



Capital Controls and the Trans-Pacific Partnership

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Dramatic Shifts in Capital Controls Thinking and Practice

The negotiations over the Trans-Pacific Partnership between the U.S. government and eight other countries are occurring at a time of dramatic transitions in the economics field and in the policy arena on the issue of capital controls. These policies include various measures designed to prevent speculative bubbles or rapid capital flight.

After decades of blanket opposition, the International Monetary Fund now endorses capital controls on inflows of speculative capital under certain circumstances.¹ The IMF even recommended outflows controls in a number of countries facing capital flight in the wake of the 2008 crisis, such as Iceland and Ukraine.²

They also found that nations which had controls in place before the current crisis were among the least hard hit, echoing Asian Development Bank and United Nations research.³ IMF, World Bank, and Cornell University studies that analyzed longer time periods found no correlation between capital account liberalization and economic growth in developing countries.⁴

Over the past year and a half, the IMF has been broadly supportive of the increasing number of emerging market countries that are using controls on inflows to deal with surges of hot money. On August 3, 2011, for example, the IMF executive board described Brazil's use of capital controls as an "appropriate" tool to manage foreign investment inflows.⁵

One reason the Brazilian government has wide flexibility to use capital controls is that it has not signed a trade or investment agreement with the United States. For several decades, it has been standard U.S. policy to include sweeping restrictions on this policy tool in U.S. free trade agreements (FTAs) and bilateral investment treaties (BITs). Governments must permit transfers relating to a covered investment to be made "freely and without delay into and out of its territory." Foreign investors are allowed to sue governments in supra-national tribunals over alleged violations of these rules.

In effect, the current policy promotes capital account liberalization between trade partners, regardless of the implications for financial stability.⁶

Obama Administration Seeks to Maintain Status Quo

Earlier this year, more than 250 economists sent a letter to the administration urging trade and investment reforms to allow greater flexibility on capital controls.⁷ “Given the severity of the global financial crisis and its aftermath, nations will need all the possible tools at their disposal to prevent and mitigate financial crises,” they wrote. Signatories included several economists who have been generally supportive of free trade but are critical of the capital control restrictions (e.g., Arvind Subramanian of the Peterson Institute for International Economics and Nancy Birdsall, President of the Center for Global Development), as well as former IMF officials (e.g., Olivier Jeanne of Johns Hopkins University) and a Nobel laureate (Joseph Stiglitz).

Treasury Secretary Timothy Geithner responded to the economists with a letter in which he stated that the administration will “seek to preserve” current policy.⁸ He argued that reforms are unnecessary because governments have sufficient alternatives to capital controls to deal with volatility. Likewise, USTR spokeswoman Carol Guthrie told a Bloomberg reporter that the U.S. expects to push for open capital-transfer rules in the Trans-Pacific Partnership negotiations. Existing rules provide “the necessary flexibility for governments, including through the standard policy tools such as monetary and fiscal policies, exchange rate flexibility, and macro-prudential measures,” Guthrie said.⁹ An *Inside US Trade* article on the Trans-Pacific Partnership, based on anonymous administration sources, reported that “on capital controls, the U.S. investment proposal essentially retains the language included in past trade deals.”¹⁰

Capital Controls Exceptions in Existing U.S. Agreements

The Obama administration position appears rigid in comparison not only to the IMF, but also to previous U.S. regimes. The majority of the 52 existing U.S. trade agreements and bilateral investment treaties restrict governments from putting controls on capital flows, with no exceptions to prevent or mitigate financial volatility. However, in eight cases, U.S. negotiators have allowed some form of safeguard for balance of payments crises.

These exceptions date back to the administration of President Ronald Reagan. For example, the US-Turkey BIT, signed in 1985, includes this exception:

*“In the exceptional financial or economic circumstances relating to foreign exchange, the Republic of Turkey may temporarily delay transfers of the type specified in Article IV (1)(e) but only (i) in a manner consistent with Article II; * (ii) for the time period necessary to restore its reserves of foreign exchange to a minimally acceptable level, but not to exceed three years from the date when the transfer is requested; and (iii) provided that the national or company has an opportunity to invest the proceeds in a manner which will preserve their value until transfer occurs.”*

* Article II covers national treatment and most-favored nation treatment obligations.

