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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Division on Globalization and Development Strategies, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

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POLICY SPACE TO PREVENT AND MITIGATE FINANCIAL CRISES IN TRADE AND INVESTMENT AGREEMENTS

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Abstract

Do nations have the policy space to deploy capital controls in order to prevent and mitigate financial crises? This paper examines the extent to which measures to mitigate this crisis and prevent future crises are permissible under a variety of bilateral, regional and multilateral trade and investment agreements. It is found that the United States trade and investment agreements, and to a lesser extent the WTO, leave little room to manoeuvre when it comes to capital controls. This is the case despite the increasing economic evidence showing that certain capital controls can be useful in preventing or mitigating financial crises. It also stands in contrast with investment rules under the IMF, OECD and the treaties of most capital exporting nations which allow for at least the temporary use of capital controls as a safeguard measure. Drawing on the comparative analysis conducted in the paper, the author offers a range of policies that could be deployed to make the United States investment rules more consistent with the rules of its peers and the economic realities of the 21st century.

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POLICY SPACE TO PREVENT AND MITIGATE FINANCIAL CRISES IN TRADE AND INVESTMENT AGREEMENTS

Kevin P. Gallagher*

I. Introduction

At least since the Great Depression, and very much so in the run-up to and in the wake of the current financial crisis, some nations have relied on capital controls as one of many possible tools to mitigate or prevent the financial instability that can come with short-term inflows and outflows of capital. In the bubble years before the current crisis became acute, nations such as China, Colombia, India and Thailand regulated inflows of capital in order to stem those bubbles. When the crisis hit, nations like Iceland, Indonesia, the Russian Federation, Argentina and Ukraine put capital controls on outflows of capital to "stop the bleeding" related to the crisis (IMF, 2009).

As will be shown in this paper, the economic evidence is fairly strong about the use of capital controls, especially when used on a temporary basis. However, there is concern that the myriad trade and investment treaties across the world may prohibit the use of measures to prevent and mitigate financial bubbles and subsequent crises. There are a number of works that examine the policy space for industrial development, but very few that examine policy space for measures pertaining to financial stability (Kolo, 2009; Shadlen, 2005; Gallagher, 2005; Anderson, 2009b; Mayer, 2009). This paper conducts a comparative analysis to pinpoint the extent to which nations have the policy space for capital controls in the world economy.

The major findings of this research are exhibited in table 1. In table 1, policy space under the WTO, the United States bilateral investment treaties (BITs) and free trade agreements (FTAs), and other BITs and FTAs by other capital exporting countries is presented. Under no regime are capital controls permitted for current transactions unless sanctioned by the IMF. For the capital account however, there is interesting variation.

The WTO allows for nations to deploy capital controls on both inflows and outflows as long as nations have not committed to the liberalization of certain financial services. If a nation has made commitments in financial services, restrictions on inflows are not permitted. However, it will be shown that there are safeguard measures that may apply. In terms of recourse, if a nation that has liberalized financial services does restrict capital inflows or outflows that

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Table 1

POLICY SPACE FOR CAPITAL CONTROLS: A COMPARISON

	WTO	*United States BITs/FTAs*	*Other BITs/FTAs*
Permissible capital controls			
Current capital	No	**No**	No
Inflows	No[a]	**No**	Sometimes
Outflows	No[a]	**No**	No
Safeguard provisions			
Current capital	Yes[b]	**No**	Yes[b]
Inflows	No	**No**	Yes
Outflows	Yes	**No**	Yes
Number of countries covered	69	58	
Dispute resolution format	State-to-State	Investor-State	Investor-State
Enforcement instrument	Retaliation	Investor compensation	Investor compensation

a Capital controls fully permissible for nations that have not committed to liberalize cross-border trade in financial services.
b Permitted only under IMF approval.

nation could be subject to a dispute panel that could rule that the nation deploying the measure could be retaliated against.

The United States BITs and FTAs do not permit restrictions on inflows or outflows. If a nation does restrict either type of capital flow they can be subject to investor-state arbitration whereby the government of the host state would pay for the "damages" accrued to the foreign investor. The BITs and FTAs of other major capital exporters such as those negotiated by the European Union (EU), Japan, China and Canada, either completely "carve out" host country legislation on capital controls (therefore permitting them) or allow for a temporary safeguard on inflows and outflows to prevent or mitigate a financial crisis. The United States does not have either measure. However, a handful of FTAs have recently allowed for a grace period whereby foreign investors are not allowed to file claims against a host state until after the crisis period has subsided.

Following this brief introduction, the paper is divided into four additional parts. The second part provides a brief overview of the economic theory, policy and evidence regarding capital controls. The third part examines policy space for capital controls under the WTO. Part four provides a comparative analysis that juxtaposes the United States treaties alongside the WTO and the regional and bilateral treaties of other major capital exporting countries. Part five summarizes the key findings and offers policy recommendations.

II. Capital account liberalization and capital controls: theory and evidence

Advocates for capital market liberalization argue that, by liberalizing the flows of international capital, developing countries would benefit by getting access to cheaper credit and investment from developed markets, promoting growth and stability. Indeed, conventional theory implies that investment tends to flow to developing countries, where the marginal returns may be higher (Barro, 1997). That view, based on the assumption of perfect capital markets, has been largely discredited with the recent experiences of currency crises (Ocampo, Spiegel and Stiglitz, 2008). International capital flows tend to be

pro-cyclical, creating excess inflows during booms and causing capital flight in moments of instability, further aggravating crises.

Moreover, it has been shown that capital market liberalization in developing countries is not associated with economic growth (Prasad et al., 2003). Indeed, the most recent research has shown that capital market liberalization is only associated with growth in nations that have reached a certain institutional threshold – a threshold that most developing nations are yet to achieve (Kose, Prasad and Taylor, 2009). This is partly due to the fact that the binding constraint for some developing country growth trajectories is not the need for external investment, but the lack of investment demand. This constraint can be accentuated through foreign capital flows because such flows appreciate the real exchange rate, thus reducing the competitiveness of goods and reducing private sector willingness to invest (Rodrik and Subramanian, 2009).

Capital controls have been found to stabilize short-term volatile capital flows; and can give policy-makers additional policy instruments that allow them more effective and less costly macroeconomic stabilization measures; can promote growth and increase economic efficiency by reducing the volatility of financing and of real macroeconomic performance; and can discourage long-term capital outflows (Ostry et al., 2010). The literature on capital controls generally discusses at least six (somewhat overlapping) core reasons why nations may want to deploy them (Magud and Reinhart, 2006). These can be referred to as “the six fears” of capital flows:

1. **Fear of appreciation**: capital inflows cause upward pressure on the value of the domestic currency, making domestic producers less competitive in the international market, hurting exports and therefore the economy.
2. **Fear of “hot money”:** the large injection of money into a small economy may cause distortions and eventually a sudden reversion if foreign investors try to leave simultaneously.
3. **Fear of large inflows:** large volumes of capital inflows, even if not all hot money, can cause dislocations in the financial system.
4. **Fear of loss of monetary autonomy**: a trinity is always at work: it is not possible to have a fixed (or highly managed) exchange rate, monetary policy autonomy and open capital markets. Specifically, when central banks intervene in the exchange market buying foreign currency in order to curb the appreciation of the exchange rate, they effectively increase the domestic monetary base. Trying to raise interest rates to offset that effect causes more capital inflows, as foreign investors rush in to take advantage of higher yields.
5. **Fear of Asset Bubbles**, raised by Ocampo and Palma (2008): This is a particularly important issue in the 2008 financial crisis, since the bursting of the real state bubble was the root cause of the banking crisis around the globe.
6. **Fear of capital “flight**”: capital may rapidly leave a nation in the event of a crisis or because of contagion (Grabel, 2003; Epstein, 2005).

