with open capital accounts and those that have yet to liberalize. At the same time, the Legal Department stated

that a new Fund institutional view could be considered as input in some cases for Board judgments in the context of bilateral or multilateral surveillance.

Fourth, an institutional view will *inform* (not dictate) the IMF's functions in the following ways. In surveillance consultations, any recommendations drawn from this framework would constitute policy advice, which is not obligations but still an essential part of the IMF's oversight role in the context of surveillance discussions and its ongoing relationship with members. Regarding financing, conditionality is itself not legally an obligation potentially subject to sanctions, but rather a condition for using IMF resources. According to the PINs, the institutional approach is intended as a point of departure—not a strict formula—for mission chiefs in designing IMF-supported financing programs. This guideline for staff could help address a separate criticism that the different teams of IMF staff may not have treated similarly situated countries in the same way—but, again, it is not intended to preclude considering the needs of specific situations.

## **FTAs AND THE IMF**

Bilateral and regional agreements seek to promote and protect investment between the signatories with strong disciplines on controls by host countries, including by ensuring free transfers of funds related to covered investments. Increased trade benefits commercial interests and clear rules on transfers usefully prevent arbitrary administration of exchange transactions. But many contain largely blanket prohibitions on capital controls even in times of economic crises, especially the plethora of those signed by the United States. Their focus on market access and investor protection

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**Recent global economic crises and the IMF's more concentrated attention to capital flows show the need for more thoughtful attention to the global effects of these regional agreements.**

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diverges from the multilateral concerns and could conflict with the work (and legal obligations) under the IMF's mandate. Recent global economic crises and the IMF's more concentrated attention to capital flows show the need for more thoughtful attention to the global effects of these regional agreements.

## **Importance of FTAs**

FTA investment rules have a broader effect than their predecessor stand-alone Bilateral Investment Treaties (BITs). FTAs necessarily cover a range of com-

mercial transactions, broader than BITs and more likely to increase capital flows. Legally, the FTAs must cover “substantially all trade” in order to allow preferences between signatories despite the WTO’s “most favored nation” rule requiring equal treatment among all WTO members (GATT, Article XXIV). FTAs’ notoriety also expands their effect and make them more likely to attract speculative capital flows than traditional BITs.

Investment provisions have already expanded to a wide range of transactions. As compared to their earlier focus in practice on foreign direct investment and (somewhat later) financial instruments associated with an enterprise, many now define investment broadly to allow for evolving coverage of new instruments. Depending on the text of the agreements, investors in “hot money” transactions (e.g., high-yield overnight deposits and other derivative financial products) could seek protections of the investment rules. Financial products are explicitly included as “investments.”

The investor-state arbitration provisions, while a valid investor protection measure, create liability for countries in ways that differ from other international agreements. In treaties calling for government-to-government dispute resolution, such as under the WTO, governments have the opportunity to filter the disputes that they initiate, allowing discretion based on awareness of political or economic circumstances.

### **Overlap with IMF Mandate**

Investment provisions that exclude any form of accommodation or safeguard for exchange or capital controls in time of economic crises raise important problems, including with the work of the IMF.

In general, the pressure to accept strong disciplines on investment rules in order to conclude the FTA often does not reconcile with the multilateral perspective represented by the work of the IMF. In contrast to sector-driven market access, the IMF “has an important role to play regarding capital flows in its bilateral and multilateral surveillance, including by monitoring global liquidity and cross-border flows, surveying international spillovers, fostering a multilateral dialogue and policy coordination over capital flows, and providing candid advice” (IMF 2011d).

The absence of a BoP safeguard in FTAs could also interfere with a member receiving IMF financing. A member could be rendered ineligible to use IMF resources if, in the context of an IMF-supported program, its FTA obligations dissuaded it from imposing controls requested by the IMF due to a large and

sustained outflow of capital (even though the IMF has not to date made such a request under Article VI, Section 1), or as part of its conditionality policies. Some of the FTA signatories are relatively mature markets with a solid record of macroeconomic and financial sector management. But recent world developments show a risk of unanticipated economic and financial crises. Regional agreements focused on sectoral interests could therefore interfere with the support that the international community expects from the IMF.

Two legal inconsistencies are also noteworthy: First, FTAs overlap with IMF jurisdiction when they cover transactions that are defined as “current” payments and transfers under the IMF’s Articles. For example, the FTAs require the signatories to permit transfers comprising dividends, interest, royalty payments, management and other fees, and payments made under a contract entered into by the investor or the covered investor, including payments (e.g., amortization) made pursuant to a loan agreement. Second, an FTA signatory could find itself in violation of the IMF Articles if it needed to impose restrictions under the IMF’s definition of current international transactions but, because of FTA rules, it does so only against non-signatories of the FTA. Under the IMF’s policies, measures that discriminate among IMF members could not be approved (even if justified for BoP reasons). Unapproved restrictions on payments and transfers for current international transactions violate members’ obligations to the IMF under Article VIII, Section 2(a). Conversely, restrictions that are consistent with the Articles (e.g., approved under Article VIII, Section 2(a) or maintained under Article XIV) are rights; FTAs’ blanket-like prohibitions could create inconsistency between the treaties.

### **Sufficiency of Current Approaches?**

The majority of recent U.S. BITs and FTAs prohibit governments from restricting controls on covered investments without exceptions for economic crises. Many of the investments chapters follow the core approach of the U.S. model BIT. Anderson (2011) reports how the U.S. essentially declined input from 250 economists for attention to multilateral issues, and the recently issued model BIT continues to lack a safeguard for economic crises. Anderson notes that “The current policy promotes capital account liberalization between trade partners, regardless of the implications for financial stability.” The following examples are illustrative:

Some FTAs have limited qualifications to the signatory’s liability for capital controls. The U.S.-Colombia FTA garnered particular attention when it entered into force in May 2012 due to special constitutional procedures in Colombia. Its content, however, closely aligned with the model U.S. approach. Although the FTA limits loss

to reductions in value of the transfer, and excludes lost profits in possible recovery, even this accommodation is limited to certain kinds of transfers and has further constraints on restrictions relating to outward payments and transfers.

The fact that the qualifications to liability are normally contained in Annexes called Special Dispute Settlement “Procedures” speaks to their limited effect. The “cooling off” period in the U.S. FTAs with Singapore and Chile (and now some others) is purely procedural. It operates only to delay when an investor can initiate a claim. The treaty still holds a signatory liable to investors for (even temporary) restrictions that were imposed to resolve an economic and financial crisis, if a panel finds that the restrictions “substantially impede transfers.” The liability applies retroactively even if the restrictions have been subsequently removed.

The oft-mentioned “side letter” to the U.S.-Singapore FTA purports to clarify what measures are considered by the U.S. government to “substantially impede transfers,” but it has minimum legal effect. It states a “rebuttable presumption” that certain forms and effects of restrictions “will be deemed (by the U.S.) as not to substantially impede transfers” including, for example, that the controls be non-discriminatory or price-based. This letter does not constrain individual investors from bringing a claim under the terms of the treaty, does not bind arbitral panels, and does not address the point that restrictions may indeed need to have substantial effects in order to serve their purpose.

The U.S.-Korea FTA that also recently entered into force (March 2012) is potentially more progressive. It allows “measures imposed pursuant to Article 6 of (Korea’s) Foreign Exchange Transactions Act” (Annex 11-G on Transfers), which accommodates Korea’s law. These measures are nonetheless subject to various disciplines in order to be acceptable under the FTA. Some of the disciplines are consistent with IMF rules, such as, transparency, limited duration and avoidance of multiple exchange rate practices. Other disciplines seem to limit the accommodation substantially, such as the exclusion for payment or transfers for foreign direct investment. It remains to be seen how the signatories will apply the rule that the measures do not otherwise interfere with investors’ ability to earn a market rate of return in the territory of Korea.

### **Considerations Towards a Solution**

Inconsistencies between treaty provisions of the FTAs and the work (and legal rules) of the IMF could be avoided in the texts of the FTAs in two legally distinct ways.

First, FTAs and regional agreements should address legal consistency with the IMF Articles. The GATS, covering service transactions and associated transfers, is a useful model in allowing exceptions in two circumstances. The first is for measures imposed consistently with the IMF's Articles (GATS Article XI:1), which addresses possible inconsistent treaty violations if an allegedly GATS-inconsistent measure were approved by the IMF (or are otherwise non-restrictive under the Articles). The second is for measures imposed at the request of the IMF (GATS Article XI.2), referring to the IMF's financing function. Both of these provisions were negotiated with IMF input and they do not depend on the WTO considering the facts of the economic situation underlying the measures. Thus, these rules operate as purely legal defenses, which would preclude investors from challenging controls covered by these provisions.

Second, bilateral and regional trade/investment agreements should contain safeguards for situations of economic crises. These clauses can be designed to balance the liberalization undertakings of the treaties with policy space to manage volatility and other vulnerabilities, including those based on the potential advice of the IMF. Precedents exist for such a safeguard.

The GATT, GATS, and the proposed Multilateral Agreement on Investment, negotiated (but not concluded) under the aegis of the OECD, establish a formal role for the IMF to provide a factual assessment of the nature and extent of the crisis. This factual assessment is part of the legal determination whether the measures were warranted and properly applied. Few U.S.-based agreements contain a safeguard. In contrast, several agreements in other regions contain various forms of safeguards (e.g., Trans-Pacific Partnership Agreements between Singapore and Australia, and between New Zealand and Malaysia, as well as FTAs among several Asian countries—see Montes, in this volume).

It is more difficult to contemplate a formal role for the IMF's factual assessments in bilateral or regional treaties as is the case for the multilateral agreements just mentioned; instead, the Executive Board should approve the staff's proposal (IMF 2010a) to engage with UNCTAD and other multilateral and regional bodies involved in the design and promotion of the international frameworks on this topic.

One design matter involves the types of economic situations that would allow Members to derogate from their liberalization commitments and impose controls. The negotiating text for the regional Trans-Pacific Partnership Agreement (leaked as this comment went to press) includes a proposal by one of the

negotiating countries for a safeguard in cases of “a serious balance of payments or external financial difficulties (or threats thereof).” It goes further than the GATT or GATS to cover “difficulties in macroeconomic management, in particular, the operation of monetary policy or exchange policy,” although this provision applies only to “exceptional circumstances.” The experience under earlier bilateral TPP agreements that contain similar language should be evaluated.

Another design issue involves the disciplines on the nature of the controls under the safeguard, with key requirements that they be temporary and non-discriminatory. As for timing, controls should be allowed for as long as they are necessary, but safeguards would be easier to accept and apply if there were a presumption for a fixed period of time that was subject to some appropriate review (e.g., IMF exchange restrictions are approved for one year at a time).

As for non-discrimination, the IMF framework on CFMs shows a new complexity. This said, the non-binding nature of the framework, and the usual practice of the IMF staff to avoid advice in individual cases that could put any individual country in conflict with a treaty obligation, reduces the chances of conflicts. For purposes of analysis, however, the standard national treatment rule in FTAs requires that the measures avoid discrimination between investments by nationals and those of the signatory party. The IMF framework, in contrast, includes residency-based CFMs, which would potentially violate the National Treatment (NT) requirement of FTAs. The prospect of this conflict seems remote, however, because a close reading of the IMF papers reflects that residency-based measures would be recommended (not mandated) usually as a last resort; even where the use of CFMs is warranted, countries should give precedence to non-residency based CFMs over residency-based measures. Nonetheless, hopefully the final paper will clarify the different language used with respect to CFMs on inflows and outflows (IMF 2012d, Box 7) as it would relate to the possible (albeit remote) use of residency-based CFMs in the context of a safeguard.

The better result is for the bilateral and regional treaties to permit policy space for necessary measures applied under safeguard provisions for economic crises and according to reasonable disciplines. This policy space should include the advice of the IMF as the international organization that brings its multilateral perspective on global financial and economic stability. The leaked draft TPP safeguard does not require that measures imposed on the safeguard be applied on a national treatment basis, apparently allowing CFMs based on residency. As for existing treaties, legal mechanisms such as waiver or amendment should be explored, pending a more thorough review of such treaties to allow for current global issues.

