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Tired of Waiting for a 21st Century Trade Agreement: Developing Countries, the TPP, and Regulating Cross Border Finance

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Early on in his term, US President Barack Obama pledged that the Trans-Pacific Partnership Agreement (TPP) would be a 21st Century trade treaty. This week a copy of the proposed investment chapter of the deal was leaked, only to reveal that the US still remains behind the times.

In these turbulent economic times for the world economy, what is among the most egregious aspects of the US proposal is that it would limit the ability of TPP members to regulate global finance. Yet emerging market negotiating partners have proposed bold alternatives that are a big step in the right direction.

In the wake of the crisis, many countries deployed regulations to curb the negative effects of cross-border capital volatility. Like earlier studies by the National Bureau of Economic Research and others confirming that such regulations (traditionally referred to as capital controls) can prevent and mitigate financial crises, new studies by the IMF and others show how countries such as Brazil, Taiwan, and South Korea have been successful in avoiding the worst of the current crisis.

The IMF and the G-20 have weighed in with support as well. The IMF has argued that cross-border financial regulations are a part of the toolkit to prevent and mitigate crises. In 2011, the G-20's "G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences", signed by the G20 leaders in Cannes– endorsed regulating global capital flows as nations see fit.

In an attempt to convey this consensus to US trade negotiators, earlier this year 100 economists signed a letter to negotiators calling on them to grant flexibility to deploy capital account regulations to prevent and mitigate crises.

This May United States Congressional Representatives Barney Frank (D-Mass.) and Sander Levin (D-Mich.) – respectively, the ranking members on the House Financial Services and Ways & Means Committees – wrote in a letter that they would not support the TPP unless the Obama administration ensured that countries maintain the ability to regulate global finance.

Tired of waiting for the US to reflect current thinking and practice, the leaked text reveals two proposals by TPP negotiating teams that are a step in the right direction when it comes to granting nations the flexibility to regulate capital flows under the TPP.

In the leaked text one can find a bracketed (meaning proposed but still under negotiation) text of an Article XX.3 "Balance of Payments" exception. This safeguard measure is almost identical to one found in the Australia-Malaysia FTA, which was signed this year and is pending ratification, as well as the Australia FTAs with New Zealand and Singapore, and also the New Zealand-Singapore FTA. It is also very similar to language in the investment treaty between Japan and Vietnam signed in 2003.

The safeguard would provide nations the leeway to regulate cross-border finance if there were "serious balance of payments difficulties or threats thereof." This is a great step in the right direction and would obviously have support among Australia, New Zealand, and Malaysia at the least—given that they have already agreed to these terms in their own agreements.

Three issues deserve to be highlighted:

1. It is very important that such a safeguard not solely be about balance of payments but also for financial stability. As we point out in the high-level Task Force on Regulating Global Capital Flows for Long Run Development, nations may not only have to regulate cross-border finance in order to meet payments obligations, but also to prevent asset bubbles, excessive exchange rate appreciation, capital flight, and to maintain an independent monetary policy.

The proposed safeguard goes a long way here. Article XX.3.2 (a) emphasizes that nations can regulate cross-border finance when it presents "external difficulties or the threat thereof"– which of course implies the need to maintain financial stability. Article XX.3.2 (b) says that nations can regulate capital flows in circumstances where financial flows can "cause or threaten to cause serious difficulties for macroeconomic management." Language like this is of utmost importance to have in the TPP.

2. Unfortunately, Article XX.3.3(a) would require that cross-border financial regulations not be "discriminatory." This is a problem given that regulating foreign finance is almost by nature discriminatory. In the new thinking at the IMF on this topic, they go so far as to define cross-border financial regulations (which they call 'capital flow management measures') as "measures affecting cross-border financial activity that discriminate on the basis of residency." To allow developing nations to continue these policies, the requirement that they are "non-discriminatory" will need to be eliminated.

3. Under these proposals the burden of proof would still be on governments to defend their policies in tribunals where private investors can make claims against regulation. The financial services chapters of other US trade treaties often have a "diplomatic screen" whereby financial authorities in disputing nations can decide whether the regulation is legitimate and therefore hold off on the ability of private investors directly suing governments. The Financial Services chapter of the TPP is still a secret, but "reading in" the diplomatic screen in order to reign in investor-state disputes would also be of seminal importance.

The leaked document also has a bracketed Annex regarding Chile's capital account regulations (Annex 12-1). Chile already has a law on its book (Encaje) that allows the nation to temporarily deploy cross-border financial regulations in order to prevent or mitigate a crisis. This Annex would grant Chile the flexibility to resort to this law when needed. This is significant given that the Administration of George Bush forced Chile to abandon such a safeguard under the US-Chile FTA. Righting that wrong under the TPP would presumably override the past deal between the two nations.

The TPP countries that propose these alternatives have economics, experience, and vision right. The US should join the fray. A safeguard provision that allowed nations to deploy cross-border financial regulations without the threat of claims by private investors would go a long way.