Variations on this exception for balance of payments crises can be found in the following existing U.S. agreements:

| Agreement | Date signed | Date of entry into force | Relevant provision |
|-------------------|-------------|--------------------------|------------------------------------|
| US-Israel FTA | Apr-85 | Aug-85 | no transfers provisions whatsoever |
| US-Turkey BIT | Dec-85 | May-90 | Protocol 2(b) |
| US-Bangladesh BIT | Mar-86 | Jul-89 | Protocol 4 |
| US-Egypt BIT | Mar-86 | Jun-92 | Protocol 10 |
| US-Tunisia BIT | May-90 | Feb-93 | Protocol 3 |
| US-Sri Lanka BIT | Sep-91 | May-93 | Protocol 6 |
| NAFTA | Dec-92 | Jan-94 | Article 2104: Balance of Payments |
| US-Jamaica BIT | Feb-94 | Mar-97 | Protocol 3 |

A recent IMF report on one of the countries that received a Reagan administration exception — Bangladesh — credits capital controls with preventing the “global flight to safety” that left so many poor economies in shambles after the crisis erupted in 2008. Bangladesh instead doubled its central bank reserves during that period.¹¹

Special Dispute Settlement Procedures in U.S. Bilateral Trade Agreements with Singapore, Chile, and Peru

Three countries involved in the Trans-Pacific Partnership negotiations have bilateral trade agreements with the United States that include annexes laying out special dispute settlement procedures related to capital controls.

These annexes represent compromises struck in the trade agreements between the United States and Singapore and Chile, which went into force in 2004. In the aftermath of the global financial crisis of the late 1990s, both of those nations sought a general balance of payments exception in their bilateral trade deals with the United States. Throughout most of the 1990s, the Chilean government subjected capital inflows to the *encaje* (“strongbox” in Spanish)—a one year, non-interest paying deposit with the central bank. The deposit requirement varied from 10% to 30%, and the penalty for early withdrawal ranged from 1% to 3%. Chile fared better than most other Latin American countries during the Mexican peso crisis in 1994 and the Asian crisis a few years later. While the role of capital controls has been intensely debated, an IMF research review concluded that the *encaje*, combined with other financial sector reforms, allowed the government more monetary policy autonomy and shifted the composition of foreign investment towards the longer term.¹²

The Bush administration, however, could not be persuaded to allow a general balance of payments safeguard. Instead, they conceded only to special dispute settlement procedures. Similar procedures were included in the 2006 U.S.-Peru Free Trade Agreement. Here are the key elements of these special procedures:

1. They extend the normal “cooling off” period before foreign investors can file claims from six months to a year after the government action in question, with some exceptions.

2. The Chile and Peru annexes (but not Singapore) limit damages arising from certain restrictive measures on capital inflows to the reduction in value of the transfers. Investors may not demand compensation for the loss of profits or business. These limits do not apply to controls on outflows.
3. In the Chile and Singapore annexes (but not Peru), there is a provision eliminating the government's liability for damages resulting from certain types of restrictions — but only if they are in effect for no more than a year and if they do not “substantially impede” transfers.

An interpretive note between the U.S. and Singapore governments expands on this point by suggesting that arbitral judges not presume that outflows controls substantially impede transfers if they meet certain criteria. One of these is that they must be “price-based.” This means that the type of quantitative controls used by Malaysia at the height of the Asian financial crisis would not be covered by this provision. Unremunerated reserve requirements such as those used by Chile in the 1990s would also be unlikely to be covered, as the minimum stay requirement can act like a quantitative restriction on outflows.¹³

These annexes cannot be considered actual safeguards to allow capital controls to prevent or mitigate financial crisis. For one thing, no capital management policy that extends beyond a year would be covered under any circumstances. The assumption that such measures should never be allowed for longer periods is outmoded, given that some controls put in place during the lead-up or the aftermath of the 2008 crisis have already stretched beyond the one-year mark. At a time when global policymakers are still trying to figure out how best to re-regulate the financial system, these loophole-filled special dispute settlement procedures should not be the model for the TPP.