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1. Deborah E. Siegel, former Senior Counsel of the IMF Legal Department, prepared this chapter in her independent capacity. It reflects her personal views and does not necessarily represent the views of the IMF.



# 7. The Trans-Pacific Partnership and Capital Account Regulations: An Analysis of the Region's Existing Agreements

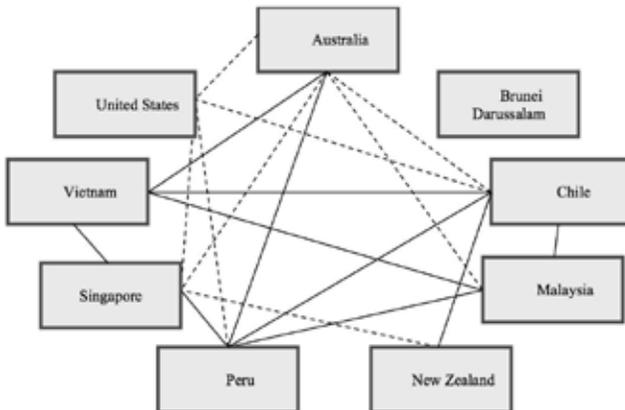
Sarah Anderson

The proposed Trans-Pacific Partnership (TPP) trade agreement initiated by the United States and eight other governments represents an important opportunity for a fresh approach to the treatment of capital controls. For decades, it has been standard U.S. policy to include sweeping restrictions on this policy tool in free trade agreements (FTAs) and bilateral investment treaties (BITs). Governments that violate these restrictions face the prospect of expensive investor lawsuits before international arbitration tribunals.

There is a growing body of evidence that capital controls can be an effective tool in addressing financial volatility (see Jeanne et al. 2012; Ostry et al. 2011; and Magud 2011). Moreover, several of the TPP governments have experience using these tools, and all of them have existing trade and investment agreements that allow more flexibility than the standard U.S. model.

The nine governments that initiated the Trans-Pacific talks already have 19 bilateral trade and investment agreements among them.<sup>1</sup> Of these, 10 are BITs and

**Figure 1: Existing Agreements between TPP Countries**



(solid line = bilateral investment treaties, dashed line = free trade agreements)

nine are broader FTAs. In addition, Brunei Darussalam, Chile, New Zealand, and Singapore have a regional trade agreement, the Trans-Pacific Strategic Economic Partnership.

Existing trade and investment agreements vary widely in their treatment of capital controls. Table 1 classifies different approaches in terms of the policy space allowed, from most restrictive to most flexible.

**Table 1**



| Treatment of Capital Controls   | Coverage in Existing Agreements  |
|---|--|
| 1. Capital controls are prohibited, with no exceptions for crises, and coverage is extremely broad, including derivatives and other portfolio investments.  | <b>Agreements between TPP countries: 0</b><br><br>Other examples: U.S. Model Bilateral Investment Treaty, U.S. trade agreement with Central America (CAFTA-DR)   |
| 2. Capital controls are prohibited, but there are special procedures for disputes related to certain types of controls. These include an extended “cooling off period” before investors can file claims and some limits on the compensation they can receive. | <b>Agreements between TPP countries: 3</b><br>(U.S. FTAs with Singapore, Chile, Peru)  |
| 3. Capital controls are prohibited, but there is a safeguard that, with some restrictions, allows the use of capital controls “in the event of serious balance of payments and external financial difficulties or threat thereof.”                            | <b>Agreements between TPP countries: 5</b><br>(Australia FTAs with Chile, Malaysia, New Zealand, and Singapore; New Zealand-Singapore FTA)<br><br>Other examples: Various safeguards exist in the North American Free Trade Agreement and six U.S. BITs signed in the 1980s and 1990s. |
| 4. Capital controls are prohibited, but there is no investor-state dispute settlement.  | <b>Agreements between TPP countries: 3</b><br>(Australia FTAs with New Zealand,* Malaysia,* and the U.S. Also: Trans-Pacific Strategic Economic Partnership between Brunei Darussalam, Chile, New Zealand, and Singapore)<br>*also include a safeguard                                 |
| 5. Capital account liberalization is encouraged, but the agreement defers to national laws and regulations.   | <b>Agreements between TPP countries: 10</b><br>(Malaysia BITs with Chile, Peru, and Vietnam; Singapore BITs with Peru and Vietnam; Chile BITs with New Zealand, Peru, and Vietnam; Australia-Chile FTA; and Australia-Vietnam BIT)<br><br>Other examples: Brunei-China BIT             |
| 6. No rules on capital controls.  | <b>Agreements between TPP countries: 0</b><br><br>Other examples: China-Germany BIT, U.S.-Israel FTA   |

**LEAKED DRAFT OF THE TPP INVESTMENT CHAPTER**

On June 13, 2012, a draft investment chapter of the TPP was leaked to the public. The draft contains four noteworthy proposals related to capital controls:

1. A safeguard similar to those in several existing TPP agreements and GATS Article 12. One innovation is that it explicitly allows governments to use controls when capital movements “cause or threaten to cause serious difficulties for macroeconomic management.” This may have been added to clarify that the safeguard applies to controls on both outflows and inflows.

**Excerpt from Article XX(3): Measures to Safeguard the Balance of Payments in the June 2012 leaked investment chapter of the TPP**

2. Nothing in this agreement shall be construed to prevent a Party from adopting or maintaining temporary safeguard measures with regard to payments or transfers relating to the movement of capital:
  - (a) in the event of a serious balance of payments or external financial difficulties or threat thereof; or
  - (b) where, in exceptional circumstances, payments or transfers relating to capital movements cause or threaten to cause serious difficulties for macroeconomic management, in particular, the operation of monetary policy or exchange rate policy.
3. Measures referred to in paragraphs 1 and 2 shall:
  - (a) be applied on a non discriminatory basis among the Parties;
  - (b) be consistent with the Articles of Agreement of the International Monetary Fund, so long as the Party taking the measures is a party to the said Articles;
  - (c) avoid unnecessary damage to commercial, economic, and financial interests of the other Parties;
  - (d) not exceed those necessary to deal with the circumstances described in paragraphs 1 or 2;
  - (e) be temporary and be phased out progressively as the situation specified in paragraphs 1 and 2 improves.

2. An exemption (Annex 12-I) for Chile’s capital account regulations, including the right to require that investments be subject to a reserve requirement. Chile managed to secure this same protection in its FTA with Australia, but not with the United States. Presumably the TPP would override older bilateral deals.
3. A provision similar to those in several Chinese BITs that would allow governments to require investors to undergo a domestic review before taking claims to international tribunals.

## Article 12.17.2

“The state Party may require the investor concerned to pursue any applicable domestic administrative review procedures specified by the laws and regulations of the state party, which may not exceed three months, before the submission of the claim to arbitration.”

### 4. An exemption for Australia from investor-state dispute settlement.

All of these provisions are in brackets, indicating a lack of agreement. Nevertheless, they suggest significant resistance to the standard U.S. approach at this stage in the negotiations.

## WHICH APPROACH BEST SUPPORTS FINANCIAL STABILITY?

In 2011, the IMF published proposed guidelines for the use of capital controls (IMF 2011). While this framework reflects the Fund’s shift away from blanket opposition to such policies, many developing country governments and academics found them to be overly restrictive. A report by the Pardee Center at Boston University offers an alternative set of guidelines, drawing from contributions by 14 international experts (Gallagher et al. 2012). This section analyzes the extent to which the existing investment agreements between TPP countries and the draft TPP chapter are consistent with five of the most relevant guidelines from that Pardee report.

### **1. Neither industrialized nations nor international institutions should limit the ability of nations to deploy capital account regulations, whether through trade and investment treaties or through loan conditionality.**

Clearly, the existing TPP agreements and the leaked draft chapter do not meet this standard. However, it’s risky to make categorical assertions about how much policy space the various exceptions in these agreements may afford. There is only one known investor-state case related to capital controls. In 1998, a Belgian investor sued Malaysia, claiming to have lost money in the Kuala Lumpur Stock Exchange as a result of exchange controls used to prevent rapid capital flight during the Asian crisis. The tribunal dismissed the case because the Malaysia-Belgium BIT contains an unusual provision limiting applicability only

to “government-approved” investment projects (ICSID 2000).<sup>2</sup> Without a significant body of rulings, it is difficult to predict how tribunals might interpret treaty text.

Nevertheless, the most flexible approach in the existing agreements seems to be those that defer to national laws. For example, the Vietnam-Chile BIT states, “Each Contracting Party shall, subject to its laws and regulations, allow without delay the investors of the other Contracting Party the transfer of funds in connection with their investments ...” However, even this would not provide ironclad protection for governments seeking to use capital controls, especially when there are no laws or regulations in place or if new forms of capital account regulations are needed to deal with evolving challenges in the global financial system. Moreover, it is unclear whether these provisions would protect against claims over violations of other treaty obligations. For example, if a government introduced new capital controls, could an investor allege a violation of the obligation to provide a “minimum standard of treatment,” which some tribunals have interpreted to mean the provision of a stable regulatory environment?

**2. Price-based capital account regulations have the advantage of being more market neutral, but quantity-based capital account regulations may be more effective, especially in nations with relatively closed capital accounts, weaker central banks, or when incentives to bring in capital are very large.**

Existing TPP agreements that defer to national laws or provide balance of payments safeguards do not distinguish between price-based or quantity-based controls. However, there is a clear bias against quantity-based controls in several U.S. agreements. The U.S. FTAs with Chile and Singapore remove the government’s liability for damages resulting from restrictions on a narrow set of transfers—but only if they are in effect for no more than a year and do not “substantially impede” transfers. An interpretive note between the U.S. and Singapore advises arbitral judges to not presume that outflow controls substantially impede transfers if they meet certain criteria, one of which is that they are “price-based.” This indicates that the type of quantitative controls used by

Malaysia at the height of the Asian financial crisis would not be covered by this provision. Unremunerated reserve requirements such as those used by Chile in the 1990s could also be targeted by investors, since the minimum stay requirement can act like a quantitative restriction on outflows (Gallagher 2011a).

**3. Capital account regulations should not only be relegated to regulations on capital inflows. Capital outflow restrictions may be among the most significant deterrents of undesirable inflows and can serve other uses as well.**

Existing TPP agreements that defer to national laws do not distinguish between inflow and outflow controls. The existing and proposed safeguards also seem to allow both. By contrast, there is a clear bias against outflows controls in many U.S. agreements. The U.S. FTAs with Chile and Peru limit the compensation investors can receive for certain restrictive measures to no more than the amount of the reduction in the value of the transfers. These limits, however, do not apply to controls on outflows.

**4. Capital account regulations should not be seen as solely temporary measures, but should be thought of as permanent mechanisms to be used in a counter-cyclical way to smooth booms and busts. Their permanence will strengthen institutional capacity to implement them effectively.**

The safeguards in existing TPP agreements and the leaked chapter do not specify a fixed deadline for lifting controls, but nevertheless state that they must be temporary and require the government to consult with other Parties on the matter. The special dispute resolution procedures in some U.S. trade agreements do not apply to any controls that extend beyond a year.

**5. It may be useful for effective capital account regulations to distinguish between residents and non-residents.**

Anti-discrimination is a core principle of international trade and investment treaties. However, as Dr. José Antonio Ocampo explains in the Pardee report, capital account regulations almost by necessity “require some discrimination between residents and non-residents, which

reflects the segmentation that characterizes financial markets in an international system: as different moneys are used in different territories, residents and non-residents have asymmetric demands for assets denominated in those currencies” (Gallagher et al. 2012, 18).

The 10 existing TPP agreements that defer to national legislation seem to allow controls that distinguish between residents and non-residents. However, three of the five existing TPP agreements that include balance of payments safeguards require the controls to be applied on a national treatment basis, one (Australia-Malaysia) requires most-favored nation treatment, and the fifth (Australia-Chile FTA) states only that the controls must be non-discriminatory. The leaked TPP chapter requires the controls to be “non discriminatory among the Parties.”

