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Kevin P. Gallagher, Sarah Anderson, and Annamaria Viterbo

Capital Flow Management and the Trans-Pacific Partnership Agreement

Introduction

The Trans-Pacific Partnership (TPP) being negotiated by 12 governments represents an important opportunity for a fresh approach to the treatment of capital flow management measures in trade agreements. Most regional and bilateral free trade agreements (FTAs) and bilateral investment treaties (BITs) enacted in the past two decades have encouraged capital account liberalization, based on the view that this policy choice would facilitate more efficient international allocation of resources and spur foreign investment and growth in developing countries.

In recent years, however, there has been a major re-thinking on the issue of capital account liberalization. In December 2012, the International Monetary Fund (IMF) issued a new "institutional view" that endorses the regulation of cross-border finance in some circumstances.[1] The IMF also pointed out that many trade and investment treaties do not provide the appropriate level of policy space to regulate cross-border finance when needed.

While the IMF's new position was the outcome of many years of analysis, it was no doubt influenced by the 2008 financial crisis and the fact that a number of governments have used various forms of capital flow management measures (CFMs) in recent years to address financial volatility. The Trans-Pacific Partnership, as the first major trade negotiations since the 2008 crisis, presents an important arena to ensure coherence between current thinking on CFMs, including the IMF's "new view," and trade and investment agreements.

Current approaches to CFMs in trade and investment agreements

The more than 3,000 bilateral investment treaties (BITs) and regional and bilateral free trade agreements (FTAs) in force today make up a patchwork of approaches to CFMs. The 32 such agreements that exist among the governments currently engaged in the Trans-Pacific talks (13 BITs and 19 FTAs) are representative.[2] All of these agreements promote capital account liberalization by obligating governments to "permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory." However, these "free transfers" provisions are enforced more rigidly in some agreements than others.

In 18 of the 32 cases, the agreements provide considerable policy flexibility on CFMs by deferring to national laws. In a few cases, the exemption refers to specific existing laws (e.g., Chile's law allowing unremunerated reserve requirements on capital inflows, known as the "encaje").

In 12 cases, the agreements include a safeguard for times of crisis. With some variations, these are similar to GATS Article XII. Governments are still obligated to provide free capital transfer,

but governments are generally allowed to use temporary and nondiscriminatory CFMs if they are facing a serious balance of payments crisis (and sometimes if the country is facing the threat of such a crisis).

Two agreements – Australia's FTAs with New Zealand and Malaysia – include balance of payments safeguards and also exclude investor-state dispute settlement. By limiting dispute settlement to only state-state processes, these agreements substantially reduce the likelihood of cases being filed related to sensitive public policies such as CFMs.

The most restrictive approach to CFMs is found in FTAs and BITs to which the United States (U.S.) is a party. The U.S. agreed to a relatively weak safeguard in the 1994 North American Free Trade Agreement. But the U.S. has not agreed to include any type of balance of payments safeguard in any BIT or FTA negotiated since NAFTA. The governments of Singapore and Chile sought exemptions for their existing CFMs in their bilateral FTAs with the United States – to no avail. As a compromise, those deals (as well as the US-Peru FTA) include special dispute resolution procedures related to investor-state claims over CFMs. With some variations, these include an extended "cooling off period" before investors can file claims and some limits on the compensation foreign investors can receive for certain types of CFMs.

Obama trade officials have continued the highly restrictive approach of previous administrations. The 2012 U.S. Model BIT, the blueprint for new BITs and investment chapters of the TPP and other FTAs, offers no exceptions for the use of CFMs in times of crisis. It also includes an extremely broad definition of investment, including short-term financial instruments such as futures, options, and other derivatives. The U.S. Model BIT does include a "prudential measures" exception similar to Article 2(a) of the GATS Annex on Financial Services. But a footnote in the Model BIT stipulates that "prudential" refers to actions to protect individual financial institutions (as opposed to macroprudential measures). An exemption for taxation measures is also limited to those that are applied in a nondiscriminatory manner and with adequate compensation.

While the TPP negotiations are secret, a June 2012 leaked draft of the investment chapter suggests a robust debate on this issue.[3] The draft contains four noteworthy proposals related to capital controls:

1. A safeguard similar to those in several existing TPP agreements and GATS Article XII. One innovation is that it explicitly allows governments to use controls when capital movements "cause or threaten to cause serious difficulties for macroeconomic management." (This may have been added to clarify that the safeguard applies to controls on both outflows and inflows.)
2. An exemption for Chile's capital account regulations, including the right to require that investments be subject to a reserve requirement.
3. A provision that would allow governments to require investors to undergo a domestic review before taking claims to international tribunals.
4. An exemption for Australia from investor-state dispute settlement.

All of these provisions are in brackets, indicating that no consensus has yet been reached. Nevertheless, they suggest that at least some TPP negotiators are skeptical of the highly restrictive U.S. approach to CFMs.

Why policy space for CFMs is important

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 non-FDI capital flows across the globe. When the crisis hit, capital rapidly left the developing world in a flight to the "safety" of the U.S. market. In the attempt to recover, many industrialized nations, including the U.S., have resorted to loose monetary policy with characteristically low interest rates. Relatively higher interest rates and a stronger recovery 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 in 2013, there has been a deceleration in capital flows to emerging markets, followed by currency depreciation and rising debt burdens.