Balance of Payments Safeguards in Other International Agreements

According to the IMF, the U.S. government's position of restricting capital controls, even in times of crisis, makes it an international outlier. The global norm is to “provide temporary safeguards on capital inflows and outflows to prevent or mitigate financial crises, or defer that matter to the host country's legislation.”¹⁴ For example, the 2003 trade agreement between TPP countries Singapore and Australia includes the following safeguard:¹⁵

ARTICLE 12: Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance of payments and external financial difficulties or threat thereof, a Party may adopt or maintain restrictions on payments or transfers related to investments. It is recognized that particular pressures on the balance of payments of a Party in the process of economic development 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.
2. The restrictions referred to in Article 12.1 shall:
 - (a) be consistent with the Articles of Agreement of the International Monetary Fund;
 - (b) avoid unnecessary damage to the commercial, economic and financial interests of the other Party;
 - (c) not exceed those necessary to deal with the circumstances described in Article 12.1;
 - (d) be temporary and be phased out progressively as the situation specified in Article 12.1 improves;
 - (e) be applied on a national treatment basis and such that the other Party is treated no less favourably than any non-Party.
3. Any restrictions adopted or maintained under Article 12.1, or any changes therein, shall be promptly notified to the other Party.
4. The Party adopting any restrictions under Article 12.1 shall commence consultations with the other Party in order to review the restrictions adopted by it.

And here is a similar safeguard in the trade agreement between TPP countries Malaysia and New Zealand:¹⁶

ARTICLE 17.3: Measures to Safeguard the Balance of Payments

1. Where a Party is in serious balance of payments and external financial difficulties or under threat thereof, it may:
 - (a) in the case of trade in goods, in accordance with GATT 1994 and the WTO *Understanding on the Balance-of-Payments Provisions of the GATT 1994*, adopt restrictive import measures;
 - (b) in the case of services, 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;
 - (c) in the case of investments, adopt or maintain restrictions with regard to payments relating to the transfer of proceeds from investment.
2. Restrictions adopted or maintained under paragraph 1(b) or (c) shall:
 - (a) be consistent with the *Articles of Agreement of the International Monetary Fund*;
 - (b) avoid unnecessary damage to the commercial, economic and financial interests of the other Party;
 - (c) not exceed those necessary to deal with the circumstances described in paragraph 1;
 - (d) be temporary and be phased out progressively as the situation specified in paragraph 1 improves; and
 - (e) be applied on a national treatment basis and such that the other Party is treated no less favourably than any third party.
3. In determining the incidence of such restrictions, the Parties may give priority to economic sectors which are more essential to their economic development. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular sector.
4. Any restrictions adopted or maintained by a Party under paragraph 1, or any changes therein, shall be notified promptly to the other Party from the date such measures are taken.
5. The Party adopting or maintaining any restrictions under paragraph 1 shall promptly commence consultations with the other Party from the date of notification in order to review the measures adopted or maintained by it.

Note that while these safeguards require the capital controls to be “temporary,” neither establishes a maximum time period. Here is a sampling of the many additional trade and investment treaties that either have a broad balance-of-payments safeguard or a special annex that completely carves out a trading partner’s rules on capital controls:

- Canada-Chile FTA (Annex G-09.1)¹⁷
- Japan-Peru BIT (Article 20)¹⁸
- Japan-Malaysia FTA (Article 88)¹⁹
- ASEAN Comprehensive Investment Agreement (Art. 16)²⁰
- EU-Korea FTA (Article 8.4)²¹

Recommendations:

Trans-Pacific Partnership negotiators should carefully review the numerous exceptions to the “free transfers” rules in U.S. and international agreements. However, given the shifts in the economics debate over these policy tools and heightened uncertainty in the international financial system, even these exceptions may be too restrictive.

If transfers provisions are to be included in the TPP at all, negotiators should consider allowing greater flexibility to use this proven tool as part of their toolbox for preventing and mitigating financial crisis. At a minimum, changes should be made to the existing U.S. model to:

1. Establish safeguard mechanisms for financial crises that are not subject to investor-state dispute settlement. At most, the provisions should be subject to state-to-state dispute settlement and even then such procedures should only be available after a consultation process.

2. Remove short-term debt obligations and portfolio investments from the list of investments covered by definition in the agreement.
3. Allow a government to restrict a transfer through the equitable, non-discriminatory, and good faith application of its laws related to macroeconomic, monetary, or exchange rate policy.

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NOTES

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