## ALTERNATIVES

There is a strong argument that capital controls simply do not belong in trade and investment agreements. Why should matters of such systemic importance be governed by a patchwork of bilateral and regional treaties and enforced by unaccountable international arbitration tribunals? Why should individual foreign investors have the authority to sue over policies intended to protect millions of people from financial crises? Wouldn't policymakers' time be better spent focusing on how to improve capital controls coordination rather than hammering out new rules to discourage them?

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**There is a strong argument that capital controls simply do not belong in trade and investment agreements.**

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Given the recent shifts in thinking about capital controls, we may well reach a point in the near future when enough government leaders are asking such questions to effect transformative policy change. However, the Trans-Pacific Partnership negotiations suggest we are not there yet. Even though more than half of the existing agreements between TPP countries defer to national laws, only one country—Chile—appears to have asked for even this degree of policy space. Thus, in the current political reality, it is worthwhile to attempt to build consensus around reforms that would at least result in the United States, the world's largest capital exporter, accepting a more flexible approach. The capital controls-related proposals in the leaked TPP are a good start. Here are a few thoughts on how the safeguard and dispute settlement proposals might be strengthened to promote financial stability.

## 1. Safeguard

**Non-discrimination:** One of the criteria for the proposed balance of payments safeguard is that the controls be applied on a non-discriminatory basis among the Parties. This is problematic because capital controls may have uneven impacts even when there is no intent to punish (or favor) certain groups of investors. In fact, as noted above, capital controls are almost by nature discriminatory. As a result, this requirement could open the door to investor-state claims over a wide range of responsible capital controls. These could even include restrictions on domestic investors and businesses, for example, limits on domestic borrowing in foreign currencies, where one of those currencies happens to be issued by one Party to the trade agreement. Negotiators should word this more carefully to ensure that it only encompasses capital controls that have the aim and effect of discriminating.

**Temporary versus permanent part of the toolbox:** The proposed safeguard does not specify a maximum duration for capital controls, but does require them to be temporary and obliges the government to enter consultations on the matter with the other Parties. This is consistent with the IMF's proposed guidelines for capital controls, but it conflicts with other IMF statements, including the IMF executive board's support for Brazil's extended use of capital controls to prevent a currency bubble (IMF 2011g). One argument in support of the temporary requirement is that, according to some analysts, capital controls are only effective in the short term anyway, as investors often find ways to circumvent them (Ostry et al. 2011). However, in the Pardee report, Shari Spiegel writes that "In general, countries that are thought of as having the most successful regimes have all maintained flexible regulations, which they adapted to changes in the economic environments, as well as to opening of loopholes" (Gallagher et al. 2012, 81). As the debate continues, TPP negotiators should insert language acknowledging the potential need for longer-term, counter-cyclical controls.

**Necessity tests:** The draft TPP states that capital controls applied under the safeguard must "avoid unnecessary damage to commercial, economic, and financial interests of the other Parties" and "not exceed those necessary" to deal with the crisis. Such "necessity tests" would allow foreign investors to claim that the government could have used alternative measures to pursue the same goal but with less impact on their financial interests. In his essay in this volume on similar rules in the GATS, Todd Tucker suggests that one way to protect capital controls from the range of grounds for attack would be to expand and strengthen the prudential measures exception so that it applies to capital controls. This exception is

in the GATS Annex on Financial Services Article 2(a) and many recent U.S. FTAs and BITs. Because it is typically in the financial services chapter of FTAs it is not included in the leaked TPP investment chapter.

## 2. Dispute Settlement

Australia's refusal to accept investor-state dispute settlement in the TPP is an important protection against lawsuits brought by foreign investors who have little regard for the public interest or diplomatic relations. Such suits could be particularly harmful in the context of a financial crisis. The other TPP governments would be well advised to seek the same exception.

In an "Investment Policy Framework for Sustainable Development" released in July 2012, UNCTAD cites another policy option for limiting States' exposure to investor-state dispute settlement. While allowing this approach for some matters, a government could exclude certain "sensitive areas," with measures relating to transfer of funds listed as one of several examples.

UNCTAD also notes another approach to limiting investor-state dispute settlement, which is to require that investors first exhaust domestic remedies. More research is needed to explore the domestic remedies that might be available for handling disputes over capital controls. However, in general, this compromise on dispute settlement would restore some balance to a system that now gives foreign investors private rights of action to enforce international legal obligations—rights that are not enjoyed by civil society organizations.

Proposed Article 12.17.2 in the draft TPP is a step in the direction of an exhaustion clause, but the three-month time limit on domestic administrative review procedures is insufficient. To avoid situations where investors get trapped in a completely corrupt or dysfunctional system, a "futility clause" could be included. This would allow investors the opportunity to take claims to international tribunals if they can prove that getting recourse through domestic processes is truly futile. In addition to requiring exhaustion of domestic remedies, the dispute settlement mechanism could provide a diplomatic screen that allows governments to work together to prevent claims that are inappropriate, without merit, or would cause serious public harm.

These changes, together with a narrowing of the definition of investment to omit portfolio and other short-term investments, would go a long way toward ensuring that Trans-Pacific nations have access to all available tools for preventing and mitigating financial crisis.

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1. As of July 11, 2012, Canada and Mexico had also entered the negotiations.
  2. Malaysia still had to pay half of the arbitration costs.

## 8. Capital Controls, Investment Chapters, and Asian Development Objectives

Manuel F. Montes<sup>1</sup>

*You never give me your money  
You only give me your funny paper*

"You Never Give Me Your Money"  
Lennon and McCartney, 1969

### WHY CAPITAL ACCOUNT REGULATIONS

Since at least the early 1990s, countries that sought to regulate the capital account risked self-inflicted stigma in the international investment arena, even in the face of uncontroverted analytical reasons for their appropriateness.<sup>2</sup>

Subsequent events, including the Asian financial crisis in 1997, have not eliminated the stigma risk from capital account controls but the analytical discussion has shifted to when, not if, such controls are warranted.<sup>3</sup>

There are compelling reasons for capital account regulations. One can classify three levels of objectives, of increasing scale and permanence, for capital account regulation:

- (1) As a tool for responding to balance of payments crises;
- (2) As a tool for regaining and maintaining counter-cyclical macro-economic policy space;
- (3) As a tool for harnessing resources of the financial sector to support industrial development and the creation of a productive domestic financial sector.

The evaluation of the impact of free trade agreements and bilateral investment treaties on the scope of capital account regulations can be undertaken in terms of how their provisions constrain the attainment of these three objectives.

This paper takes as a starting point the view elaborated in Gallagher, Griffith-Jones, and Ocampo (2012a) that capital account controls (called by those authors as “capital account regulations”) must be an essential part of the toolkit for macroeconomic policy. Ocampo (2012) demonstrates that capital account regulations are necessary to establish the tools for counter-cyclical macroeconomic policy. This view is more expansive than the one taken in the recent International Monetary Fund (IMF) staff (Ostry and others 2010) view that capital controls could be appropriate principally in times of balance of payments crises.<sup>4</sup> An immediate implication of a view that capital account regulations are permanent features of macroeconomic management is that governments must establish and maintain bureaucratic capabilities to implement such regulations. Governments must also stand ready to continually amend regulatory approaches in response to the continuing evolution of private agents’ tactics to evade them (Spiegel 2012).

To these two justifications must be added that capital account regulations are essential tools for achieving longer-term development objectives. In a paper first published in 1993, Akyuz (2012) identifies the analytical reasons for restricting the participation of foreign portfolio managers and foreign banking institutions in the domestic financial sector if the priority is to achieve industrial development objectives and, indeed, to concomitantly develop the domestic financial sector itself as part of the overall development strategy.

The core of the developmental argument against fully open capital accounts is that “most international financial transactions are portfolio decisions, largely by rentiers, rather than business decisions by entrepreneurs” (Akyuz 2012, 29). This means that

The bulk of capital movements is motivated primarily by the prospect of short-term capital gains, rather than by real investment opportunities and considerations of long-term risk and return. The speculative element is capable of generating gyrations in exchange rates and financial asset prices by causing sudden reversals in capital flows for reasons unrelated to policies and/or the underlying fundamentals. Rather than penalizing inappropriate policies, capital flows can help to sustain them (Akyuz 2012, 29).

Akyuz (2012) cites the United States and Italy as cases where capital flows have sustained inappropriate policies in his 1993 analysis. Since then, as other countries sought to internationalize their financial sectors, many emerging countries, including the main participants in the Asian financial crisis, have

seen extended periods of self-fulfilling short-term capital inflows through the creation of domestic asset price bubbles. These extended—but ultimately unsustainable—periods of exchange overvaluation aggravate the trade deficit and can cause long-term damage to the traded goods sector. Government efforts to dampen the inflationary impact of the inflows lead to costly sterilization policies and a regime of high domestic interest rates, further depressing incentives for long-term domestic investment. As Akyuz (2012) pointed out, these unfavorable impacts of open capital accounts on long-term development are independent of whether there are chronic fiscal deficits or if trade and/or domestic financial liberalization have been completed. The issue therefore is not one of the order of liberalization; it is one of development.

If the objective is to engender long-term investment and economic diversification, a certain amount of stability in exchange rates and the availability of finance at reasonable rates of interest for long-term domestic investments are required. In most situations in developing countries, capital control regulations are the least costly measures for exchange rate and domestic price stability.

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**In most situations in developing countries, capital control regulations are the least costly measures for exchange rate and domestic price stability.**

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Hypothetically, these measures can also be used to change the maturity structure of foreign capital flows, even though these measures cannot really change the basic nature of portfolio flows from external sources. The actual measures applied will depend on many factors and these measures will need to be often updated to respond to evasive actions of the private sector. These measures must be fit to the size and diversity of a country's trade linkages, the ease of movement of asset claims across borders, the level of real sector and financial system development, and so on.

The analysis in this paper suggests that the investor protections that many Asian countries have undertaken in the investment chapters of their free trade agreements exclude the possibility of capital account measures because most of these protections apply in a blanket manner to all financial investments, including those not yet in existence at the time of the treaty. All kinds of portfolio, short-term, and speculative investments are protected under these commitments. There are also often explicit transfer provisions requiring free movement of capital (without having to frame it as an expropriation). These commitments do not recognize the distinction between legitimate regulatory activity and state actions, which can be interpreted as indirect (so-called “regulatory takings”) expropria-

tion. Under these commitments, indirect expropriation is ground for investor actions to seek to stop regulatory actions and launch arbitration proceedings to obtain compensation. According to these agreements, these investor actions can be started without the need to course grievances through domestic regulatory and judicial processes.

There are also interactions among commitments undertaken by one country to its partners. The existence of a most favored nation treatment can mean that even if safeguards have been included in one treaty they would not apply if other treaties do not have such safeguards.

## **REGIONAL/BILATERAL TRADE AGREEMENTS AND INVESTMENT TREATIES**

Countries in the Asian region have been as active as those in other regions in negotiating and acceding to bilateral and regional trade agreements that have investment chapters or provisions which potentially involve restrictions on capital account regulations. Chapter 8 in Khor (2008) analyzes the kinds of provisions that tend to be part of these investment chapters. In particular, free trade agreements with the United States consistently include these provisions. In this section, we shall review the free trade agreements for which there is a notification to the World Trade Organization (WTO) for key Asia-Pacific countries.

The WTO lists 14 notifications<sup>5</sup> of Free Trade Agreements (FTAs) for India, of which four have investment chapters. Except for the FTAs with Chile and Mercosur, Indian FTAs include investment chapters with countries outside the subcontinent, including Japan, the Republic of Korea, and Malaysia. Pakistan has six notifications, of which two, with China and Malaysia, have investment chapters. China has seven notifications, and only those with Macau and Hong Kong do not have investment provisions.

