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US trade agreements threaten emerging markets' financial stability

By Kevin P. Gallagher
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At the recent annual meeting of the Asian Development Bank Taiwan's Central Bank governor Perng Fai-nan urged emerging market nations in Asia to use capital controls to promote financial stability.

Yesterday, this call was echoed by Noeleen Heyzer, executive secretary of the United Nations Economic and Social Commission for Asia and the Pacific. She singled out China, India, Singapore, Indonesia and South Korea as the most vulnerable nations in need of controls

These statements would have been unthinkable a decade ago, and shows how much has changed.

Part of the stigma attached to capital controls has been dampened by the new tune at the International Monetary Fund (IMF). In a February 2010 staff position note and in the IMF's Global Financial Stability Report (GSFR) the IMF said that capital controls are a legitimate part of the toolkit for emerging markets. What's more, the IMF's economists found that those countries that deployed capital controls in the run-up to the current crisis were among the least hard hit from the global financial crisis.

It is time for the debate over capital controls to shift from whether to deploy controls to how and when.

The problem is that many of the world's trade and investment treaties, especially those with the US, make it very difficult to effectively use capital controls.

In a new study I wrote for the United Nations I found that those nations that have liberalised their financial services sectors at the World Trade Organisation are not permitted to deploy capital controls. Close to 100 countries have not committed to opening financial services under the WTO, yet 37 are very vulnerable, including Singapore, Indonesia, Philippines, and Argentina.

But my real concern regards trade and investment agreements with the US.

These agreements mandate the free transfer of payments without delay and without any safeguard measures such as those found in the WTO arrangements.

Moreover, rather than disputes going through a diplomatic screen, these treaties have "investor-state" dispute systems whereby a private investor can directly file a claim against a government and that claim can be decided at a private tribunal at the World Bank.

The first trade agreements that had these measures were the US-Chile Free Trade Agreement and the Singapore Free Trade Agreement.

Chile is world renowned for its successful use of capital controls to stem inflows in the past and wanted to maintain the right to use those controls.

Singapore saw Malaysia deploy controls in the wake of the Asian crisis and wanted to hold the right as well. The US did not permit such flexibility.

At present, the US is negotiating investment treaties with India and China, and trade treaties with South Korea and Colombia. All these countries have deployed capital controls and some are considering controls to stem the current bubblesaccumulating in the developing world.

A US treaty with these nations would make it very costly to cautiously use capital controls to stem asset bubbles and maintain financial stability.

Those nations negotiating treaties with the US should think twice about signing on to provisions that will mandate the unbridled opening of the capital account without safeguards.

Emerging markets were smarter than the US in not following the US lead in unregulated capital markets. Such sense helped many developing countries avoid the worst of the crisis.

Developing countries should be shrewd again by not permitting the US to export its faulted financial model to the developing world through trade and investment treaties.

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