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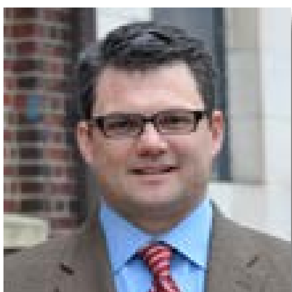
Global Financial Reform and Trade Rules: The Need for Reconciliation



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

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

> "…we …offer concrete remedies to reconcile the incompatibility between the ability to deploy capital account regulations and the trade and investment regime."

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

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This effort builds on an initial workshop of the Task Force that resulted in a report titled "Regulating Global Capital Flows for Long-Run Development." In that report the Task Force asserted that capital account regulations (CARs), traditionally referred to as "capital controls," were an essential part of the macroeconomic toolkit for emerging market and developing countries. The Task Force stressed that CARs on inflows and outflows of capital should be a permanent part of a series of counter-cyclical measures to smooth financial booms and busts in a nation in order to create the proper environment for long-run growth. The Task Force also noted that at times it may be necessary for nations to cooperate on "both ends" of capital flows in order to regulate cross-border finance in an efficient manner.

> "Under investor-state provisions, private firms and investors may directly file claims against governments that regulate capital. Therefore, those sectors that may bear the cost have the power to externalize the costs of financial instability to the broader public while profiting from awards in private tribunals."

In this paper, we highlight the main incompatibilities between capital account regulations and the trading system that were identified by members of the Task Force, and offer concrete remedies to reconcile the incompatibility between the ability to deploy capital account regulations and the trade and investment regime.

Results of Compatibility Review Between CARs and the Trading System

Members of the Task Force were asked to review agreements at the WTO and various FTAs and BITs to examine the extent to which the trading regime was compatible with the ability to deploy effective capital account regulations. A number of potential incompatibilities were found between the WTO and the ability to deploy CARs. Even more alarming is the lack of policy space to use CARs under a variety of FTAs and BITs — especially those involving the United States.

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

In contrast, FTAs and BITs are products of asymmetric bargaining power, often pitting a large country against a smaller one where market access to the larger is conditioned on large concessions by the smaller nation. This is accentuated by the "negative list" approach to the negotiation where a nation has to liberalize all of its financial services except for those that a nation lists to protect. This is problematic because of the weaker negotiating position of EMDs and the lack of ability to anticipate future financial services and how they might be regulated.

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

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

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

Box 1: WTO vs FTAs-BITs

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

The World Trade Organization

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

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

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

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

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

Box 2: Key Safeguards Relevant to CARs

GATS Article XII: Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

2. The restrictions referred to in paragraph 1:
   (a) shall not discriminate among Members;
   (b) shall be consistent with the Articles of Agreement of the International Monetary Fund;
   (c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;
   (d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;
   (e) shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.

3. In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programmes. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

Article 2(a) of the Financial Services Agreement

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

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

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

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

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

Free Trade Agreements and Bi-lateral Investment Treaties

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

Most FTAs and BITs are wider in scope than the WTO. Whereas the GATS only covers capital transfers related to trade in financial services, FTAs and BITs often cover all transfers between parties. In addition, transfers are often broadly defined as any investment, including stocks, bonds, currencies, derivatives, direct investment and beyond. Thus a much broader number of investments must be allowed to be transferred "freely and without delay" among parties to an agreement.

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

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

The IMF has expressed concern that many FTAs and BITs lack the adequate safeguards to put in place CARs: "The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows" (IMF 2012, 8). The IMF has developed an institutional view on the use of CARs that defines CARs as "measures affecting cross-border financial activity that discriminate on the basis of residency"(IMF 2011). Therefore forbidding nations to violate "national treatment" in treaties may thus constrain the ability of nations to use CARs in general and under IMF advice in particular. Some U.S. treaties allow nations to deploy price-based taxation measures on capital flows, or have an annex that allows a nation to deploy CARs as long as they meet national treatment requirements. Such limitations may nullify the ability to use CARs by definition. Moreover, such incompatibility may make it more difficult for nations to accept the IMF policy advice based on its new institutional view.

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

Making the Trade Regime Compatible with Regulating Financial Flows

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

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

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

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

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

Box 3: Potential Reforms to the Trading System

WTO Reforms

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

Reform of FTAs and BITS

1. Negotiate commitments with a "positive list" approach
2. Consider excluding certain kinds of investments as beyond the scope of agreements
3. Include balance of payments safeguards that clearly allow for the use of CARs

4 Include a prudential carve out that clearly allows for the use of CARs

5 Ensure that disputes are resolved by nations states and in collaboration with financial and monetary regulators

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

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

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

3. Amend existing treaties to reconcile current incompatibilities. Another route to reform would be formal amendments to existing treaties. Amendments to the GATS can be submitted to the Ministerial Conference by a member or by the Council for Trade in Services, and be adopted by consensus or with a two-thirds majority vote. For an Amendment to enter into forcé, it must be ratified by two-thirds of WTO members. Nevertheless, a new set of guidelines for investment treaties that better balances investor protection and development includes amending existing treaties as an option for reform (UNCTAD 2012).

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

Each of these processes and procedures has its own costs, benefits, and level of political feasibility that will vary on a case-by-case basis. Some members of the Task Force prefer a preventative approach to clarify and amend existing agreements now, before such language is tested in dispute settlement bodies. However, some expressed caution that certain procedures may open a Pandora's box and leave the trading system even more incompatible with the adequate regulation of global finance. But there is no disputing that the analyses conducted by the Task Force makes clear that several areas in the trading system are potentially incompatible with the ability of nations to deploy capital account regulations for stability, growth, and development.

Additional Pardee Center publications:

Issues in Brief, No. 23, April 2012
Free Trade and Inclusive Development: Lessons from the Indian Experience
Suranjana Nabar-Bhaduri

Pardee Center Task Force Report, March 2012
Regulating Global Capital Flows for Long-Run Development

Pardee Center Conference Report, Winter 2012
Development That Works

Pardee Center Task Force Report, September 2011
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This policy brief is an outcome of a June 2012 workshop at the Center for the Study of State and Society (CEDES) in Buenos Aires co-sponsored by CEDES, the Global Development and Environment Institute at Tufts University, and the Frederick S. Pardee Center for the Study of the Longer-Range Future at Boston University, with support from the Ford Foundation. A Pardee Center Task Force Report to be published in 2013 will explore the issues discussed here in more depth. For more information, including a list of workshop participants, visit http://www.tinyurl.com/CARs-Trade-Workshop.