

GEGI Exchange

A Global Economic Governance Initiative policy brief


Safeguarding United States' Trade and Investment Treaties for Financial Stability

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The Global Economic Governance Initiative is a research program of the Center for Finance, Law & Policy, the Frederick S. Pardee Center for the Study of the Longer-Range Future, and the Center for International Relations. GEGI was founded in 2008 to advance policy-relevant knowledge on economic governance in a globalizing world. GEGI's research and publications focus on the challenges of structuring a 21st century global economic governance system that promotes the broad goals of financial stability, opportunities for economic and human development, and environmental sustainability.

This policy brief discusses new evidence in the economics profession showing that capital controls are important macro-prudential measures that nations should have in their toolkit to prevent and mitigate financial crises. United States trade and investment treaties do not reflect this emerging consensus on capital controls. It is essential to rectify this problem as the United States finalizes its new moves forward on negotiations for a Trans-Pacific Partnership Agreement (TPP) and a bilateral investment treaty (BIT) with China.

New Research on Capital Controls and Financial Stability

 Cross-border capital flows can help developing countries grow. Indeed, many developing countries may lack the savings or financial institutions that can help finance business activity. Capital from abroad can fill that gap. Therefore, under normal circumstances, the more capital flowing into a developing country, the more the country benefits. However, certain types of capital flows are more stable than others. Foreign direct investment (FDI)—firms that establish a physical presence in another country—is seen as much more stable than currency, stock and bond, and derivative trading. Moreover, non-FDI cross-border capital flows tend to be “pro-cyclical”: too much money comes in when times are good, and too much money evaporates during a downturn.

A key characteristic of the global financial crisis has been the mass swings of capital flows across the globe. Indeed, international investment positions now surpass global output. Developing and emerging markets are no strangers to these flows. When the crisis hit, capital rapidly left the developing world in a flight to the “safety” of the United States market. In the attempt to recover, many industrialized nations, including the U.S.,

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have resorted to loose monetary policy with characteristically low interest rates. Relatively higher interest rates and a stronger recovery have triggered yet another surge in capital flows to the developing world. The result was an increasing concern over currency appreciation, asset bubbles, and even inflation. As active US monetary policy has tapered off, there has been a deceleration in capital flows to emerging markets, followed by currency depreciation and rising debt burdens.


Under these circumstances, capital controls can help smooth the inflows and outflows of capital and protect developing economies. Most controls target highly short-term capital flows, usually conducted for speculative purposes.

For example, Colombia's 2007 capital controls required foreign investors to park a percentage of their investment in the central bank, which helped that nation escape some of the damage from the global financial crisis (Coelho and Gallagher, 2013). Chile and Malaysia, two nations that form part of the TPP negotiations, successfully used capital controls in the 1990s to avoid the worst of the damages during crises in that decade (Magud et al, 2006).

In the wake of the financial crisis, nations such as Brazil, Indonesia, South Korea, Taiwan and Thailand have all used capital controls to stem the massive inflows of speculative investment entering their economies and wreaking havoc on their exchange rates and asset markets (Ahmed and Zlate, 2013). South Korea, where the won has appreciated by 30% since 2008, has direct limits on foreign exchange speculation, for example, and has also levied an outflows tax on capital gains of foreign purchases of government bonds.

A pathbreaking IMF study finds that capital controls like these have helped developing nations stem currency appreciation and asset bubbles in the past (Ostry et al, 2010). Moreover, the IMF study found that capital controls helped buffer some of the worst effects of the financial crisis in some developing countries. In lieu of these findings, the IMF now endorses the use of capital controls as a part of the macroeconomic policy toolkit. The IMF (2009) permitted capital controls on outflows in Iceland, Ukraine and Latvia as the crisis hit, and recommended that countries such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital that herded to emerging markets in 2009-2010. New studies by the Federal Reserve and Columbia University show that the myriad uses of capital controls in the wake of the crisis met their stated goals (Ahmed and Zlate, 2013; Erten and Ocampo, 2013).

Capital Controls and U.S. Treaties

 In contrast with the treaties of many other industrialized nations however, the template for United States trade and investment treaties does not leave adequate flexibility for nations to use regulate capital flows to prevent and mitigate financial crises. At their core, U.S. treaties see

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restrictions on the movement of speculative capital as a violation of their terms. The safeguards in U.S. treaties were not intended to cover the regulation of capital flows (Gallagher, 2011; Gallagher and Stanley 2012, 2103).