Table 2 exhibits a sample of various types of capital controls that have been deployed by nations to address these fears.

Table 2

CAPITAL CONTROLS AND CAPITAL MANAGEMENT TECHNIQUES

Inflows

- Restrictions on currency mismatches[a]
- End use limitations[b]
- Unremunerated reserve requirements[c]
- Taxes on inflows
- Minimum stay requirements
- Limits on domestic firms and residents from borrowing in foreign currencies
- Mandatory approvals for capital transactions
- Prohibitions on inflows

Outflows

- Limits on ability of foreigners to borrow domestically
- Exchange controls
- Taxes / restrictions on outflows
- Mandatory approvals for capital transactions
- Prohibitions on outflows

Source: Ocampo, Kregel and Griffith-Jones, 2007; and Epstein, Grabel and Jomo, 2008.

a Borrowing abroad only allowed for investment and foreign trade.

b Only companies with foreign currency reserves can borrow abroad.

c Per cent of short-term inflows kept in deposit in local currency for specified time.

Economists usually differentiate between capital controls on capital inflows and controls on outflows. Moreover, measures are usually categorized as being "price-based" or "quantity-based" controls. Table 2 lists examples of controls on inflows and outflows, though sometimes the distinction can be murky (Epstein, Grabel and Jomo, 2008; Ocampo, Kregel and Griffith-Jones, 2007). Examples of quantity-based controls are restrictions on currency mismatches and minimum stay requirements and end-use limitations. Many of these have been used by nations such as China and India. Examples of price-based controls include taxes on inflows (Brazil) or on outflows (Malaysia). Unremunerated reserve requirements (URR) are both. On one hand they are price-based restrictions on inflows, but they also include a minimum stay requirement which can act like a quantity-based restriction on outflows.

Controls are most often targeting foreign-currency and local currency debt of a short term nature. Foreign direct investment (except for FDI in the financial sector) is often considered less volatile and worrisome from standpoint of macroeconomic stability. Inflow restrictions on currency debt can reduce the overall level of such borrowing and steer investment toward longer-term productive investments and thus reduce risk. Taxes on such investment cut the price differential between short and long term debt and thus discourage investment in shorter term obligations. Outflows restrictions and measures are usually deployed to "stop the bleeding" and keep capital from leaving the host nation too rapidly.

According to the IMF, between 2004 and 2009, 46 nations deployed capital controls 117 times. These figures should be seen as underestimates, because Central Banks voluntary report such information to the International Monetary Fund (IMF), which until recently did not see capital controls as favourable actions. Examples include URRs by Colombia and Thailand, taxes on inflows by Brazil, taxes on all financial transactions by Bolivia and quantitative restrictions on inflows and outflows by China (IMF, 2009).

The literature on the effectiveness of capital controls is too vast to cover here. However, two comprehensive assessments of the literature have recently been conducted. In sum, the literature strongly supports the use of capital controls on inflows. Evidence on outflows is more controversial. Magud and Reinhart (2006) conduct the most assessment of the literature to 2006. In their analysis, they express concern over the lack of a unified theoretical framework to analyze the macroeconomic consequences of the controls, the heterogeneity of countries and control measures, the multiplicity of policy goals and what constitutes "success". As most studies investigate a few country cases (mainly Chile and Malaysia), it is difficult to make generalized conclusions from the literature in the field. Theirs is the most valiant attempt to overcome these shortcomings. What's more, the authors also "weight" the findings in the literature with respect to their econometric rigor.

To summarize, say Magud and Reinhart (2006), "in sum, capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows and reduce real exchange rate pressures". In terms of outflows, it is clear that such provisions were successful in Malaysia, but it is not so clear about the case of other nations (table 3).

In a February 2010 Staff Position Note (2010), the 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). To come to this conclusion, this recent and landmark IMF study reviews the experiences of post-Asian crisis capital controls. The IMF also conducted its own cross-country analysis in this study, which also has profound findings. The econometric analysis conducted by the IMF examined how countries that used capital controls fared versus countries that did not use them in the run-up to the current crisis. 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" (IMF, 2010: 19).

There has even been some attention by prominent economists on the need for restrictions on outflows. Calvo (2009) argues that capital controls could be deployed to dampen the impact of capital flight during crises. Even in "normal" times however, Calvo argues that prudential regulations should sometimes be coupled with foreign exchange restrictions to reduce capital flight.

Table 3

LITERATURE ON THE EFFECTIVENESS OF CAPITAL CONTROLS

	Reduce the volume of capital flows?	*Alter the composition of flows?*	*Reduce real exchange rate pressures?*	*Make monetary policy more independent?*
Controls on inflows				
Brazil	Unclear	Yes	No	Unclear
Chile	Unclear	Yes	Unclear	Yes
Colombia (1993)	Yes	Yes	Yes	Yes
Colombia (2007)	No	Yes		
Czech Republic	No	Yes		
Malaysia (1989)	Yes	Yes		
Malaysia (1994)	Yes	Yes	Yes	Yes
Thailand	Yes	Yes	Yes	Yes
Croatia		Yes		
Controls on outflows				
Malaysia (1998)			Unclear	Yes
Spain	Unclear		Unclear	Unclear
Thailand	Yes		Yes	Yes
Multi-country studies	Yes	Yes	Yes	No

Source: Magub and Reinhart, 2006; and IMF, 2010.

To summarize, there is an emerging consensus in the economics profession regarding capital controls. Capital controls, especially those on inflows, are increasingly seen as a prudential measure for developing countries hoping to prevent and mitigate financial crises.

III. Policy space for capital controls at the WTO

This section of the paper examines the extent to which the WTO, grants nations the policy space to deploy capital controls. The key of WTO law that covers capital flows is the General Agreement of Trade in Services (GATS). The GATS is currently the only binding multilateral pact that disciplines capital controls, though specific countries may have certain freedoms if the governments in place in the 1990s did not make widespread commitments in the financial services sector. More specifically:

- A member is most protected from a WTO challenge over capital controls if it committed no financial services sectors to GATS coverage in any mode.
- However, even nations that have made widespread commitments in financial services may have – if challenged – recourse to various exceptions, although these have not been tested and the record of WTO exceptions in other contexts is not reassuring.
- The policy space for controls on *current* account transactions defers to the IMF.