The Association of Southeast Asian Nations (ASEAN) countries follow the China pattern in that it is the exception that FTAs notified to the WTO do not have an investment chapter. In the case of Thailand, out of 10 notifications, only two do not have investment chapters.

Asian countries have recently been active in acceding to Bilateral Investment Treaties (BITs), particularly in the last decade with the ramping up of the treaty facilitation activities in the investment division of the United Nations Conference on Trade and Development (UNCTAD). UNCTAD's database lists 37 BITs for Thailand, 88 for China, 30 for the Philippines, 36 for Malaysia,

32 for Vietnam, 52 for Indonesia, 19 for Singapore, 19 for Cambodia, 33 for India, and 39 for Pakistan. It is notable that Singapore, an important investment destination, has relatively fewer treaties listed in the database. As will be explained in a subsequent section, because of the effect of most favored nation provisions and the definition of an investor, the number of treaties is not necessarily a good indication of the constraints imposed on countries of bilateral investment provisions.

## **CONSTRAINTS ON CAPITAL ACCOUNT REGULATIONS**

### **Overall Framework**

The purposes of regional agreements and preambular phrases in bilateral agreements indicate that Asian countries overwhelmingly subscribe to the notion of removing barriers to the free flow of goods, services, and investment as a guarantor of growth and development. In actual practice, the reinstatement of capital account regulation was not one of the lessons countries in the region learned from the Asian crisis. In fact, Asian emerging countries “are now much more closely integrated into the international financial system than they were in the run-up to the 1997 crisis” (Akyuz 2011, 17).

Both official pronouncements and the recent policy changes indicate that Asian countries either do not fully understand or do not place high priority on the third justification for capital account regulation—to mobilize resources for industrial development and to ensure the stable development of domestic financial resources. Asian countries have instead demobilized enormous domestic and externally borrowed resources in building up international reserves, thereby insuring themselves against balance of payments crises and pro-cyclical IMF adjustment policies. On this basis, they have deployed other measures for the first objective of capital controls at the expense of being able to perform on the other two objectives. The scope for counter-cyclical macroeconomic policy is itself handicapped by the reserve build-up. In developing countries, in particular, the reserve build-up also involves an opportunity cost on the resources that could have been applied to industrial development or the development of domestic financial services themselves.

What is notable is that in some agreements undertaken by countries in the region, there are provisions that appear to be based on a different overall framework which, instead, recognizes the need for domestic authorities to impose capital account regulations and other barriers to the free flow of external finance

flows. For example, Article 10.8 of the India-Malaysia FTA lists the fund transfers that must be undertaken “freely and without delay” as:

- (a) initial capital and additional amounts to maintain or increase investment;
- (b) returns;
- (c) proceeds from the total or partial sale or liquidation of any investment;
- (d) payments made under a contract, including a loan agreement;
- (e) payments made pursuant to compensation for losses from expropriation;
- (f) payments arising out of the settlement of a dispute; and
- (g) earnings and other remuneration of personnel from the other Party employed and allowed to work in connection with that investment.

While some of these transfers could also prove problematical in a balance of payments crisis, there is no blanket commitment against capital transfer restrictions.

In the same India-Malaysia FTA, the space for capital account regulations is further reserved by a subsequent provision (Article 10.8.3) that explicitly recognizes the possibility of prohibitions or delays on fund transfers in situations related to protecting domestic investors, dealings in securities, futures, options, and derivatives, and ensuring compliance with orders and judgements from administrative and judicial proceedings.

The India-Malaysia FTA is also notable for provisions, in Annex 10-1, that define when an action can be deemed an indirect expropriation. This Annex provides that “determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers” a set of factors, such as whether the character of a government action is disproportionate to its stated objective.

### **Balance of Payments Safeguards**

Most Asian FTAs contain balance of payments safeguards, allowing countries to implement capital control measures in the event of balance of payments crises. For example, Article 17.2 in the ASEAN-Australia-New Zealand FTA provides that:

Nothing in this Chapter<sup>6</sup> shall affect the rights and obligations of any of the Parties as members of the International Monetary Fund under the IMF Articles of Agreement, including the use of exchange actions which are in conformity with the IMF Articles of Agreement, provided that a Party shall not impose restrictions on any capital transactions inconsistent with its specific commitments regarding such transactions, except under Article 4 (Measures to Safeguard the Balance of Payments) of Chapter 15 (General Provisions and Exceptions) or at the request of the International Monetary Fund.

Asia is home to one of the two most egregious FTAs, the Singapore-U.S. FTA, which includes “blanket prohibitions on capital restrictions” (Siegel 2003–2004, 297). The IMF<sup>7</sup> has expressed its reservations about these prohibitions because of its contravention to the use of capital controls during balance of payments crises. Siegel puts a spotlight on the fact that, depending on how investments are defined in BITs, “investors in hot money transactions (e.g. high yielding overnight deposits and other derivative financial products) could seek protections of the investment rules” (Siegel 2003–2004, 298). Her analysis concludes that a U.S. Treasury official opinion that accepts a cooling off period of one year in which investors could not sue for damages in a balance of payments crisis does not reduce the level of Singapore’s liability.

Because IMF members have the right to impose capital controls and IMF staff have the power to request members to impose controls, the inconsistent rights and obligations emanating from the Singapore-U.S. FTA creates “a risk that in complying with its obligations to the FTA, a member could be rendered ineligible to use the Fund’s resources under the Fund’s Articles” (Siegel 2003–2004, 301).

### **Definition of Investment or Investor**

Asian FTAs and BITs tend to have an expansive definition of “covered” investment and the definition of “investor.” Investment definitions tend to be of the form “including, but not limited to.” Particularly in a situation of balance of payments crisis, an expansive definition of investment will create state liabilities to private investors in the kind of controls Malaysia imposed during the Asian financial crisis of the late 1990s.

Some definitions of investment manage to specifically exclude current account transactions, such as in Article 1.j in the ASEAN-Korea FTA, which provides:

The term investment does not include claims to money that arise solely from: i) commercial contracts for the sale of goods or services by a natural or juridical person in the territory of a Party to natural or juridical person in the territory of any other Party; or ii) the extension of credit in connection with a commercial transaction, such as trade financing.

This would permit countries to impose restrictions on the use of trade credits for carry trade transactions. But the exclusion of current account transactions are also sometimes weakened by definitions that include specific protection for intellectual property rights even though royalty payments are categorized as current account transactions.

Article 88.d in the Malaysia-Pakistan FTA possibly provides a restriction on investment from local laws and policies by defining investment as “every kind of asset owned or controlled, directly or indirectly, by an investor of a Party in the territory of the country of the other Party, in accordance with the latter’s laws, regulations and national policies.”

The definition of who has standing as an investor to initiate an investor-state claim is also critical. Most BITs and FTAs define investors as those with juridical standing in contracting governments. This extends investor protection to multinational companies that are incorporated in the contracting government territories, even if they are not headquartered or undertake significant operations in these locations. By sourcing an investment project in a front office in a jurisdiction that has an investment agreement, an investor obtains protection even though s/he does not have any significant operations in that locality. Some provisions restrict the kind of parties that can be considered investors. For example, the Philippines-Japan FTA restricts “juridical persons” with access to the protections of the treaty to those owned by 50 percent or more by investors from the contracting countries. The same treaty further provides that the branch of a juridical person of a “non-Party” located in the area of a “Party” shall not be considered an investor.

### **Most Favored Nation (MFN) Provisions**

Almost all Asian investment agreements include a standard Most Favored Nation provision. Most clauses apply to agreements that could be finalized subsequent to the particular agreement. This extends to the countries in the agreement with the MFN clause the best treatment available to investors in these other countries. In investor-state disputes, arbitration panels can apply the most favorable treat-

ment to investors from other treaties/agreements, even if the investor is covered under another agreement or treaty.

MFN provisions could bite most specifically in efforts to re-regulate the financial sector, reversing years of financial deregulation in Asian economies. Such an effort would be consistent with recent re-regulation efforts underway under the Financial Stability Board (FSB). At this point, having not suffered too heavily in the first phase of the global financial crisis, it is unclear whether Asian countries have an immediate interest in re-regulating finance beyond complying with future FSB standards.

### **National Treatment**

National treatment clauses require equal treatment of foreign investors as locals. With the participation of foreign firms in the domestic financial sector, financial re-regulation efforts, particularly those aimed at building domestic capability in the financial sector, expose Asian countries to liabilities from violating national treatment.

A developing country that allows a domestic company to operate a hedge fund domestically is likely to have to permit hedge funds from the developed country party to enter and operate under pre-establishment national treatment obligations under a BIT.<sup>8</sup> The financial resources, not to mention the external market links, of the domestic company would often be much smaller than those of the foreign company. The foreign company would have an undue advantage and greater capacity to destabilize the economy, through exchange rate transactions, for example.

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**With the participation of foreign firms in the domestic financial sector, financial re-regulation efforts, particularly those aimed at building domestic capability in the financial sector, expose Asian countries to liabilities from violating national treatment.**

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There are additional implications in a situation of bailing out domestic financial companies. National treatment will require symmetrical treatment of foreign companies, severely curtailing domestic authorities' capacity to supervise and assist local financial companies (UNCTAD 2011b). An example is the Ecuador-Netherlands BIT, which does not appear to have exceptions for subsidies, grants or government-supported loans, guarantees, or insurance.

## ASIAN CHALLENGES

Asian policymakers have revealed their preference for a policy combination of self-insurance through reserve accumulation and continuing capital account liberalization and strengthened investor protection.

The capacity of Asian economies to withstand financial and balance of payments crises based on this strategy remains untested. Reserves proved equal to the task in the 2007–2008 crisis but there are no analytical guidelines for when reserve accumulations are too much and too little. It is clear that the strategy entails opportunity costs. The resources of the Chiang Mai Initiative, which has been multilateralized, have never been called upon.

Most importantly, the continued accession by Asia-Pacific countries to FTA investment chapters and BITs using standard provisions under a long-term purpose of combining financial liberalization and foreign investor protection will severely restrict the abilities of these countries to channel capital resources toward industrial and financial development.

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1. Senior Advisor on Finance and Development, the South Centre. I gratefully acknowledge the suggestions and comments of Sanya Reid Smith and the research assistance of Ana Giulia Stella, Anna Bernardo, and Xuan Zhang. I am solely responsible for all errors, opinions, and analyses. Email: montes@southcentre.org.

2. For a historical example on the Philippines during an earlier period of burgeoning yen carry trade, see Montes (1997).

3. The shift in the IMF staff discussion to *when* instead of *if* the capital controls are justified fundamentally contradicts the fact that the IMF Articles of Agreement reserves for member countries the sovereign right to impose capital controls.

4. See also Gallagher (2010) for a discussion of the impact of U.S. FTAs and BITs, particularly Table 6, which lists capital control measures, such as restrictions on currency mismatches and minimum stay requirements, which could potentially run afoul of these agreements with the U.S.

5. We cannot presume that the notifications to the WTO are a complete set of existing FTAs. We assume that these notifications provide a sufficient sample to discern patterns related to investment provisions.

6. There is a different balance of payments safeguard that applies to trade such as Article XII of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade 1994 in Annex 1A to the WTO Agreement. See, for example, Article 21 of the Japan-ASEAN comprehensive partnership, agreement.

7. While the article being cited has the usual disclaimer that the opinions are those of the author (who was then a Senior Legal Counsel at the IMF), footnote 1 states that “much of the analysis is drawn from an article by Mr. Sean Hagan, Deputy General Counsel, Legal Department, IMF” (Siegel 2003–2004, p. 297).

8. Such as the 2004 U.S. Model BIT. (See also Khor (2008) Chapter 8 for a discussion of impact of “pre-establishment” rights in U.S. FTAs.)

## 9. The Potential Impact of a U.S.-China Bilateral Investment Treaty (BIT) on China's Economy

Qiyuan Xu and Feng Tian

Bilateral Investment Treaty (BIT) negotiations between the United States and China were launched during the fourth round of the U.S.-China Strategic Economic Dialogue in June 2008. Ever since, a potential U.S.-China BIT has become one of the more discussed initiatives between the U.S. and China (Tian 2010). This short essay analyzes the extent to which investment measures proposed by the United States under the BIT would leave ample room for China to internationalize its currency and regulate cross-border capital flows.