This shortcoming in U.S. treaties has recently been the subject of significant controversy. In January of 2011, 250 economists from the United States and across the globe, including a Nobel Laureate, former IMF officials, two former ministers of finance, and members of pro-trade think tanks such as the Peterson Institute for International Economics sent a letter to the U.S. government calling on the U.S. to address this imbalance in U.S. trade treaties (GDAE, 2011). That letter was followed by a rebuttal letter signed by many of the major corporate lobby organization in the United States and has since become elevated as an important issue in pending treaties and negotiations (USCIB, 2011).

U.S. trade and investment treaties explicitly deem capital controls as actionable measures that can trigger investor-state claims. The Transfers provisions in the investment chapters of trade treaties, or in stand alone BITS, require that capital be allowed to flow between trading partners “freely and without delay”. This is reinforced in

trade treaties' chapters on financial services that often state that nations are not permitted to pose "limitations on the total value of transactions or assets in the form of numerical quotas" across borders.

In the financial services chapters of U.S. trade treaties, and in U.S. BITS, there is usually a section on "exceptions." One exception, informally referred to as the "prudential exception," usually has language similar to the following from the US-Peru trade treaty:

and exchange rate policy (of which capital controls are a part). Yet the last sentence in that paragraph specifically excludes transfers.

These provisions were very controversial with the US-Chile and US-Singapore trade treaties in the early 2000s. U.S. trading partners repeatedly asked for a safeguard that would include capital controls but the United States has denied that request. In a few instances, U.S. negotiators granted special annexes that allowed U.S. trading partners to receive an extended grace period before investor-state

Financial Services chapter: Article 12.10: Exceptions

1. Notwithstanding any other provision of this Chapter or Chapter Ten (Investment),

➔ Fourteen (Telecommunications), or Fifteen (Electronic Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, a Party shall not be prevented from adopting or maintaining 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 institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement referred to in this paragraph, they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions.

Capital account regulations are not seen as permissible under this exception. This has been communicated by the United States Trade Representative and in 2003 testimony by the Under Secretary of Treasury for International Affairs to the U.S. Congress (Taylor, 2003). In general this is because the term "prudential reasons" usually interpreted in a much narrower fashion, pertaining to individual financial institutions. Concern has also been expressed that the last sentence is "self-canceling," making many measures not permissible

claims can be filed with respect to capital controls, as well as limits on damages related to certain types of controls.

These annexes are still inadequate in the wake of the financial crisis for at least four reasons. First, the annexes still allow for investor-state claims related to capital controls—they just require investors to delay the claims for compensation. An investor has to wait one year to file a claim related to capital controls to prevent and mitigate crises, but that

2. Nothing in this Chapter or Chapter Ten (Investment), Fourteen (Telecommunications) or

➔ Fifteen (Electronic-Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, applies to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit or exchange rate policies. This paragraph shall not affect a Party's obligations under Article 10.9 (Performance Requirements) with respect to measures covered by Chapter Ten (Investment) or under Article 10.8 (Transfers) or 11.10 (Transfers and Payments).

The prudential exception in services chapters or BITS is usually followed by an exception for monetary policy that often reads like (again to use the US-Peru Trade treaty):

This second exception could be seen as granting nations the flexibility to pursue necessary monetary

claim can be for a measure taken during the cooling off year. The prospect of such investor-state cases could discourage the use of controls that may be beneficial to financial stability. Second, many other nations' treaties allow for capital controls. Indeed, the Canada-Chile FTA, the EU-Korea FTA, the Japan-Peru BIT, and the Japan-Korea BIT

(just to name a few) all grant greater flexibility for capital controls (Anderson, 2011, Viterbo, 2011). This gives incentives for nations to apply controls in a discriminatory manner (applying controls on EU investors but not on US investors). Third, the IMF has expressed concerns that restrictions on capital controls in U.S. agreements, even those with the special annexes, may conflict with the IMF's authority to recommend capital controls in certain country programs, as they have done in Iceland and several other countries. Finally, the special dispute settlement procedure included in the US-Chile and Singapore FTAs did not become a standard feature of U.S. agreements. It is not in CAFTA, any U.S. BIT, or the pending US-Korea FTA.