A. The General Agreement on Trade in Services

The GATS is part of the Marrakesh Treaty that serves as an umbrella for the various agreements reached at the end of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) negotiations that established the WTO. The GATS provides a general framework disciplining policies "affecting trade in services" and establishes a commitment for periodic future negotiations. The GATS is divided on the one hand into a part on "General

Obligations", which binds all members. These include the obligation to provide most favoured nation treatment to all WTO members (Article II), and some disciplines on non-discriminatory domestic regulations that are still being fully developed (Article VI).

On the other hand, the GATS also includes a part dealing with "Specific Commitments", which apply only to the extent that countries choose to adopt them by listing them in their country specific schedules. These cover primarily the disciplines of Market Access (Article XVI) and National Treatment (Article XVII) (Raghavan, 2009).

Numerous annexes cover rules for specific sectors: the Annexes on Financial Services are of particular relevance for capital controls. However, trade in services occurs across the four services modes discussed in the GATS in general:

> **Mode 1: Cross-border supply** is defined to cover services flows from the territory of one Member into the territory of another Member (e.g. banking or architectural services transmitted via telecommunications or mail);
>
> **Mode 2: Consumption abroad** happens when the consumer travels outside of the country to access a service such as tourism, education, health care and so forth;
>
> **Mode 3: Commercial presence** occurs when the user of a financial service is immobile and the provider is mobile, implying that the financial service supplier of one WTO Member establishes a territorial presence, possibly through ownership or lease, in another Member's territory to provide a financial service (e.g. subsidiaries of foreign banks in a domestic territory); and
>
> **Mode 4: Presence of natural persons** are when financial services are supplied by individuals of one country in the territory of another.

IMF analysts have found that about 16 countries have significant Mode 1 commitments in financial services, while around 50 each have significant Mode 2 and 3 commitments for the sector – this includes most OECD countries (Valckx, 2002; Kireyev, 2002).

Generally speaking, GATS negotiations and commitments are of a "positive list" approach, whereby nations only commit to bind specified sectors to GATS disciplines. This stands in contrast with a "negative list approach", which is more common for goods negotiations and in most FTAs. In a negative list or "top down" approach, negotiators assume that all sectors will be covered in some way, except a handful that are listed by particular nations.

WTO members have recourse to binding dispute settlement procedures, where perceived violations of GATS commitments can be challenged and retaliatory sanctions or payments authorized as compensation.

B. *Capital account liberalization, capital controls and GATS*

Unbeknownst to many, GATS commitments require the simultaneous opening of the capital account. Those nations that make commitments under Modes 1 and 3 for financial services are required to permit capital to flow freely to the extent that such capital is an integral part of the service provided – though some exceptions may apply. GATS Article XVI on Market Access contains a footnote (8) that references capital liberalization:

> If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I [i.e. Mode 1] and if the cross-border movement of capital is an essential part of the service itself, *that Member is thereby committed to allow such movement of capital*. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I [i.e. Mode 3], *it is thereby committed to allow related transfers of capital into its territory*. [italics added]

While Modes 1 and 3 are explicitly referred to here, Article XI(2) also refers to capital liberalization:

> Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that *a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions*, except under Article XII or at the request of the Fund. [italics added]

Taken together, these provisions indicate that a country that makes GATS financial service commitments in the modes of cross-border trade (Mode 1) and establishment of commercial presence (Mode 3) may explicitly be required to open its capital account. In such instances, the nation's ability to deploy capital controls *related to capital inflows* would be restricted. The text is silent on whether capital controls related to capital outflows are similarly disciplined.

As an aside, capital account transactions are not restricted under the IMF Articles Agreement, and thus nations are free to choose whether capital controls are part of their arsenal to prevent and mitigate financial crises. However, a distinction needs to be made with respect to *financial services* and *capital flows*. Under the GATS, nations liberalize specific types of financial services, such as banking, securities, insurance and so forth – which does not necessarily imply capital movements or changes in fundamental capital account regulation.

However, there are scenarios where the liberalization of financial services will require an open capital account. The IMF cites the following Mode 1 example, where "a loan extended by a domestic bank to a foreign customer using internationally raised capital creates international capital flows and international trade in financial services. 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" (Kireyev, 2002). Another paper by an IMF official provides examples of how the GATS Mode 1 essentially requires the liberalization of a capital account:

> ... to the extent that a member restricts its residents from borrowing from non-residents, a member's commitment to allow banks of other members to provide cross-border lending services to its nationals would require a relaxation of this restriction. Similarly, if a member also makes a commitment to permit non-resident banks to provide cross-border deposit services, such a commitment would require the member to liberalize restrictions it may have imposed on the ability of residents to hold accounts abroad. In these respects, the GATS serves to liberalize the making of both inward and outward investments (Hagan, 2000).

This is echoed in a recent book by Sydney Key (2003) who says "The bottom line is that if a country makes a commitment to liberalize trade with respect to a particular financial service in the GATS, it is also making a commitment to liberalize most capital movements associated with the trade liberalization commitment. The WTO, in a recent paper (2010), quoted from Key's work to make the same point. In other words, liberalizing cross-border trade in financial services (Mode 1) may need an open capital account to facilitate such trade that of course results in international capital flows. A similar scenario can be outlined in terms of Mode 3 liberalization. A loan extended by a foreign bank to a domestic client requiring capital to be transferred from the parent company of the foreign bank to its subsidiary abroad would also require an open capital account. In any event, it is worth noting that WTO panels are not bound to the IMF's distinction between service transactions and capital flows.

If a nation has not listed cross border trade in financial services (Mode 1) or commercial presence of foreign services (Mode 3), that country may be free to deploy capital controls as they see fit. Indeed, numerous developing nations have not "listed" the liberalization of cross-border trade in financial services nor Mode 3 commitments under the GATS. According to the WTO, the majority of developing countries made relatively less commitments in financial services related to capital markets (WTO, 2010).

It is also possible that certain types of measures may be more GATS compliant than others. Article XVI, paragraph 2 is seen as a non-exhaustive list of the types of financial services whereby a host nation "shall not maintain" restrictions on the flow of capital. The list of measures does not explicitly mention any of the capital controls and other capital management techniques found in table 2. Therefore, a case could be made that capital controls of the kind discussed in table 2 are not even covered by the GATS.

If a nation's capital controls were found in violation of its GATS commitments, it could invoke one or more exceptions in the GATS text. A first option would be to claim that the measure was taken for prudential reasons under Article 2(a) of the Annex on Financial Services. This exception reads:

> 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.

Inflows controls such as unremunerated reserve requirements or inflows taxes could be argued to be of a prudential nature, especially given the new IMF report discussed earlier. However, the sentence stating that prudential measures "shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement" is regarded by some as self-cancelling and thus of limited utility (Tucker and Wallach, 2009; Raghavan, 2009). Others however do not see the measure to be second-guessing but rather "as a means of catching hidden opportunistic and protectionist measures masquerading as prudential" (Van Aaken and Kurtz, 2009). Still others point out that, in contrast with other parts of the GATS that require a host nation to defend the "necessity" of the measure, there is no necessity test for the prudential exception in the GATS. This arguably gives nations more room to deploy controls. Indeed, Argentina lost cases related to controls under BITs because they failed such a "necessity test"(Burke-White, 2008). Nations have requested that the WTO elaborate on what is and is not covered in the prudential exception, but such requests have fallen on deaf ears (Cornford, 2004). And as of this writing, the prudential exception has not been tested.