### **RAPID PROGRESS IN RMB INTERNATIONALIZATION**

The United States released the 2012 Model BIT in April of that year. It is a successor of the 1982, 1994, and 2004 model BITs. At the same time, the framework of China's economic policies has been greatly changed since 2008. On one hand, the domestic financial market has experienced substantial reforms, while on the other hand, China has also moved to significantly internationalize its currency, the yuan (or renminbi (RMB)).<sup>1</sup> As shown in Table 1, the RMB is now convertible across the current account and to some extent within the capital account.

It is well worth mentioning that the RMB's offshore market was established in Hong Kong<sup>2</sup> in August 2010. The offshore market is called the CNH market and the RMB's onshore market in Shanghai is referred to as the CNY market. The process and rules surrounding the CNH market are among the most important measures of the RMB's internationalization. The offshore CNH market is a preferable testing ground for internationalization because the risks can be contained and the RMB's internationalization can be promoted by the dual system (Li 2008). It brings some facilities for the use of RMB in international trade and investment, and subtle influences on capital flows come with it as well. This is made clear by a series of researchers such as He et al. (2011), Garber (2011), Yu (2012), Zhang and Xu (2012), Xu and He (2012).

How might a BIT with the United States affect these efforts?

**Table 1: RMB's Cross-Border Settlement: Progress of Policies**

|                                      | The Debit Side  | The Credit Side   |
|--------------------------------------|---|---|
| <b>Current Account</b>               |   |   |
| Trade item                           | Import (2009)   | Export (2009)   |
| Other items                          | Service trade, incomes and transfer payment items (2010)                              |   |
| <b>Capital and Financial Account</b> |   |   |
| Direct investment                    | Overseas Direct Investment (ODI) (2011)   | Foreign Direct Investment (FDI) (2011)  |
| Portfolio investment                 | Pander Bonds (2005)<br>RMB Qualified Domestic Institutional Investors (R-QDII) (2007) | Dimsum Bonds (2007)<br>Domestic Interbank Bond Market (2010)<br>RMB Qualified Foreign Institutional Investors (R-QFII) (2011) |
| Loans                                | Cross-Border RMB Loans (2012) <sup>i</sup>  |   |

<sup>i</sup> At the time of writing, approval from the authorities is still pending.

**THE IMPORTANT FEATURES OF THE U.S. 2012 BIT MODEL**

This part of the essay critically examines some of the aspects of a potential U.S.-China BIT. The analysis conducted focuses on the U.S. 2012 Model BIT, which gives one a fairly good idea of what the U.S. proposes to a negotiating partner. Of first concern is the overly broad definition of investment in the U.S. 2012 Model BIT. Regarding market access, the provisions of national treatment and the most favored nation treatment are covered for all investments. At the same time, there are also related provisions in the U.S. 2012 model that require the free flow of all such investment among parties. Failure to allow such transfers could be subject to claims of expropriation and such disputes could be solved through investor-state rather than through state-state dispute resolution. Here is how we interpret the logic of the model BIT:

First, all stocks, bonds, futures, loans and intellectual property are covered investments. Second, once there is the intent to invest from a foreign private investor, the foreign investor must be treated completely the same as a domestic investor in every respect (National Treatment). Third, all investment between parties must flow freely and without delay. Moreover, the flow of the investment should be freely exchanged into U.S. dollars, euros, Japanese yen and other freely convertible

currencies. And the entire process of flow and exchange should not be delayed for any reasons.

### THE POTENTIAL IMPACT OF U.S.-CHINA BIT ON CHINA'S ECONOMY

The investment rules under the 2012 Model BIT would complicate China's efforts to internationalize the RMB and the ability of China to deploy certain macro-economic policies and manage its foreign exchange reserves. As shown in Table 2, there are a number of ways that these complications will become manifest. When reflecting upon this, it is important to note that the People's Bank of China (PBOC) almost always attempts to stabilize the RMB's exchange rate and thus by definition the onshore foreign exchange market is subject to frequent interventions by the authorities.

**Table 2: Summary of the RMB Capital Flow Effects with the Background of RMB's Cross-Border Settlement**

|                           | Capital flows out in RMB (from China to U.S.)      | Capital flows back in RMB (from U.S. to China) |   |
|---------------------------|--|--|---|
|                           | (2)  | (1)  | (3)   |
|                           | Overseas direct investment<br>Portfolio investment | Foreign direct investment                      | Portfolio investment<br>Loans   |
| Monetary market           | Interest rate grows moderately                     | Constant                                       | Interest rate goes down, while the price of financial assets rise and the extent of speculative intention in monetary demand increases. As a result, the real economy will be affected. There will probably be an asset bubble. |
| Foreign exchange reserves | A growth of the increment                          | A decline of the increment                     | No effect   |

A detailed description of the process of the analysis (Xu and He 2012) is beyond the scope of this brief discussion. But the conclusions are as follows: For the different channels of RMB capital flows, the adverse effects can be classified into three categories.

First, in the case of RMB FDI from the U.S. to China, the RMB's flow across borders would have no effects on domestic monetary supply or demand. Meanwhile the amount of foreign exchange reserves would probably decline, and as a

consequence the ratio of foreign exchange reserves to the PBOC's total assets will decrease. Therefore, such RMB cross-border settlement should be encouraged, and the related provision in the U.S. 2012 Model BIT should also be permitted. However, regulatory authorities will have to pay close attention on a case-by-case basis because not all financial transactions will be permitted in a treaty.

Second, for the cases of RMB overseas direct investment (ODI) and RMB portfolio investment from China to the U.S., it turns out that the corresponding influences on the monetary demand and supply are rather limited. Even so, such investment would lead to extra growth of foreign exchange reserves. To make the conclusion clear, three points should be considered:

- (1) To what extent is RMB ODI and RMB portfolio investment being accepted in the U.S. If the RMB investment to the U.S. is rejected because the currency is not convertible, then such kind of investment would hardly be able to be accomplished.
- (2) The conclusion above is related to the hypothesis that the PBOC always attempts to stabilize the RMB's exchange rate. If the hypothesis is not valid, that is to say, the Chinese yuan's exchange rate is mostly decided by the strength of the market, then such capital flows would not cause the extra increase of foreign exchange reserves. From this point of view, the reforms of the RMB's exchange rate system would be accelerated. The exchange rate should be much more flexible and depend much more on the supply and demand strength of the market.
- (3) If the authorities keep the stabilization of RMB's exchange rate as the policy target, then such RMB capital flows are bound to result in extra growth of FX reserves. So when the U.S. 2012 model is discussed, the authorities should consider the cost and the risk of more accumulated FX reserves.

Finally, for cases of RMB portfolio investment and RMB loans from the U.S. into China, such RMB capital flows would have no effect on the increase of PBOC's FX reserves. Yet on the other side, if the amount of the capital flow is large enough, the aggregate monetary demand and supply would be influenced substantially. The mechanism could be described as follows: the capital inflow increases the money supply and at the same time, brings down the interest rate; and then the price of financial assets would be driven up, and eventually the real economy would be affected. It is thus evident that if there is a large amount of such capital

inflow, the financial market and the real economy would be in trouble to some extent. The authorities consequently should pay close attention to these kinds of capital inflows. It would be reasonable to keep controls on these channels and then reduce the control asymptotically in the future.

### **CHINA WILL NEED DOMESTIC FINANCIAL REFORM PRIOR TO RMB INTERNATIONALIZATION AND THE ACCEPTANCE OF THE U.S. 2012 BIT MODEL**

From the above consideration, and with the background of RMB cross-border settlements, it is not rational for China to accept the U.S. 2012 BIT Model. Although the first category shows a positive effect, the other two categories would create challenges for the management of the FX reserves, the financial market, and the real economy.

From the point of view of China, the reforms of the exchange rate regime are more urgent than RMB cross-border settlement. Currently, there are simultaneously two markets for RMB exchange: the onshore market CNY in Shanghai and the offshore market CNH in Hong Kong. The former is subject to intervention from PBOC, and the latter is mainly decided by the market. There are respectively different prices in these two markets. The behavior of the RMB's cross-border settlement would be distorted both by carry trade and arbitrage, and the domestic macro economy would inevitably be influenced. If the U.S. 2012 Model BIT were accepted by China, the instability of the economic situation would increase. For this reason, the reforms of the RMB's exchange rate regime should become a top priority. Meanwhile the current reforms still have a fairly long way to go, so China needs to be cautious in both the RMB's cross-border settlement and the negotiation of a U.S. 2012 Model BIT.

China entered the WTO in 2001. At that time China promised to open financial services to foreign investors. As promised, China has accomplished the target by 2006. But there are still some controls left on market access. For example, foreign investors who enter the stock market must be certificated by the authorities and get only a limited quota. Not only the negotiation of a BIT with the U.S., but also the RMB internationalization would be blocked by these restraint measures. These measures are also considered one of the distortions in China's economy. But with a policy framework of interest and exchange rates controlled by the authorities, there is great risk in loosening the market access completely. From this point of view, the reforms of the financial market should be the priority for China. Only then could RMB internationalization and the BIT negotiation be started with a solid base.

## IT IS NECESSARY FOR THE U.S. TO ADJUST THE BIT MODEL FOR DEVELOPING PARTNERS LIKE CHINA

It would be prudent for the U.S. to revise the 2012 Model BIT with respect to China. It is not plausible for China to accept the language in the current model. Furthermore, besides China, there are other developing countries as potential partners. It would be practical for the U.S. to adjust the related provisions in the 2012 model to help the developing partner maintain stability and bring the cooperation to a win-win scenario.

According to the National Treatment clause in the U.S. BIT Model 2012, each party shall accord to investors (or covered investments) of the other Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, manage-

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**It would be prudent for the U.S. to revise the 2012 Model BIT with respect to China. It is not plausible for China to accept the language in the current model.**

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ment, conduct, operation, and sale or other disposition of investments in its territory. We can find similar words in its most favored nation (MFN) treatment clause. These two

facts show U.S. BIT Model 2012 follows a pre-establishment national treatment (NT) and MFN approach. At the same time, the China-Japan-Korea trilateral investment<sup>3</sup> treaty only covers investors' investments with respect to investment activities when NT and MFN are concerned.

It is important for the transfer of investments to occur, but treaties must have proper safeguards. China also promises free and prompt transfer in almost all the BITs it has signed to date, but most treaties have a balance of payments safeguard. In the China-Uzbekistan BIT,<sup>4</sup> both sides agree to temporarily restrict transfers provided that each Contracting Party implements measures in accordance with international standards; that is, these restrictions should be imposed in an equitable, non-discriminatory and good faith basis, in case of a serious balance of payments difficulty or of a threat. The same safeguards can be found in the China-France BIT and others.<sup>5</sup>

The U.S. Model BIT does not have a balance of payments safeguard. Rather, it notes only that a party may prevent a transfer through the equitable, non-discriminatory, and good faith application of its laws relating to issuing, trading, or dealing in securities, futures, options, or other derivatives.

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1. The Chinese yuan's internationalization has never been confirmed by the authorities, including by the People's Bank of China. As a result of the conservative attitude, it is always cited by the authorities as the RMB's cross-border settlement. Corresponding to the new development, a new department called RMB's cross-border settlement has been established both in the first headquarters of PBOC in Beijing and the second headquarters in Shanghai.
  2. The yuan's offshore market in London has been established since May 2012. Meanwhile the yuan's offshore markets are also under active construction both in Singapore and Tokyo.
  3. The name of the agreement is Agreement among the Government of Japan, the Government of the Republic of Korea and the Government of the People's Republic of China for the Promotion, Facilitation and Protection of Investment. It was signed on May 13, 2012.
  4. The name of the agreement is Agreement Between the Government of the People's Republic of China and the Government of the Republic of Uzbekistan on the Promotion and Protection of Investments. It was signed in 1992, and revised in 1994 and 2011.
  5. The name of the agreement is the Agreement Between the Government of the People's Republic of China and the Government of the Republic of France on the Reciprocal Promotion and Protection of Investments. It was signed in 1984, and revised twice, in 1985 and 2007.