New IMF Rules on Capital Controls

 The IMF has now issued rules that run up against US trade and investment treaties with respect to capital controls. On December 3, 2012 the IMF made public an Executive-Board approved "institutional view" on capital account liberalization and the management of capital flows. In a nutshell, the IMF's new "institutional view" is that nations should eventually and sequentially open their capital account. (IMF, 2012b). This is indeed in contrast with its view in the 1990s that all nations should be uniformly required to open their capital accounts regardless of the strength of a nation's institutions. The IMF now recognizes that capital flows also bring risk, particularly in the form of capital inflow surges and sudden stops that can cause a great deal of financial instability. Under such conditions, and under a narrow set of circumstances, according to the new "institutional

controls to nations under certain circumstances. And under a very narrow set of circumstances a nation may receive recommendations to discriminate capital flows based on residency.

The IMF is aware of the fact that they may recommend capital controls to nations that do not have the policy space to deploy such instruments because they would be deemed actionable under a trade agreement or investment treaty. In the final report the IMF states:

"As noted, the Fund's proposed institutional view would not (and legally could not) alter members' rights and obligations under other international agreements. Rather, conformity with obligations under other agreements would continue to be determined solely by the existing provisions of those agreements. Thus, for example, even where the proposed Fund institutional view recognizes the use of inflow or outflow CFMs as an appropriate policy response, these measures could still violate a member's obligations under other international agreements if those agreements do not have temporary safeguard provisions compatible with the Fund's approach (IMF, 2012b, 42)."

This echoes what the IMF stated in a board report earlier this year:

"The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows. These challenges should be weighed against the agreements' potential benefits. In particular, such agreements could be a step toward broader liberalization. However, these agreements in many cases do not provide

"The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows," says the IMF.

view' the IMF may recommend the use of capital controls to prevent or mitigate such instability in official country consultations or Article IV reports. In other words, the IMF now sanctions staff and management to recommend the use of capital


appropriate safeguards or proper sequencing of liberalization, and could thus benefit from reform to include these protections (IMF 2012a, 8)."

Indeed, the IMF suggests that the new IMF institutional view could help guide future trade

treaties and that the IMF could serve as a forum for such discussions.

“In particular, the proposed institutional view could help foster a more consistent approach to the design of policy space for CFMs under bilateral and regional agreements. Recognizing the macroeconomic, IMS, and global stability goals that underpin the institutional view, members drafting such agreements in the future, as well as the various international bodies that promote these agreements, could take into account this view in designing the circumstances under which both inflows and outflows CFMs may be imposed within the scope of their agreements. Similarly—and depending on the stages of development of the relevant signatories—the sequenced approach to liberalization under the integrated approach could be taken into account to guide the pace and sequencing of liberalization obligations, and the re-imposition of CFMs due to institutional considerations (IMF, 2012b, 33).”

Reforming U.S. Treaties for Financial Stability

 This problem should be rectified. It is in the interests of the U.S. and its trading partners to have adequate policy space to prevent and mitigate financial crises. A number of (non-exclusive) options are possible. First, some IMF officials have gone so far as to recommend that speculative capitals in the form of derivatives and other financial “innovations” be omitted from the definition of investment in treaties (Hagan, 2000). Another option, more recently advocated by the IMF, is to come up with a uniform safeguard language that can be used by all nations (IMF, 2010, Gallagher and Stanley, 2013). Finally, and more specific to U.S. treaties, the “exceptions” language in U.S. treaties could be broadened to explicitly allow for the flexibility to deploy controls and other measures now recognized as prudential to prevent or mitigate a crisis.

The “prudential exception paragraph” could have a footnote with an explicitly non-exhaustive list that clarifies that prudential measures include capital controls, among other measures. The last sentence in that paragraph could be deleted (as it is in the North American Free Trade Agreement), as could the omission of “transfers” from last sentence in the “monetary policy” exception also quoted above.

The global financial crisis has made it all too obvious that granting our trading partners the flexibility to use legitimate policies to prevent and mitigate financial crises is also good for the United States. When its trading partners fall into financial crisis, the United States loses export markets and subsequently jobs in the export sector. Capital controls can help stabilize exchange rates, which is good for long-term investors and for exporters and importers from the United States. When countries abroad cannot control financial bubbles that drive up currency values, American consumers may be hurt by rising prices on imported goods. As we have learned all too well, financial instability in a globalized world can be contagious, and quickly come back to the United States. ▶

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