If a country's capital controls were found in violation of its GATS commitments in financial services, it could also invoke Article XII "Restrictions to Safeguard the Balance of Payments" (BOP). Paragraph 1 of Article XII states:

> 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.

The next paragraph specifies that such measures can be deployed as long as they do not discriminate among other WTO members, are consistent with the IMF Articles (thus pertain only to capital account controls), "avoid unnecessary damage" to other members, do "not exceed those necessary" to deal with the balance-of-payments problem, and are temporary and phased out progressively.

It may be extremely difficult for a capital control to meet all of these conditions, especially the hurdles dealing with the notion of "necessity", a slippery concept in trade law that countries have had difficulty proving. Moreover, concern has been expressed about the extent to which the balance-of-payments exception provides nations with the policy place for restrictions on capital inflows that are more preventative in nature and may occur before "serious" balance-of-payments difficulties exist (Hagan, 2000). If a nation does choose to use this derogation, the nation is required to notify the WTO's Balance-of-Payments Committee (described below).

Table 4 lists the 37 economies that have committed to scheduling the liberalization of some combination of Modes 1, 2 and 3 under the GATS (Valckx, 2002). They would be the most prone to

Table 4

MOST VULNERABLE TO ACTIONS AGAINST CAPITAL CONTROLS UNDER GATS

Argentina	Mongolia
Australia	Mozambique
Bahrain	New Zealand
Canada	Nigeria
China, Hong Kong	Norway
China, Macao	Panama
Ecuador	Philippines
Estonia	Qatar
Gabon	Romania
Gambia	Sierra Leone
Hungary	Singapore
Iceland	Solomon Islands
Indonesia	South Africa
Japan	Switzerland
Kuwait	Tunisia
Kyrgyzstan	Turkey
Latvia	United Arab Emirates
Malawi	United States
Mauritius	

Source: Valckx, 2002.

being disciplined under GATS. Finally, there is not a reassuring record of countries being able to invoke exceptions at the WTO.

C. Capital controls and current transactions

Capital controls on the inflows or outflows of dividends, interest payments and the like are *current account* restrictions. Remember that, as a rule, the IMF Articles of Agreement do not permit current account restrictions. However, the IMF may recommend diversion from those rules during a crisis and/or under an IMF financial programme. In these circumstances, Article XI, paragraph 2 of the GATS applies. This article states that the IMF has jurisdiction over these types of circumstances and the GATS does not apply. Therefore, when a country is permitted by the IMF as part of an IMF financial programme to pursue capital controls on current transactions, as has been the case with Iceland in 2008–09, then the WTO has no jurisdiction over the use of controls.

When a nation seeks to pursue capital controls related to the current account and such actions are not part of an IMF Financial programme, the nation has the potential to do so but has to submit a request to the WTO's Balance-of-Payments Committee.

D. The Balance-of-Payments Committee

Any capital control involving capital or current account restrictions must be submitted to the Committee on Balance-of-Payments Restrictions, which was established for the earlier BOP safeguard under GATT and was traditionally responsible for consultation dealing with trade restriction for balance-of-payment purposes. The same body and procedures now apply to financial and other services.

The Committee has never pronounced on any current or capital account restrictions related to financial services, but the GATS text specifies that consultations related to these matters can evaluate whether the CMT meets the various criteria outlined above, whether "alternative corrective measures … may be available" and "in particular" whether the measure is progressively phased out.

This is a unique procedure in the GATS. While the WTO compatibility of a country's domestic policy normally is only tested through formal dispute settlement proceedings, CMTs face an additional set of hurdles and proceedings under Article XII.

Returning to some of the key questions outlined above, the following can be said about the WTO in relation to capital controls. While the WTO's financial services provisions remain untested in formal dispute settlement, they nonetheless represent the world's only multilateral body with enforcement capacity to discipline capital controls, on terms that provide less policy space than the IMF Articles of Agreement. Capital controls may be disciplined under the WTO for approximately 50 of the WTO members. If a nation has made commitments in financial services, restrictions on Inflows are explicitly mentioned in the market access provisions of the GATS (though not one capital control is explicitly listed in the non-exhaustive list) but outflows may also be covered. In terms of compliance, the potential penalty for non-compliance is sustained cash payments or cross-retaliation rights to a large set of complaining countries. When nations file claims, the dispute resolution process is "state-to-state" rather than "investor-state" which will be discussed later in the report.

IV. Capital controls in the United States trade and investment treaties

The United States has engaged in investment treaty-making since its War of Independence through what were called Friendship, Commerce and Navigation treaties. The successors to those agreements are bilateral investment treaties (BITs), which the United States has been negotiating since 1977. The United States did not invent BITs; Europeans have BITs going back to 1959. Indeed, there are now close to 2000 BITs in existence. Beginning with the North American Free Trade Agreement (NAFTA) in 1994, the United States FTAs also have investment provisions analogous to those found in BITs. Finally BITs and FTAs also include provisions on financial services.

The United States has concluded 46 BITs since 1977 and more recently has used very similar language to the BITs as part of investment chapters in 12 United States Free Trade Agreements (FTAs) (Vandevelde, 2008). This section of the paper reveals that the United States-style investment rules run far

deeper and include many more limitations on the ability of nations to deploy capital controls. Specifically, the United States investment rules:

- Elevate the rights of the United States capital investors over domestic capital investors, whereby the United States investors can file claims against violating parties through an investor-state dispute settlement process and receive financial compensation for violations, while domestic investors do not have such rights;
- Do not permit restrictions on both capital inflows and outflows;
- Provide no clear exceptions for balance-of-payments exceptions, though some FTAs provide a grace period for filing investor-state claims.

This section of the paper will have two parts. First will be short background on the purpose and main provisions of the United States BITs and investment components of FTAs. Second will be an examination of the extent to which nations may deploy capital controls under the United States BITs and FTAs.

A. *Investment provisions in the United States BITs and FTAs*

BITs and investment provisions in the United States FTAs have evolved over time to have at least five general features. Normally, through an interagency process and with input from outside experts and interests, the United States puts together a "Model BIT" that serves as the template for negotiations for BITs and FTAs:

> The model would be tendered to the other party at the beginning of negotiations with the hope that agreement would be reached on a text that did not differ substantively or even in a significant stylistic way from the model. If too many departures from the model were demanded by the other party, then no BIT would be concluded (Vandevelde, 2008: 1).

Scholars have characterized the model BITs and subsequent treaties as occurring in three "waves", from 1981 to the early 1989 where 35 BITs were negotiated, from the early 1990s to 2002 where the NAFTA and a handful of BITs were signed, and from 2002 to the present where FTAs with Chile, Singapore and Central America were negotiated (Vandevelde, 2008). Table 5 lists all United States BITs and FTAs with investment provisions based on the various models. In 2009 the United States engaged in a review of the 2004 Model BIT that formed the core of most United States BITs and investment components of FTAs. The new model is scheduled for release in mid-2010 and may be used for negotiations of BITs with China, India and Brazil, and in FTA negotiations with Pacific nations.