## 10. Capital Account Regulatory Space under India's Investment and Trade Agreements

Smitha Francis<sup>1</sup>

### INTRODUCTION

Indian policy towards capital account convertibility (including for foreign direct investment or FDI) was very restrictive until the initiation of economic reforms in 1991. Subsequently, there has been a marked change in India's official attitude towards foreign capital and there has been gradual and continuous deregulation of capital inflows and outflows, which accelerated in the 2000s. Indeed, with the growing external integration of the economy and knowing that capital flows are highly pro-cyclical, the Reserve Bank of India (RBI) reinterpreted its broad mandate a few years ago by adding financial stability to its traditional dual objectives of growth and price stability (Reddy 2010). Since 2004, price and financial stability were explicitly given greater weight and provided the justification for making concerted use of counter-cyclical monetary and regulatory policies to manage India's external sector.

India's Foreign Exchange Management Act (FEMA Act 1999) gives power to the central bank to prohibit, restrict, or regulate any class of capital account transactions. Thus even while maintaining an open capital account, there have been both quantitative and price-based capital account regulations in place—whether for FDI, foreign portfolio investments, or external debt. For example, there have been sectoral equity caps in the case of FDI and ceilings on investments by foreign institutional investors (FIIs) in shares/convertible debentures/government securities, regulations on maturities and interest rates offered on non-convertible and partially/optionally convertible debentures/preference shares, etc. The liberalization of capital inflows and

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**Indian policymakers have been increasingly grappling with the multiple challenges and consequences of the large and volatile foreign capital inflows that have accelerated since the mid-2000s.**

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outflows are also aligned with extensive recourse to prudential measures and other controls over the activities of financial sector intermediaries (Reddy 2010; Stanley 2011; Prakash and Ranjan 2012). Despite all such efforts to manage the economy's growing external integration, Indian policymakers have been increasingly grappling with the multiple challenges and consequences of the large and volatile foreign capital inflows that have accelerated since the mid-2000s.<sup>2</sup> But while there is some current discussion related to capital controls in the wake of rupee depreciation and the economy's ever increasing external vulnerability,<sup>3</sup> India may not have adequate flexibility to regulate its capital account transactions because of the trade and investment treaties signed up to now.

Following the liberalization of the foreign investment policy, India has entered into bilateral investment treaties called Bilateral Investment Promotion and Protection Agreements (BIPAs) with a number of countries in order to promote and protect bilateral investments on a reciprocal basis. India has so far signed BIPAs with 82 countries, of which 72 have been in force.<sup>4</sup> As of July 2012, there are also 18 preferential trade agreements in force involving India. The majority of these in force since the mid-2000s—involving both developed and developing countries—are comprehensive in nature, which go beyond trade liberalization in manufactured goods to cover liberalization in agricultural trade, services, investment, etc. These are the India-Singapore Comprehensive Economic Cooperation Agreement (CECA), Asia Pacific Trade Agreement (APTA), India-South Korea Comprehensive Economic Partnership Agreement (CEPA), SAARC Agreement on Trade in Services, India-Japan CEPA, and India-Malaysia CECA.

Both BIPAs and comprehensive trade agreements require all transfers “relating to investment” from the contracting parties to be allowed freely and without delay into and out of the host Parties. The overall implications of India's commitments under the various treaties on its policy space for regulating capital flows have to take into account the interactions of the definition provisions with the operative provisions in these agreements as well as the interaction between investment provisions across different agreements (Francis 2011). In addition, given that financial sector liberalization has been making its entry through Mode 1 (cross-border trade) and Mode 3 (commercial presence) commitments in the services chapter of the comprehensive trade agreements, the capital transfer provisions under the services chapter also have to be analyzed. This report chapter assesses the impact of the commitments under the multitude of India's bilateral investment treaties (BITs) and trade agreements on its regulatory power

related to capital account regulations and suggests some ways to deal with the prevailing incompatibilities.

## **CAPITAL ACCOUNT REGULATORY SPACE IN INDIA'S BIPAs AND TRADE AGREEMENTS**

India's Model Bilateral Investment Promotion and Protection Agreement (Model BIPA), under Article 7 titled "Repatriation of Investments and Returns," commits the country to allow the free transfer of all funds related to covered investments. An analysis of the capital transfer provisions in the 72 Indian BIPAs in force and the four major comprehensive trade agreements (India-Singapore CECA, India-South Korea CEPA, India-Japan CEPA, and India-Malaysia CECA) reveals that all of them contain the relevant article. But given that the interaction between the definitional and operative provisions influences the interpretations of the capital transfer provisions, we first consider how investments and investors are defined in these agreements.

### **Definitions of Investment**

The majority of BIPAs (58 out of the total 72 in force) follow the same broad investment definition provided under Article 1 of the Indian model BIPA. According to this broad investment definition,

"investment means every kind of asset established or acquired including changes in the form of such investment in accordance with the national laws of the Contracting Party in whose territory the investment is made..."

and is followed by a non-exhaustive list of tangible and intangible assets that includes:

- movable and immovable property and related rights;
- equities and debentures and any other similar forms of participation in a company;
- a wide range of intangible assets such as intellectual property rights and all types of business concessions.

All of the four major trade agreements studied also follow similar broad formulations of investment definition. It is pertinent to remember that International Investment Agreements (IIAs) originally came into existence in order to guarantee the safety and returns on investments by multinational companies (MNCs) in

developing countries through FDI. But it is clear that apart from FDI, the above investment definition covering “every kind of asset” will clearly include investments in Indian equities and debt securities of both private and public enterprises by foreign portfolio investors, private equity, hedge funds, etc., and also in Indian sovereign debt where government securities are not explicitly excluded.

The majority of the BIPAs also explicitly mention that any alteration of the form in which assets are invested or reinvested does not affect their character as investments. Only a handful of the BIPAs provide that such alteration in investment should not be in conflict with the host country legislation. Similarly returns that are invested/re-invested are also given the same protection as investments.

The formulation of investment definition in the India-Mexico BIPA is the only one that is most significantly different from all the other Indian BIPAs in operation by providing an exhaustive list of assets (see Box 1). By providing an exhaustive list of permitted assets and specific limitations on the type of assets considered as investments, this definition is useful while considering alternative formulations.

### **Box 1: Investment Definition in India-Mexico BIPA**

Investment means the following assets established or acquired by an investor of one Contracting Party in accordance with the laws in force of the other Contracting Party in whose territory the investment is made, and involving the commitment of capital, expectation of gain or profit or an assumption of risk:

- (a) an enterprise having substantial business operations in the territory of the host Party;
- (b) investment through any form of equity participation in an enterprise;
- (c) investment through debt securities and loans to an enterprise have to either be in an affiliated enterprise, or should be of at least three years maturity;
- (d) investment through debt securities, or loans—both regardless of their maturities, cannot be in sovereign debt or in the debt securities of state enterprises.

### **Capital Transfer Provisions**

The capital transfer articles in the BIPAs provide for a general obligation on the signatories to transfer all funds related to investments as provided in Article 7 of the Indian Model BIPA, as follows:

“Each Contracting Party shall permit all funds of an investor of the other Contracting Party related to an investment in its territory to be freely transferred, without unreasonable delay and on a non-discriminatory basis.”

This commitment by the host countries to permit the free transfer of all funds related to covered investments is typically accompanied by an illustrative list of transactions that are to be allowed. The majority of India’s 72 BIPAs follow the exact text under Article 7 of India’s model BIPA, which lists the permitted transfers as follows:

Such funds may include:

- (a) Capital and additional capital amounts used to maintain and increase investments;
- (b) Net operating profits including dividends and interest in proportion to their share-holdings;
- (c) Repayments of any loan including interest thereon, relating to the investment;
- (d) Payment of royalties and services fees relating to the investment;
- (e) Proceeds from sales of their shares;
- (f) Proceeds received by investors in case of sale or partial sale or liquidation;
- (g) The earnings of citizens/nationals of one Contracting Party who work in connection with investment in the territory of the other Contracting Party.

This list—consisting of both current account and capital account transactions—is clearly non-exhaustive, given the wording “may include.” That is, over and above these listed transfers, any other funds related to investments as defined in the agreement—including the original and subsequent additional capital investments as well as all types of returns on those investments—have to be permitted without any undue/unreasonable delay and restrictions.

The majority of the 72 BIPAs follow the above text on capital transfers. While there are minor variations in the formulation of the text in some of the BIPAs, their implications remain the same. In only six BIPAs—those with Belgium, Denmark, France, Germany, Italy, and the Netherlands—is the list of funds exhaus-

tive and the type of permitted transfers is thus arguably restricted to those listed therein. But the list of funds that are to be permitted “without delay” remains the same as above.

Under the broad asset-based definition of investment, these capital transfer provisions mean that the country cannot impose any restrictions on any type of inflows and outflows related to investments by portfolio investors, private equity, hedge funds, apart from traditional FDI by MNCs. The protection provisions would mean that host country governments can be sued even by investors in any of these financial assets as well as by sovereign bondholders, by deeming legitimate regulatory policies as expropriation.

Further, even while stating that the capital transfers have to be allowed “without undue delay” or “without unreasonable delay,” the majority of the Indian BIPAs (63) do not stipulate what constitutes undue or unreasonable delay in this context, thus leaving the interpretation open-ended and problematic even in those cases where restrictions on capital outflows are exempted under safeguard measures. The phrase “without delay” or “unreasonable delay” is omitted only in the India-Argentina and India-Belgium BIPAs. This kind of formulation would allow India some flexibility in imposing meaningful non-discriminatory capital account regulations (where such measures are allowed under some exceptions to the free capital transfer obligation). In seven BIPAs (those with Austria, Denmark, Germany, Kuwait, Italy, Spain, and Saudi Arabia) there is a stipulated time duration within which the capital transfer should be allowed (varying from one to six months from the date of the request for transfer), making India’s commitment even more stringent. Any delay in the ability of investors to transfer their funds beyond the stipulated time will therefore be considered unreasonable.

Clearly, the majority of India’s BIPAs restrict the country’s regulatory power to impose capital account regulatory measures on cross-border capital flows, whether for prudential financial sector regulation or for preventing a financial crisis. Indeed, in a situation of a BoP or a simple confidence crisis (due to a domestic political crisis or owing to contagion from external shocks), these capital transfer provisions obliging India to allow the free repatriation of investments and returns without delay and restrictions can lead to tremendous pressure on the currency and the foreign exchange reserves of the country, precipitating a financial and economic crisis.

When the transfer provision is read together with the definitions of investment and investors, its implications on financial sector and macroeconomic regulatory space related to capital account management are significantly more far-reaching. Under the broad asset-based definition of investment, wherein such a definition covers investments by portfolio investors, private equity, hedge funds, etc., apart from traditional FDI, these capital transfer provisions mean that the country cannot impose any restrictions on any type of inflows and outflows related to any such investments.

The fact that the following specific transaction—*“capital and additional capital amounts used to maintain and increase investments”*—provided in the article on free transfers means that the investor is allowed to bring in additional capital to maintain his existing investment. This could mean that India can be challenged by existing investors when existing regulations related to any of the different classes of foreign investments that come under the purview of the broad investment definition are changed.

When it comes to the definition of investor, who is a natural person or a company/enterprise, the implications of the investments being allowed and therefore the scope of the free capital transfer provisions differ dramatically depending on whether the definition of companies relies on: place of incorporation; the location of the registered office or seat; and the nationality of the ownership or controlling interest. Indeed investors from countries who are not even signatory to a BIPA could challenge the country for regulatory changes if “investor” is not defined carefully.

