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Capital Controls and Trade Agreements

The use of capital controls to prevent and mitigate financial crises is re-gaining legitimacy across the economics profession and in international institutions such as the International Monetary Fund (IMF). Indeed, in a 2010 Staff Position Note, the IMF declared that capital controls are now “justified as part of the policy toolkit”\(^1\). Getting the economics right is a step in the right direction, but not enough. Focus needs to turn to the numerous barriers to capital controls erected during the decades of skepticism toward them. One such barrier is trade policy. Many trade and investment agreements, especially those of the United States, do not permit the use of capital controls without significant penalty.

Time is of the essence. With interest rates low in high income countries, the carry trade is again bringing massive inflows of speculative capital to developing countries that could disrupt their recovery from the crisis\(^2\). In the medium-term, fear of debt overhang and inflation in high income countries may lead to a rise in interest rates and swift flight of capital out of developing countries. International organizations such as the United Nations have long advocated the careful use of capital controls on speculative capital\(^3\). Rapid inflows of capital can lead to unstable currencies and asset price appreciation and make it difficult for a nation to conduct independent monetary policy, among other things. Rapid capital flight can lead to excessive depreciation of currencies and assets, and lead to general investor panic.

Capital controls are regulatory measures to smooth the amount and composition of capital flows. More often than not, such controls focus on short-term “hot money” capital of a speculative nature. Examples of capital controls include taxes on short-term inflows or outflows, and the much heralded “unremunerated reserve requirements” (URR) deployed by countries such as Chile, Colombia, and Thailand. With URR, inflows of short-term debt need to be accompanied by a deposit placed with the central bank for a certain period of time\(^4\).

In a February 2010 Staff Position Note, IMF staff reviewed all the evidence on capital controls on inflows, pre- and post-crisis, and concluded: “capital controls—in addition to both prudential and macroeconomic policy—is justified as part of the policy toolkit to manage inflows. Such controls, moreover, can retain potency even if investors devise strategies to bypass them, provided such strategies are more costly than the expected return from the transaction: the cost of circumvention strategies acts as sand in the wheels (IMF, 2010).”

The IMF also conducted its own cross-country analysis in this study, which also has profound findings. The IMF’s econometric analysis examined how countries that used capital controls fared in the run-up to the current crisis compared to countries that did not use them. They found that countries with controls fared better: “the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility”\(^5\).

Some prominent economists acknowledge the need for restrictions on outflows. Calvo argues that capital controls could be deployed to dampen the impact of capital flight during crises. Even in “normal” times, Calvo argues that prudential regulations should sometimes be coupled with foreign exchange restrictions to reduce capital flight\(^6\).

Many trade and investment agreements do not allow nations to deploy capital controls. Under the World Trade Organization (WTO), if a nation has committed to granting cross-border market access in financial services or to allowing foreign investment in financial services, it must liberalize its capital account in order to honor those commitments. The WTO does have a prudential exception and a balance of payments exception, but it is
not clear that such safeguards will apply to all types of capital controls. In any event, at this writing, most developing countries have not yet agreed to grant market access in the financial services sectors that would require open capital accounts. However, developed countries see liberalization of financial services in developing countries as the cornerstone of a new WTO agreement under the Doha Round.

Some, but not all free trade agreements (FTAs) and bilateral investment treaties (BITs) also restrict the ability of nations to deploy capital controls. US agreements do not permit capital controls. Since the 2003 US-Chile Free Trade Agreement, every US trade or investment agreement requires the free flow of capital to and from the US and its trading partner, without exception. When a WTO dispute arises, such a dispute has to be brought by a state (and can thus be “screened”). FTAs however, allow the foreign firm to directly file a claim against a host state for such measures. If a claim is lost, the host state has to change its policy and pay damages to the private firm. Such a claim was rendered under the US-Argentina BIT when, in the aftermath of Argentina’s financial crisis, Argentina sought to impose a tax on outflows that was deemed to be tantamount to an “expropriation”.

However, while US FTAs and BITs strictly forbid the use of capital controls, the agreements of other major capital-exporting nations allow for more flexibility. Most BITs and FTAs involving Japan, the European Union, and Canada either have a safeguard measure whereby a nation is able to pursue its domestic regulations related to capital controls, or a safeguard measure to prevent and mitigate financial crises. For instance, the EU-Chile and Canada-Chile FTAs each grants Chile the flexibility to deploy its URR when Chile deems necessary. The US-Chile agreement does not allow for capital controls, even on a temporary basis.

Now that capital controls are more acceptable, it is time to ensure that nations can now use the now legitimized “toolkit”. Some trade treaties, especially those of the United States, prevent the use of capital controls as part of the toolkit. After the current crisis hit, so may the politics. Nations like the US may see that even financial crises with their origins abroad can adversely affect US firms and households as well—and that the benefits of macroeconomic and financial stability can be significant.

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