Table 5

UNITED STATES BITs AND FTAs

Countries with BIT	*Countries with FTA*
Albania	Australia
Argentina	Bahrain
Armenia	Canada
Azerbaijan	Chile
Bahrain	Costa Rica
Bangladesh	Dominican Republic
Bolivia	El Salvador
Bulgaria	Guatemala
Cameroon	Honduras
Congo	Israel
Croatia	Jordan
Czech Republic	Mexico
Dem. Rep. of the Congo	Morocco
Ecuador	Nicaragua
Egypt	Oman
Estonia	Peru
Georgia	Singapore
Grenada	
Honduras	
Jamaica	
Jordan	
Kazakhstan	
Kyrgyzstan	
Latvia	
Lithuania	
Mongolia	
Morocco	
Mozambique	
Panama	
Poland	
Republic of Moldova	
Romania	
Senegal	
Slovakia	
Sri Lanka	
Trinidad and Tobago	
Tunisia	
Turkey	
Ukraine	
Uruguay	

Source: http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp; http://www.ustr.gov/trade-agreements/free-trade-agreements.

This paper will focus on the treaties completed up through the 2004 model BIT, the last being the BIT with Rwanda and the FTAs with Peru, Colombia, Panama and the Republic of Korea (the latter three signed but not ratified at this writing). In terms of coverage, whereas the earliest BITs and FTAs focused almost solely on foreign direct investment, contemporary treaties cover both inflows and outflows of virtually all types of investment, including equities, securities, loans, derivatives, sovereign debt and the financial services facilitators of such flows. According to Vandevelde (2008), there are five general components of the United States BITs and subsequent provisions in the United States FTAs:

1. **Minimum Standard of Treatment** that an investor should enjoy, including national treatment and most-favoured nation status in both the pre-establishment and post-establishment rights. On an absolute level, the United States investors are to receive "fair and equitable treatment and full protection in accordance to customary international law.
2. **Restrictions on Expropriation.** BITs and FTAs strictly forbid the direct or indirect expropriation of the United States investments absent prompt and full compensation.
3. **Free Transfers.** The United States nationals and firms must be permitted to freely transfer payments in and out of a host country "without delay". This will be discussed in detail below.
4. **No performance requirements.** The United States BITs forbid nations from imposing performance requirements such as local content rules, joint venture and research and development requirements, export requirements, rules related to personnel decisions and so forth.
5. **Investor-state Arbitration.** In stark contrast to dispute settlement under the WTO and all other aspects of FTAs other than investment rules, the United States firms have the right to binding arbitration of disputes related to violations of the agreements. As is the case with most BITs across the world, foreign firms do not have to file claims through governments but can take a claim to an arbitral panel, often the International Centre for the Settlement of Investment Disputes (ICSID) at the World Bank for any perceived violation of the above principles.

In addition to these core elements, the United States treaties often have some so-called "exceptions" such as for essential security, matters related to taxation (where there is another body of the United States international law) and others. Finally, post-2004 BITs have putative limitations on the ability of host states to reduce environment or labour laws to attract foreign investment. Before moving forward, it should be underscored that these treaties elevate foreign investor rights over domestic investors, as they do not require the host country's firms to liberalize their investments, nor do they permit host country investors to use investor-state arbitration (Hagan, 2000). Table 5 lists those nations with a BIT or FTA with the United States.

B. *Capital controls and the United States BITs and FTAs*

The free transfer of funds to and from the United States is a core principle of the United States BITs and FTAs, as well as those of most other capital exporting countries. When a host nation violates that principle, or if capital transfers violate the other principles, a nation could be subject to an investor-state arbitration claim where they could be sued for damages. All of the United States BITs and FTAs therefore restrict the ability of host nations to deploy capital controls (Anderson, 2009a). Argentina, after its crisis in 2001–02, was subject to numerous such claims in the hundreds of millions of dollars.

All United States BITs and FTAs require host nations to permit free transfers without delay of all types of covered investments. Moreover, financial services are covered in BITs and comprise a separate chapter in FTAs. Analogous to the GATS, if a nation commits to liberalizing financial services, the free flow of such investment are covered there as well. It should be noted however that under the services chapters of FTAs, dispute resolution is state-to-state.

Over the years, the United States treaties have listed numerous types of investments covered, such as securities, loans, FDI, bonds (both sovereign and private) and derivatives. Treaties also make a point to say such a list is non-exhaustive. Taken together, the transfers provisions, along with the other principles of the agreements ensure that an investment can enter and leave a nation freely. If such an investment is restricted, a host-nation can be subject to arbitration.

Of all the treaties the United States has signed, there is only one clear exception to this rule, the

balance-of-payments exception found in NAFTA. Article 2014(1) can be invoked when the host state "experience serious balance-of-payments difficulties, or the threat thereof". Like similar exceptions at the WTO and the Organisation for Economic Co-operation and Development (OECD), use of the exception must be temporary, non discriminatory and consistent with the IMF Articles of Agreement; thus, capital controls can only be aimed at capital account transactions unless approved by the IMF.

C. *"Cooling off" provisions*

As discussed earlier, Chile is a nation that has deployed capital controls to some success. The United States negotiated FTAs with Chile and Singapore (who had also used capital controls in the wake of the 1997 Asian crisis) at the turn of the century, both went into force in 2004. The limits in the United States model on capital controls became major sticking points for both Chile and Singapore. In fact, during the negotiations with Chile, USTR head Robert Zoellick had to intervene with the Finance Minister of Chile to salvage the negotiations over this issue. During those negotiations, the United States negotiated a "compromise" that, with some variation, has been used in agreements with Singapore, Peru and Colombia. Interestingly however, it has not become a matter of practice. Such a cooling off period was not included in the 2004 Model BIT nor the FTAs with the Dominican Republic-Central America-United States Free Trade Agreement (DR-CAFTA), Panama and others.

The compromise has since become known as the "cooling off" provision whereby the United States cannot file a claim as in violation of the investment provisions until a period of one-year after the provision has been deployed. The cooling off periods are illustrated in an Annex to the agreements. The rationale would be that the host nation may need to address or stem a financial crisis and that the nation should not be subject to claims in the middle of such action. However, and this is important, the cool off period allows a foreign investor to sue for damages related to capital controls that were deployed during the cool off year, but cannot file the claim until after that year. To be clear, an investor has to wait one year to file a claim related to capital controls to prevent and mitigate crises, but that claim can be for a measure taken during the cooling off year (Hornbeck, 2003).

It should also be noted that these provisions are not mutual. The cooling off period is only for investors suing "a Party other than the United States". Finally, the Annexes agree that once the claim is brought, only "actual reduction of the value of the transfer" counts as a loss. Loss of profits, loss of business and other similar consequential or incidental damages cannot be recovered. All of these agreements include some exceptions to the Annex, instances where the cooling off period and limitation on damages does not apply: payments on current transactions, on transfers associated with equity investments, and loan or bond payments.