The definition of companies varies across the BIPAs that are in operation. In the case of 44 out of the total 72 Indian BIPAs in force, companies are defined based on incorporation alone in the case of both India and the bilateral partner. But under a definition based on incorporation alone, investors from non-Parties can also benefit from the terms of protection in an agreement simply by incorporating their venture in India or the bilateral partner and benefit from the free transfer of inflows and outflows. For example, in the case of Mauritius—it is well known that a host of foreign companies have set up their offices in that country and make investments in India as Mauritius investments and are able to benefit from the free capital transfer provisions under the BIPA. Indeed, Mauritius emerges as one of the largest foreign investors in India.

Given that the place of incorporation may not be more than a formal or artificial link, definitions based on seat and control is better suited to establish the true links of a particular company to a contracting party.<sup>5</sup> It is only in the case of 15 BIPAs that the definition of investor specifies that incorporated companies are required to have either substantial business operations, or registered/permanent seat, or real and continuous business activity in their territory, to be covered under the treaty. In another 12 BIPAs, it is only in the case of the bilateral partner that incorporated companies are required to have either substantial business operations, or registered/permanent seat, or real and continuous business activity in their territory. This implies that under these agreements too, third Party companies incorporated in India can make claims for free capital transfer to these bilateral partners. This could also lead to potential investor challenges in the case of regulatory changes related to inflows and outflows.

Another significant problem area is in the case of the BIPAs with Mexico, Kuwait, Russian Federation, Qatar, Saudi Arabia, Tajikistan, and Yemen, where government and government-owned enterprises are covered in the definition of an investor. This is also the case with the trade agreements with Singapore, South Korea, Japan, and Malaysia. This would mean that any kind of investments by these “investors” and in particular where the investment definition does not explicitly exclude government securities—only Mexico does—even these benefit from the free capital transfer provision. This can create serious hurdles in the course of a sovereign debt restructuring process.<sup>6</sup>

Apart from the fact that enterprises owned by government are covered, the India-Singapore CECA also states that free transfers (and other provisions of the investment chapter, except national treatment) are applicable to branches of enterprises incorporated in a third Party but registered/set up in Singapore. In fact, Singapore is also among the largest investors in India.

In general, the only basic limitation recognized in the majority of Indian BIPAs is that any transfer of funds not “related to investment” or not “in connection with an investment” is outside the scope of the capital transfer obligations.<sup>7</sup> Thus under the majority of BIPAs (53 out of the total 72), which do not recognize any exception to the investor’s right to transfer capital funds related to their investments in India, various existing capital account regulations may be interpreted as a breach of these agreements, even though such capital controls can be adopted under the FEMA Act. Under broad definitions of investments and investors in the BIPAs, India’s regulatory power to apply capital account measures can

therefore be preserved only if they contain certain exceptions such as allowing the host country to impose restrictions on capital transfers for meeting regulatory or monetary policy objectives.

In 13 BIPAs, there are some qualifications or exceptions provided to India's commitment for free capital transfer provision related to meeting the financial/fiscal/tax obligations of the host Party. However, only eight Indian BIPAs explicitly recognize BoP-related, currency stability-related or other monetary policy-related exceptions. These are the India-Bulgaria, India-Iceland, India-Czech Republic, India-Mexico, India-Romania, India-Slovak-Republic, India-Syrian Arab Republic, and India-Uzbekistan BIPAs.

- In Iceland's case, India can restrict transfers in accordance with internationally recognized standards.
- In the Syrian Republic's case, India can prevent transfers for stabilizing its currency.
- In the case of the BIPAs with four European countries, Bulgaria, Czech Republic, Romania, and Slovak Republic, India can adopt safeguard measures in exceptional circumstances such as serious macroeconomic difficulties or serious BoP difficulties for the host Contracting Party or for any customs, economic and monetary union, common market, free trade area or regional economic organization, of which it is a member. These also allow a Contracting Party to implement any obligation that arises from its membership in any such region/organization.
- In the case of Mexico, India can adopt restrictions on transfers in cases of serious BoP and external financial difficulties or threat thereof, consistent with IMF Articles.
- In the case of Mexico, the Syrian Republic, Bulgaria, Romania, and the Slovak Republic, India can additionally adopt regulations relating to issuing, trading or dealing in securities, futures, options or derivatives.
- It is only in Uzbekistan's case that India can restrict transfers in accordance with the procedure provided under its foreign exchange regulation and other legislations.

On the other hand, India's FTAs with Singapore, Japan, South Korea, and Malaysia appear to have relatively more extensive safeguard measures that allow the

host Parties to adopt or maintain restrictions on transfers, which give better regulatory space to India in comparison with its BIPAs.

Article 6.7 (Restrictions to Safeguard the Balance of Payments) in the India-Singapore CECA, Article 12.4 (Measures to Safeguard the Balance of Payments) in the India-Malaysia CECA, Article 97 (Temporary Safeguard Measures) of the India-Japan CEPA, and Article 10.11 of the India-South Korea CEPA allow a Party to adopt or maintain restrictions on payments or transfers related to investments in the event of serious BoP and external financial difficulties or threat thereof. Additionally, the last two trade agreements also allow a Party to maintain or adopt restrictions

“in cases where, in exceptional circumstances, movements of capital cause or threaten to cause serious difficulties for macroeconomic management, in particular, monetary and exchange rate policies.”

The services chapters in all the four agreements also provide for BoP safeguard restrictions as under GATS Article XII (see Gallagher and Stanley in this volume for Article XII).

However, all the safeguard measures allowed as exceptions, apart from being non-discriminatory, must be temporary and cannot go beyond what is necessary to remedy the specific situation being addressed. They must also avoid unnecessary damage to the commercial, economic, and financial interests of the investor. Further, the Singapore CECA stipulates that transfers can be restricted only on a national treatment basis.

There are several unsettled interpretation issues thrown up by the inter-related provisions under the BoP safeguard measures even under GATS that provide for state-to-state dispute settlement as discussed in detail by Tucker (2012) and Viterbo (2012) in this volume. Further, it is not clear whether GATS-type of safeguard measures adequately guarantee that nations can use measures to regulate the inflows of capital through the type of restrictions that the RBI has traditionally employed. Thus India needs to re-examine even the available safeguard provisions in the FTAs, especially in the absence of clear case law involving investor-state dispute arbitration.

## **CONCLUSIONS**

Under the majority of India's BITs, which do not recognize any exception to investors' right to transfer capital funds related to their investments in India,

India's regulatory power to adopt capital account regulatory measures is severely restricted and there is an urgent need to review and amend the BIPAs to make them compatible with India's national foreign exchange laws. Article 5.2 in the India-Uzbekistan BIPA, which states that "... *currency transfer ... shall be made... in accordance with the procedure provided under the Foreign Exchange Regulation and other legislation*" of the host Party, is a useful formulation to consider in this context. In particular, given that a broad definition clearly erodes India's ability to regulate different forms of capital flows,<sup>8</sup> it is also crucial to re-formulate the definitions of investment and investors. In this context, the investment definition under the India-Mexico BIPA offers a useful formulation for consideration. Similarly, investors should be defined based on ownership and control in order to establish the true links of a particular company to a Contracting Party.

On the other hand, India's comprehensive FTAs with Singapore, Japan, South Korea, and Malaysia appear to have relatively more extensive safeguard measures that allow India to adopt restrictions on transfers. However, the problem with broad investment and investor definitions remain and it is important to review and amend these as well.

Further, even where the use of capital controls is allowed in the BIPAs or FTAs, they are permitted only as defined under emergency situations in case of "serious difficulties" with monetary policy, exchange rate policy, balance of payments or macroeconomic policy, and that, too, only temporarily. Thus the problem that even these safeguard measures do not allow India to make use of different prudential measures in order to *prevent* "serious difficulties" persists.

Both BIPAs and FTAs need to be amended in order to preempt the subjection of legitimate national regulatory measures to investor-state dispute settlement procedures.

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1. The author is with Economic Research Foundation (ERF), New Delhi, which is also the Secretariat for International Development Economics Associates or IDEAs ([www.networkideas.org](http://www.networkideas.org)). She is grateful to Jayati Ghosh, Kevin Gallagher, Leonardo Stanley, and the participants at the CEDES Workshop on "Compatibility Review of the Trade Regime and Capital Account Regulations," co-organized by CEDES, GEGI, and GDAE, Buenos Aires, 28–29 June 2012, for their constructive comments.
  2. See Chandrasekhar, C. P. and Jayati Ghosh (2012a) and (2012b), Chandrasekhar, C. P. (2012a), Subramanian (2012), Sen (2010), and Sen (2012). Meanwhile, there has been further deregulation of many of the capital account regulatory measures in the post-crisis period since 2010, continuing into July 2012. See the various RBI notifications such as [http://www.rbi.org.in/scripts/BS\\_PressReleaseDisplay.aspx?prid=26714](http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=26714) and [http://rbi.org.in/scripts/BS\\_PressReleaseDisplay.aspx?prid=25789](http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=25789).
  3. See Bhusnurmath (2012) and Chandrasekhar (2012b).
  4. This information is as of December 2011, as available from the website of the Ministry of Finance, Government of India, [http://finmin.nic.in/bipa/bipa\\_index.asp?pageid=1](http://finmin.nic.in/bipa/bipa_index.asp?pageid=1).
  5. For a detailed discussion on the different definitions of "investor" under BITs and FTAs and their implications, see Thanadsillapakul (2009).
  6. See Francis (2011) and also Gallagher (2011).
  7. See also Ranjan (2012), which cites the example in *Continental Casualty v. Argentina*, ICSID Case No. ARB/03/9, where the tribunal held that a transfer that is not 'related to investment' was outside the scope of Article V of the U.S.-Argentina IIA. Article V of the U.S.-Argentina IIA, like Article 7 of the Indian Model BIPA, is broad and covers all transfers related to investments.
  8. India is already facing this problem with its national FDI regulation by removing the distinction between long-term productive FDI and volatile portfolio investments. See Rao and Dhar (2011) and Francis (2010) for detailed discussions.

# Afterword

Michael Waibel

In *Gruslin v. Malaysia*, a Belgian investor brought an International Centre for Settlement of Investment Disputes (ICSID) arbitration against Malaysia based on his holding of 2.3 million USD in a mutual fund registered in Luxembourg that in turn had purchased equities in Malaysia. In September 1998, Malaysia banned all international transfers—a measure designed to prevent contagion from the devaluation of the Thai bhat. Malaysia’s decision went against economic orthodoxy at the time, and attracted considerable controversy (Kaplan and Rodrik 2001). Gruslin contended that Malaysia’s exchange controls led him to lose his entire interest in the fund.

The *Gruslin* tribunal dismissed the case for lack of jurisdiction on a prior ground; namely, that only “approved projects” fell within its jurisdiction. In declining jurisdiction, the tribunal never reached the question of whether Malaysia’s capital account regulations (CARs) breached the free transfer clause in the Belgo-Luxembourg-Malaysia BIT. However, the arbitration raised the issue of potential conflicts between CARs and investment treaty obligations for the first time. As the Task Force report shows, similar concerns have also arisen in international trade law, especially the compatibility of CARs with the GATS.

Over the past two decades, the rise of BITs/FTAs has led to a patchwork, yet comprehensive liberalization of the capital accounts for the countries that enter into such agreements. The report shows that free transfer clauses are a ubiquitous feature of modern BITs, and to a lesser degree, of FTAs. Simultaneously, the definition of “investment” has expanded substantially into the realm of portfolio investment.<sup>1</sup> The push towards greater openness of the capital account through the backdoor limits the ability of governments to deploy CARs. The risk is that this uncoordinated opening up of the capital account undermines the resolution of future financial crises and chills macro-prudential measures.

The Task Force expresses concern about the shrinking of policy space, particularly as regards investment. BITs/FTAs with free transfer clauses, often without

limitations, chip away at the ability of countries to regulate capital in- and outflows. For example, Article 5 of the German Model BIT (2008) simply states in unconditional terms that the host State “shall guarantee to investors of the other Contracting State the free transfer of payments in connection with an investment.” Under such provisions, host states become potentially liable for compensation to those affected by such restrictions. Unlike expropriation or fair and equitable treatment that protect individual investors against discriminatory and arbitrary treatment, free transfer clauses could undermine macro-level government policy much more generally.