The cooling off language triggered controversy in the United States, leading to hearings specifically on the subject on 1 April 2003 at the Subcommittee on Domestic and International Monetary, Trade and Technology of the Committee on Financial Services in the United States House of Representatives (US House of Representatives, 2003). The committee was chaired by Congressman Michael Oxley (R-Indiana, majority), with the minority head being Barney Frank (D-Massachusetts, minority). In general, the lively hearings revealed that most Republicans were against the use of capital controls, whereas Democrats favoured more flexibility. The hearings were very lively.

The leading advocate for restricting capital controls was John Taylor, then Under-Secretary of the United States Treasury for International Affairs in the Bush Administration. As a Stanford University economist he had become famous for the "Taylor Rule" that sets a formula for inflation targeting. Insiders thus began referring to the cooling off provisions as the "Taylor Provisions". Interestingly, the hearings included harsh rebuttals to Taylor by Nancy Birdsall of the Center for Global Development, Jagdish Bhagwati of Colombia University and Daniel Tarullo, then of Georgetown University and now on the Board of Governors of the United States Federal Reserve System. These individuals are staunch supporters of free trade in goods, but argued that capital account liberalization without exception is dangerous from economic and foreign policy perspectives. Congresswoman Carolyn Maloney (D-New York, now chair of Joint Economic Committee) argued in favour of flexibility. At the hearings, Barney Frank famously remarked that "ice is in the eyes of the beholder", arguing that the cooling off period still effectively restricts Chile and Singapore from using capital controls.

Around the same time, senior IMF officials in the legal department wrote articles arguing that BITs should have at least temporary derogations for balance-of-payments difficulties and that the cooling off period was not sufficient. Hagan (2000) expresses concern that if one nation forbids a host country from using capital controls on a temporary basis, but the host country is permitted to use controls under agreements with other nations, then the controls will be discriminatory in nature and lead to distortions. Siegel (2004) who called the cooling off provisions "draconian", expressed concern that the United States transfers provisions raised jurisdictional issues with the IMF. The United States provisions call for free transfers of all current transactions, but unlike WTO, OECD and other capital exporters, the United States provisions do not include mention of the ability of the IMF to recommend capital controls as part of a financial programme. Siegel argues that FTAs "create a risk that in complying with its obligations under the FTA, a member could be rendered ineligible to use the Fund's resources under the Fund's articles" (Siegel, 2004: 4). Finally, in meetings with IMF officials, concern was expressed over the lack of consistency between the United States agreements and others. For instance, the Republic of Korea has a broad exception under the OECD codes and its other BITs, but not with the United States. Which measure holds?

D. Illustrative discussion of capital controls and violations of the United States investment rules

It should be clear from the above discussion that capital controls are in fundamental violation of the core principle in the United States trade and investment treaties that requires the free transfer of funds without delay. That said, it is important to understand exactly how these provisions work in relation to various types of controls. Such an exercise reveals that it is possible that some kinds of capital controls may be able to slip through the United States investment rules. However, given that there are no derogations in the United States treaties, such possibilities are far from certain. Some of the avenues in which capital controls could be actionable under the United States BITs and FTAs are exhibited in table 6.

Capital inflow restrictions such as URRs, minimum stay requirements, outright prohibitions on certain types of inflows are designed to keep out or slow the flow of short-term inflows into an economy. On the surface, restrictions on inflows may escape violation because an investor has to show that the investor has been "damaged" or that the value of an investment has been diminished in order to file a claim. Instruments to prevent an investment before

Table 6

POSSIBLE CONFLICTS BETWEEN CAPITAL CONTROLS AND THE UNITED STATES AGREEMENTS

Capital control	*Potential conflict*
Restrictions on currency mismatches	Absolute violation of transfers and services provisions, dimishes value of investment
Unremunerated reserve requirements	Absolute violation of transfers provisions, diminishes value of investment and analogous to an expropriation if an investor wanted to retrieve its funds during the "minimum stay" portion of the URR
Taxes on inflows	Relative violation of pre-establishment national treatment, diminishes value of investment, could be seen as expropriation
Minimum stay requirements	Absolute violation of transfers provisions analogous to an expropriation if an investor wanted to retrieve its funds during the "minimum stay"
Taxes/restrictions on outflows	Absolute violation of transfers and services provisions, possible expropriation

it occurs therefore may have more "cover" under the agreements. However, restrictions on inflows violate the ability of investors to have market access and national treatment pre-establishment. A claim could arise simply on those grounds or because an investor who may have made previous investments in a host country and is suddenly not permitted to do so because of a capital control, could claim that the investor no longer enjoys fair and equitable treatment and the minimum standard of treatment under the agreement. What's more, if an investor wanted to pull funds from a country that were held by a URR or minimum stay requirement (as a form of outflow then), the capital control would restrict the free transfer out of the country and clearly be subject to a claim – as would almost all the other outflows measures listed in table 2. Indeed, not only do restrictions on outflows violate transfers provisions, but they can also be seen as expropriations. Moreover, if a nation has committed to liberalizing financial services under the services chapter of an FTA, all inflows and outflows that pertain to the (negatively) listed service cannot be restricted.

One other possible avenue for policy space may be available for limits by domestic firms or domestic residents in borrowing or lending abroad. Remember that investment rules do not cover domestic investors, nor are domestic investors able to resort to investor-state dispute settlement. On the surface, such a provision would not be subject to a claim as a violation of the transfers provisions because such restrictions to not consider a covered investment. However, it may be possible that a claim could arise by an investor arguing that national treatment principles had been violated. By restricting the United States banks from lending in dollars, it could possibly be claimed that a nation is treating its domestic currency more favourably. An investor may attempt to claim that a measure of this kind is in violation of fair and equitable treatment for reasons discussed above.

One window that would appear to be available to nations is the ability to tax capital inflows and outflows. Brazil taxed inflows of capital in late 2009, Malaysia taxed outflows in 1998–99. All United States treaties have a chapter or series of paragraphs discussing taxation, saying that "nothing in Section A shall impose obligations with respect to taxation measures". Yet, it distinguishes between traditional taxation and taxation that may be expropriating. Thus, the evidence is not clear cut. In one of the numerous cases against Argentina in the aftermath of its 2000–01 crisis, an ICSID tribunal ruled that a tax on outflows was tantamount to an expropriation (Salacuse, 2010).

It may be possible that a nation can claim that actions taken during a financial crisis are measures needed to protect the essential security of the nation. Language like Article 18 of the United States Model BIT is found in most treaties:

> ... to preclude a Party from applying measures that it considers necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests (USTR, 2004).

The article does not mention economic crises per se, but "all tribunals that have considered the matter thus far have interpreted the rules broadly enough to include such crises" (Salacuse, 2010: 345). However, tribunals differ greatly over how grave the difficulties may be. In Argentina again, only one of three tribunals ruled that Argentina could not be held liable for actions it took to halt its crisis (Salacuse, 2010). A key matter is whether or not a measure by a nation to stem a crisis can be seen as "self-judging". In other words, can the nation deploying the control be the judge of whether or not the measure taken was necessary to protect its security. The language quoted above in the 2004 Model BIT, which says "that *it* considers" is now seen as to mean that a measure is self judging (because of the "*it"*), but Argentina's BITs with the United States and others did not include as precise language at the time.