Members of the Task Force are concerned that prying open the capital account one agreement at a time is suboptimal and leads to a fragmented regime. It also ignores public order requirements for coordinating the response to global imbalances, sudden stops and reversal of capital flows. As Deborah Siegel notes, many guarantees on free transfers in BITs/FTAs have a sweeping character—skewing the cost-benefit analysis of whether CARs should be used to manage a crisis or as a macro-prudential tool. The inclusion of free transfer clauses in BITs/FTAs can change the calculus of governments, and chill the use of CARs.

## **THE RATIONALE FOR AND USE OF FREE TRANSFER CLAUSES**

One could question what precisely free transfer clauses add to BITs/FTAs, though no members of the Task Force call for omitting free transfer clauses altogether. In the investment community, the view is widespread that to restrict governments’ policy options in this way is desirable. To render measures that are prejudicial to foreign investment costly is precisely what investment treaties seek to achieve. This is illustrated by the paradigmatic statement of the arbitral tribunal in *Continental v. Argentina*:

This type of provision is a standard feature of BITs: the guarantee that a foreign investor shall be able to remit from the investment country the income produced, the reimbursement of any financing received or royalty payment due, and the value of the investment made, plus any accrued capital gain, in case of sale or liquidation, is fundamental to the freedom to make a foreign investment and an essential element of the promotional role of BITs (ICSID 2008, para. 239).

However, this oft-repeated, and unqualified statement that free transfer clauses are critical to investment protection, that other substantive protections would be

hollow without being backed up by free transfer clauses, and that significant safeguards go against the grain of such protection may not survive empirical scrutiny.

Free transfer clauses have been largely dormant provisions in BITs/FTAs. No ICSID tribunal has thus far ruled on the merits of such clauses. And investors have invoked free transfer clauses only rarely, and in no case did the provision play a central role in the tribunal's determination.<sup>2</sup> The result is substantial uncertainty about how free transfer clauses would apply and whether they would substantially restrict countries' room for maneuver. The Task Force believes that we should worry about their impact on national and international policy space, even though free transfer clauses have yet to acquire actual importance in the adjudication of international investment disputes. One way to lessen the uncertainty is for the state parties to issue authentic interpretations to clarify that the use of CARs is permissible generally, save in specific circumstances.

There is widespread agreement among members that restrictions on the use of CARs may be harmful and that states should have the freedom to employ CARs in limited circumstances, subject to multilateral oversight. In addition, they take the view that liberalization of capital account transactions should be embedded in a carefully designed system of multilateral safeguards. Multilateralism is seen as a better guarantee for protecting public and private interest in financial crises. Especially in bilateral agreements, there is a danger that superior bargaining power leads to outcomes that are suboptimal from a public perspective.

As Siegel explains, the seemingly unqualified right to impose CARs pursuant to Article VI (3) of the IMF Articles was qualified by the extension of IMF's surveillance function with the Second Amendment to the IMF Articles. At the multilateral level there is already an important safeguard against members using CARs in circumstances for protectionist purposes—though crucially, this determination is vested in a multilateral institution with specialized expertise in macroeconomics that is bound to evaluate the case for CARs on a case-by-case basis, taking into account all the circumstances of each case.

Task Force members also regard the conditions for justifying GATS violations as too restrictive. Annamaria Viterbo underscored that the Appellate Body in *Argentina-Textiles and Apparel* unduly narrowed the scope of GATS Article XI:2. Only CARs that are legally binding fall under it, leaving CARs deployed in the context of an IMF standby-by arrangement that are formally non-binding, open to challenge. Todd Tucker emphasizes more generally that the defenses that

could justify *prima facie* violations of GATS commitments face an uphill struggle. CARs will often discriminate de facto between residents and non-residents.

## GROWING RECOGNITION OF LEGITIMATE USES OF CARs

Countries such as Egypt, India, and South Africa have recently been reviewing their BIT programs, and decided to safeguard more policy space under free transfer clauses. More generally, the recent trend is to include balance of payments exceptions to free transfer clauses in BITs, and on occasion, prudential exceptions (UNCTAD 2012, 90). Qiyuan Xu and Feng Tian argue that the transfer of funds provision contained in the U.S. Model BIT is likely to be a major stumbling block in BIT negotiations between the U.S. and China, and will require significant adjustment to take account of China's current exchange regime.

The Task Force also highlights that the IMF, too, is warming to the use of CARs, and has expressed concern that BITs/FTAs "in many cases do not provide appropriate safeguards or proper sequencing of liberalization, and could thus benefit from reform to include these protections" (IMF 2012, 8). CARs may "provide breathing space while fundamental policy is adjusted" (Ibid., 41).

As Andrés Arauz submits, CARs can be useful both not only for crisis management, both also for foresighted macro-prudential management with a view

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### **The question looms large of how a potential conflict between a transfer clause and the IMF Articles should be resolved. Which ought to prevail in case of conflict?**

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to preventing crises from building up in the first place. Luiz Fernando de Paula and Daniela Magalhães Prates argue that a country like Brazil that has no BITs/FTAs has

more policy space to implement measures to lean against the tide of hot money inflows, such as the 2 percent financial transactions tax on non-resident equity and bond holdings that Brazil introduced in October 2009.

## THE POTENTIAL FOR NORM CONFLICT

For the most part, free transfer clauses do not refer to the IMF Articles of Agreement. The question looms large of how a potential conflict between a transfer clause and the IMF Articles should be resolved. Which ought to prevail in case of conflict? The *Continental* tribunal, while finding that the transfer in question did not fall within the scope of the transfer clause because it was not a transfer related to the investment, pointed out *obiter* that the free transfer clause in the

U.S.-Argentina BIT was *lex specialis* in relation to the IMF regime and also more liberal than the IMF regime.<sup>3</sup>

Annamaria Viterbo highlights the serious potential of conflicts of norms between obligations to liberalize capital movements and CARs, and that while soft law may provide helpful guidelines in some cases, it is incapable of resolving such conflicts of norms definitely—whereas precisely such a definite resolution is what is needed for dispute settlement purposes. Her concern is echoed by Deborah Siegel, who underscores how fragmented rules on free transfers have proliferated in the vacuum left by the absence of hard multilateral rules on CARs.

## **DISPUTE SETTLEMENT**

Another question concerns the level of scrutiny that ICSID tribunals ought to bring to bear on CARs, and whether they could simultaneously violate treatment obligations other than the free transfer clause. In what circumstances do exchange restrictions constitute expropriation or a violation of the fair and equitable standard? BIT/FTA drafters could formulate BoP and prudential safeguards as a general exception to all of the BIT's treatment obligations. Thus, if a government imposed exchange restrictions consistent with the BIT's BoP safeguard, no further examination for violation of the fair and equitable or the expropriation treatment standard would be required.

ICSID tribunals could use a proportionality test, so that only a measure that imposes the minimal restriction on investor right survives scrutiny. This level of scrutiny appears to be too high. One should bear in mind that the U.S. Supreme Court, for example, generally reviews economic policy measures under a rational basis test. As a result, a policy measure is constitutional if it is rationally related to a legitimate governmental interest (Tribe 2000, 1361).<sup>4</sup> To be sure, this level of scrutiny does not render such provisions self-judging. Rather, it leaves policymakers substantial leeway, while still subjecting them to scrutiny at a general level. A similar approach suggests itself for investment tribunals and the WTO.

Members of the Task Force additionally call for governments to act as gatekeepers for dispute settlement also in respect of BITs/FTAs, just like they already do for WTO dispute settlement. Governments would thereby filter potential complaints. Because of their vantage point, they are likely to be more sympathetic on average to the use of CARs by other governments than private investors. Accordingly, many Task Force members mooted the idea of excluding investor-state dispute settlement in respect of free transfer clauses, so that violations of

the free transfer clause could only be invoked in state-to-state arbitration. This could be combined with a requirement for the tribunal to consult the IMF to align BITs/FTAs with the multilateral monetary order, modeled on the WTO.

Members of the Task Force share the view that financial stability should no longer be sacrificed on the altar of comprehensive capital account liberalization. BITs/FTAs in particular appear to overprotect investment at the expense of international financial stability. The existing safeguards mechanism in both trade and investment law are insufficiently fleshed out, and may prevent their invocation even when the policy rationale is compelling. The better, and more foresighted approach is to recognize the legitimate needs of governments to restrict CARs in crisis situations and for macro-prudential reasons, rather than inviting serial withdrawal from the international economic order.

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1. Cf. most recently *Deutsche Bank v. Sri Lanka*, ICSID Case No. ARB/09/2, Award, 31 October 2012 (a derivative used to hedge oil is an investment).

2. *Metalpar v. Argentina*, Award, 6 June 2008, ICSID Case No. ARB/03/5 (required authorization from central bank no breach); *Biwater Gauff v. Tanzania*, Award, 24 July 2008, ICSID Case No. ARB/05/22, para. 16 (no breach); *Continental Casualty v. Argentina*, Award, 5 September 2008, ICSID Case No. ARB/03/9 (no covered transfer); *Pan American Energy v. Argentina*, Decision on Preliminary Objections, 27 July 2006, ICSID Case No. ARB/03/13 (declined jurisdiction, on other grounds); *Gruslin v. Malaysia*, ICSID Case No. ARB/99/3, 27 November 2000; *CMS v. Argentina*, Award, 12 May 2005, ICSID Case No. ARB/01/8 (claim for breach of clause withdrawn); *Genin v. Estonia*, ICSID Case No. ARB/99/2, Award, 25 June 2001 (no analysis of and no finding on free transfer clause); *Joy Mining v. Egypt*, ICSID Case No. ARB/03/11, Award on Jurisdiction, 6 August 2004 (invoked, but no *prima facie* breach).

3. Para. 244.

4. See also *United States v. Carolene Products Co.*, 304 US 144. Regulation in the socioeconomic sphere passes constitutional muster if any state of facts either known or reasonably inferable afforded support for the legislative judgment.

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The Pardee Center Task Force on Regulating Global Capital Flows for Long-Run Development is a project of the Center's Global Economic Governance Initiative (GEGI), coordinated by Boston University Associate Professor of International Relations and Pardee Faculty Fellow Kevin P. Gallagher. This Task Force report, *Capital Account Regulations and the Trading System: A Compatibility Review*, builds on the Task Force's first report published in March 2012, *Regulating Global Capital Flows for Long-Run Development*, co-sponsored by the Initiative for Policy Dialogue at Columbia University and the Global Development and Environment Institute (GDAE) at Tufts University. This report is sponsored by GEGI with the Center for the Study of State and Society (CEDES) in Buenos Aires, Argentina, and GDAE, and in collaboration with the Boston University Center for Finance, Law & Policy.

The Pardee Center Task Force was convened initially in September 2011 as consensus was emerging that the global financial crisis has re-confirmed the need to regulate cross-border finance. The March 2012 report argues that international financial institutions—and in particular the International Monetary Fund (IMF)—need to support measures that would allow capital account regulations (CARs) to become a standard and effective part of the macroeconomic policy toolkit. Yet some policymakers and academics expressed concern that many nations—and especially developing countries—may not have the flexibility to adequately deploy such regulations because of trade and investment treaties they are party to.

In June 2012, the Pardee Center, with CEDES and GDAE, convened a second Task Force workshop in Buenos Aires specifically to review agreements at the World Trade Organization and various Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) for the extent to which the trading regime is compatible with the ability to deploy effective capital account regulations. This report presents the findings of that review, and highlights a number of potential incompatibilities found between the WTO and the ability to deploy CARs. It also highlights an alarming lack of policy space to use CARs under a variety of FTAs and BITs—especially those involving the United States. Like the first report, it was written by an international group of experts whose goal is to help inform discussions and decisions by policymakers at the IMF and elsewhere that will have implications for the economic health and development trajectories for countries around the world.

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