Finally, Article 20.1 of the 2004 Model BIT includes a provision on prudential measures that has almost the exact language found in the GATS under domestic regulations. It reads:

> Notwithstanding any other provision of this Treaty, a Party shall not be prevented from adopting or maintaining measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party's commitments or obligations under this Treaty (USTR, 2004).

This language is only to be found in the United States-Rwanda BIT that is yet to be ratified and not found in the United States FTAs. Regarding capital controls, the United States Government has stated that it is not its intention that controls be covered under this provision (US Department of State Advisory Committee on International Economic Policy, 2009). As discussed earlier, some have expressed concern that the last sentence of this paragraph may be self-cancelling, others see it as quite flexible (Key, 2003; Raghavan, 2009; Stumberg, 2009; Tucker and Wallach, 2009; Van Aaken and Kurtz, 2009).

V. The United States investment provisions versus others by major capital exporters

The investment provisions in the United States FTAs and of the United States BITs stand in stark contrast to the treaties of other major capital exporting nations. This section of the paper reviews the measures in the OECD codes of liberalization and some specific treaties by the EU, Canada, Japan and China.

A. OECD codes

In many respects, the OECD has the most expansive investment rules, as they cover all types of capital flows, whether they are from the current or capital account. However, the OECD also has the broadest level of temporary derogations. Similar scope and derogation can be found in the OECD-sponsored Multilateral Agreement on Investment (MAI), which was never agreed upon. In terms of policy space for capital controls under the OECD Codes and the MAI:

- Members (OECD members) are expected to liberalize both the current and capital account.
- Members have a broad, but temporary derogation where capital controls on both inflows and outflows are permitted.
- The OECD's draft MAI included a broad derogation analogous to that of the Codes.

Incorporated in the early 1960s, two legally binding "Codes" govern capital flows in OECD countries, the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations – usually referred to as the Capital Movements Code and the Current Invisible Code. These codes cover all types of investments – inflows and outflows from the current and capital account – and require their liberalization.

Initially, speculative capital was excluded from the Codes on grounds that short-term capital would disrupt the balance-of-payments position of OECD members and make it difficult for nations to pursue independent monetary and exchange rate policies. This was changed in 1989 when a group of nations led by the United Kingdom and Germany who argued that all OECD nations by then had sophisticated enough money markets that they could withstand liberalization of short-term flows. All nations that acceded to the OECD since 1989, regardless of their level of development, also liberalized their capital accounts fully to include short and long-term maturities. The Republic of Korea, however, in its accession, argued that it should have a grace period to gradually open their capital account as they developed. The OECD denied this request, conditioning membership on an open capital account. In the end, the Republic of Korea conceded (Abdelal, 2007).

Alongside the broad mandates for OECD countries there are also broad exceptions. Article 7 (in each set of Codes) holds the "clauses of derogation" that govern the temporary suspension of commitments. Under these safeguards, a nation may suspend liberalization. Article 7b allows a member to put in place temporary capital controls to stem what may "result in serious economic disturbance in the Member State concerned, that Member may withdraw those measures". Article 7c is the balance-of-payments exception "If the overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious that Member may temporarily suspend the application of measures of liberalisation taken" (OECD, 2009). Greece, Iceland, Portugal, Spain and Turkey have all used the derogation. The OECD permitted them to do so because these nations were seen to be at a lower stage of development relative to the other members of the OECD (Abdelal, 2007).

The OECD sponsored Multilateral Agreement on Investment was launched in 1995 as an attempt at a global treaty that would have similar provisions to

the Codes – for OECD and non-OECD (developing) countries alike. The draft text of that treaty included a broad safeguard for capital controls and other measures for balance-of-payments problem. In the end, the MAI was abandoned in 1998 (OECD, 1998).

B. BITs and FTAs for other major capital exporters

The EU, Japan, Canada and increasingly China are major capital exporters. Each of these capital exporters has numerous BITs and FTAs with nations across the world. And loosely, the BITs of these nations have the same general characteristics found in the United States BITs. However, in the case of the use of capital controls to prevent and mitigate financial crises, the BITs and investment provisions of all BITs and FTAs by these exporters either contain a broad "balance-of-payments" temporary safeguard exception, or a "controlled entry" exception that allows a nation to deploy its domestic laws pertaining to capital controls.

Examples of the balance-of-payments approach can be found in the EU-South Africa and Mexico FTAs (remember Mexico negotiated such a provision in NAFTA), the Japan-Republic of Korea BIT and the ASEAN agreements. The Republic of Korea-Japan BIT has language that clearly allows for restrictions on both inflows and outflows, presumably inspired by the 1997–98 crisis. The BIT states that nations may violate transfers provisions.

(a) in the event of serious balance-of-payments and external financial difficulties or threat thereof; or

(b) in cases where, in exceptional circumstances, movements of capital cause or threaten to cause serious difficulties for macroeconomic management, in particular, monetary or exchange rate policies (quoted from Salucuse, 2010: 268).

Another way capital controls are treated by capital exporters in FTAs and BITs is referred to as "controlled entry" whereby a nation's domestic laws regarding capital controls are deferred to. Canada and the EU's FTAs with Chile and Colombia each have a balance-of-payments safeguard *and* a controlled entry deferment (Canada Foreign Affairs and International Trade, 2009). As an example of controlled entry, the investment chapter of the FTA between Canada and Colombia has an Annex which states "Colombia reserves the right to maintain or adopt measures to maintain or preserve the stability of its currency, in accordance with Colombian domestic legislation".

Controlled entry provisions are to be found in BITs as well. The EU does not sign many BITs as a union, but individual countries do. The China-Germany BIT states that transfers must comply with China's laws on exchange controls (Anderson, 2009b). In the case of China, that nation has to approve all foreign inflows and outflows of short-term capital (IMF, 2009).

Interestingly, EU member BITs vary a great deal. Some, like the China-Germany BIT and the United Kingdom-Bangladesh BIT, allow for a nation to defer to its own laws governing capital controls. On the other hand, Sweden and Austria had the United States-style BITs with no exceptions whatsoever. However, the European Court of Justice ruled in 2009 that Sweden's and Austria's BITs with several developing countries were in violation of their obligations under the EU treaty. While the EU treaty requires EU members to allow for free transfers, it also allows members to have exceptions. The court found that Sweden's and Austria's treaties were incompatible with the EU treaty and that such treaties would need to be renegotiated to include exceptions to the transfers provisions (Salacuse, 2010).

Echoing concerns expressed by the IMF earlier in the paper, host countries facing a diversity of commitments through different treaties can cause jurisdictional issues and cause economic distortions. The pending United States-Republic of Korea Free Trade Agreement is illustrative of the jurisdictional issue. If the Republic of Korea decided it needed to deploy controls on inflows as a prudential measure to prevent a crisis, they may have all the leeway to do so under the exceptions to the OECD codes, but not under the FTA with the United States. A conflict over which regime should prevail could arise. This could be further accentuated if the IMF was asked to conduct a country programme for the Republic of Korea and advised the nation to deploy capital controls.

The United States FTAs with Chile and Colombia just discussed are examples of potential discrimination problems. If Chile or Colombia wished to deploy a non-discriminatory URR to all

short-term capital inflows, the countries' treaty commitments would not permit the measures to be truly non-discriminatory. Chile or Colombia would only be able to apply the measure to the EU or to Canadian firms and capital, not to capital flowing from the United States, thereby distorting capital markets and defeating the purpose of the non-discriminatory prudential measure.

Returning to some of the key questions outlined above, the following can be said about the BITs and FTAs in relation to capital controls. The United States holds 58 signed or pending BITs and FTAs with other countries. Almost all capital controls are actionable under these treaties. Recourse can be in the form of a one-time compensatory pay-off.

VI. Summary and recommendations for policy

This paper has shown that the United States trade and investment agreements, and to some extent the WTO, leave little room for deploying capital controls to prevent and mitigate a financial crisis. This is the case despite the increasing economic evidence showing that certain capital controls can be useful in preventing or mitigating financial crises. It also stands in contrast with investment rules under the treaties of most capital exporting nations.

That being said, there is room for developing countries to deploy capital controls to prevent and mitigate financial crises under the following circumstances:

- The controls are on capital account transactions, not current account transactions, unless sanctioned by the IMF;
- the nation has not committed financial services under the GATS at the WTO;
- the nation does not have a BIT or FTA with the United States.

Many nations fall under this category of course, including China, Brazil, India and others who frequently deploy capital controls, either on a permanent or temporary basis to ensure macroeconomic stability. A more plausible option is reforming current and future agreements. Especially in the wake of the global financial crisis, nations should coordinate their policies so as to avoid discrimination and jurisdictional inconsistency.

In terms of the WTO, close to 100 nations have not made financial services commitments under the GATS and are therefore free to deploy whichever type of capital control on capital account transactions they see necessary. However, the 37 economies listed in table 4 have made significant commitments on either Modes 1 or 3 for financial services and could be significantly vulnerable to actions against the use of capital controls.

Those nations that still retain the policy space to deploy capital controls and have not reached the threshold (identified by Kose et al., discussed earlier) necessary to withstand capital account liberalization should pursue Mode 1 (cross border trade in financial services) commitments with caution in the Doha Round. As this paper has shown, such commitments implicitly require an opening of the capital account. Moreover, those nations should exercise even more caution in terms of Mode 3 (FDI in financial services) commitments. The IMF study discussed in this paper shows that those developing countries that liberalized FDI in financial services fared worse during the current crisis (Ostry et al., 2010). Regarding those nations that have already made commitments with respect to financial services under the GATS (the nations in table 4), their only recourse will be the untested exceptions for prudential regulation and balance-of-payments exceptions.

Based on the analyses in this paper, there are five non-exclusive examples that the United States could consider that would give countries more policy space for capital controls that would make its BITs and FTAs more conducive to the use of capital controls and more consistent with most international trade and investment agreements:

- Remove short-term debt obligations and portfolio investments from the list of investments covered in treaties. This has been raised as a possibility by parties ranging from the IMF to civil society (Hagan, 2000; IISD, 2005).
- Create "controlled entry" Annexes in BITs and FTAs analogous to the Canada-Chile, Canada-Colombia, China and EU agreements with those nations. Controlled entry grants a nation the full ability to use capital controls on capital account transactions as they see fit.

- Design a balance-of-payments exception that covers both inflows and outflows such as the provisions found in the Japan-Republic of Korea BIT.
- Clarify that the Essential Security exceptions cover financial crises and that measures taken by host nations are self-judging.
- Resort to a state-to-state dispute resolution process for claims related to financial crises, analogous to the WTO and the other chapters in most FTAs.

The last recommendation is an important one. Under a state-to-state dispute resolution system, the state can take a much broader view regarding financial stability than an individual firm can. Whereas individual speculative firms may stand to lose from a capital control in the short term (unless their clients default, of course), the net welfare benefits of a measure may be positive. The state is seen as being in a better position to "screen" for such benefits and also to weigh a dispute case against a variety of other geopolitical and economic considerations it may have with a host nation. Given that BITs and FTAs current lack a state-to-state dispute system with appropriate screening mechanisms, these are likely to be used most by the private sector to file claims in response to measures taken to mitigate the global financial crisis (Van Aaken and Kurtz, 2009).

Leading political scientists have been puzzled as to why the United States continues its policy of capital account liberalization given the economic evidence, the treaties of its peers and the literature arguing that governments should favour capital controls (Alfaro, 2004). Cohen (2007) attributes the United States stance as due to a combination of ideology and domestic politics. Regardless of the party in power in the United States, Treasury officials and Presidential advisors have largely favoured capital account liberalization despite strong evidence and theory to the contrary. Perhaps more importantly, Cohen notes that while the costs of capital controls are directly felt by a handful of politically organized United States constituents – Wall Street – the beneficiaries are diffuse and do not feel the direct effects.

The arguments posed by the community lobbying against flexibilities for capital controls in the United States are threefold. First, it is argued that capital controls simply do not work and that the United States treaties help nations get rid of sub-optimal policy. Second, such controls hurt the United States investors by restricting their ability to mobilize funds. Third, changing the United States treaties would send a signal that earlier treaties are problematic and jeopardize commitments previously taken.

The evidence and politics may be changing. As discussed earlier, the evidence in favour of many capital controls is positive. Secondly, the current crisis has made it clear that while it is recognized that some individuals may incur costs or damage in the short-term, these may be minimal relative to what they could be under a crisis. Stability among our investment partners helps the United States investors and exporters have more certainty for markets. Crises could lead to defaults and large losses to United States assets and export markets. And, crises can cause contagion that spreads to other United States investment and export destinations. Third, the United States may now be more sensitive, given that it has taken numerous prudential measures in the wake of the current crisis –measures that may not survive the scrutiny of various trade and investment treaties with capital exporters who have investments in the United States (Van Aaken and Kurtz, 2009).

In 2009, the United States Department of State's Advisory Committee on International Economic Policy assembled a subcommittee to review the 2004 Model BIT. Some on that subcommittee recommended that the administration review the provisions on transfers and consider including temporary derogations (USDOS, 2009). Furthermore, members of the Democratic Party who favoured flexibilities for controls in 2003 are now in the majority, and the United States-Colombia FTA is pending in Congress. Albeit unsuccessfully, Congressman Michael Michaud (D-Maine) introduced a provision to the Wall Street Reform and Consumer Protection Act of 2009 that would have ensured that trade agreements preserve "the ability of each country that is a party to such an agreement to regulate foreign investment in a manner consistent with the needs and priorities of each such country", and that "allows each party that is a party to such trade agreement to place prudential restrictions on speculative capital to reduce global financial instability and trade volatility" (Michaud, 2009). There is similar language in a pending bill in the United States Congress entitled the Trade Reform, Accountability, Development and Employment (TRADE) Act. Nevertheless, it remains to be seen if the current crisis is a wake-up call for more prudent trade and investment policy.

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