As articulated by the IMF in the new 'institutional view' on managing capital flows, under circumstances like these, CFMs may help smooth the inflows and outflows of capital and protect developing economies. New economic research has shown how regulations on capital flows can internalize the externalities related to excessive capital flows such that they correct distortions in a recipient economy. This work has been developed by economists Anton Korinek, Olivier Jeanne, and others, and is summarized by Korinek in the *IMF Economic Review*. According to this research, externalities are generated by capital flows because individual investors and borrowers do not know (or ignore) what the effects of their financial decisions will be on the level of financial stability in a particular nation. A better analogy than protectionism would be the case of an individual firm not incorporating its contribution to urban air pollution. Whereas in the case of pollution the polluting firm can accentuate the environmental harm done by its activity, in the case of capital flows a foreign investor might tip a nation into financial difficulties and even a financial crisis. This is a classic market failure argument and calls for what is referred to as a Pigouvian tax that will correct for the market failure and make markets work more efficiently.

In the wake of the financial crisis, nations such as Brazil, Indonesia, South Korea, Taiwan and Thailand have all deployed CFMs to stem the massive inflows of speculative investment entering their economies and wreaking havoc on their exchange rates and asset markets. South Korea, where the won has appreciated by 30% since 2008, has direct limits on foreign exchange derivatives transactions, for example, and has also levied an outflows tax on capital gains of foreign purchases of government bonds. Brazil has put taxes on bonds and equities, and has extended regulations to the foreign exchange derivatives market as well. New research at the Federal Reserve Bank of

the United States, and separately by economists at Columbia University has found that those nations that deployed CFMs were able to reduce the amount of capital flows, reduce pressure on the exchange rate, and grew faster than nations that did not deploy CFMs.[4]

Reform Options

To preserve appropriate policy space to introduce CFMs, international trade and investment treaties should include strong safeguard provisions, including a balance of payments and a prudential measures clause.

Until now, when present in BITs and FTAs, these safeguards are usually modeled on standard GATS clauses. The GATS, however, was negotiated having capital account liberalization in mind, with requirements greatly limiting States' power to introduce CFMs.

The adoption of measures in response to ordinary balance of payments difficulties is envisioned by GATS Art. XII. No explicit reference is made to CFMs, but it cannot be deemed that they are excluded. However, the prevailing view is that GATS Art. XII permits only controls on capital *outflows*, while controls on capital *inflows*—which are precautionary in nature—are not allowed.

Furthermore, in order to be consistent with WTO law, CFMs should also meet the other requirements for non-discriminatory, necessary and temporary measures. As a consequence, States must avoid measures discriminating on the basis of residency (which would also amount to a breach of national treatment), favoring instead currency-based measures (like currency-specific reserve requirements or limitations on foreign currency borrowings), even if the latter may be less effective.

Some concerns are also raised by the necessity test and temporariness. Their impact on the design of CFMs should be carefully assessed.

As for the necessity test, in WTO dispute settlement proceedings, the initial burden of proof is on the respondent, which has to prove that the measure under review was necessary. In fact, GATS Art. XII is not a self-judging provision.

The temporariness requirement leaves out of its scope CFMs used as a counter-cyclical permanent mechanism. The question, though, remains unanswered on the definition of "temporary" and on the maximum length of time during which CFMs can be deployed before being phased out.

With respect to prudential exception clauses, BITs and FTAs often preserve the right of a State to introduce measures for prudential reasons, among which are measures protecting investors, depositors, policy holders, and safeguarding the integrity and stability of the financial system.

However, since the GATS prudential exception does not provide a definition of "prudential", the question over whether CFMs (in particular controls on *inflows*) fall within the scope of the clause remains unsettled. It has been argued that "prudential" only covers international financial standards and other Basel-type measures, leaving out macro-prudential measures and CFMs.

Another issue relates to the second sentence of the clause (Art. 2 (a) of the GATS Annex on Financial Services), which is usually reproduced in trade and bilateral investment treaties. This sentences states that prudential measures not conforming to obligations arising from the GATS cannot be used by a State to avoid the commitments and obligations undertaken. It would appear from the

wording that the safeguard is 'self-cancelling' and its elimination has often been suggested.

After analyzing the various aspects of the issue, we have reached the conclusion that safeguard clauses should always be included in BITs/FTAs treaties to help States prevent—or recover from—a financial crisis through an agreed and generally accepted course of action without facing the risk of being challenged before investor-States arbitral tribunals.

The proposed balance of payments safeguard in the leaked investment chapter of the TPP would be an improvement over the rigid approach of the U.S. Model BIT. However, governments may want to consider revisions to this proposal to ensure sufficient policy space. These revisions (*see box*) may include adding a clear reference to financial stability and the management of the financial system, and deleting references to non-discrimination and temporariness to which the same concerns raised for the GATS apply:

TPP Draft Article XX.3: Measures to Safeguard the Balance of Payments

1. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining temporary safeguard measures with regard to transfers or payments for current account transactions if there is serious balance of payments or external financial difficulties [or threats thereof].

2. Nothing in this agreement shall be construed to prevent a Party from adopting or maintaining temporary safeguard measures with regard to payments or transfers relating to the movement of capital:
(a) in the event of serious balance of payments or external financial difficulties or threat thereof; or
(b) where, in exceptional circumstances, payments or transfers relating to capital movements cause or threaten to cause serious difficulties for [financial stability or] macroeconomic management, in particular the operation of monetary policy or exchange rate policy [and policies relevant to the management of the financial system].

3. Measures referred to in paragraphs 1 or 2 shall:
~~(a) be applied on a non discriminatory basis among the Parties;~~
(b) be consistent with the Articles of Agreement of the International Monetary Fund, so long as the Party taking the measures is a party to the said Articles;
(c) avoid unnecessary damage to commercial, economic, and financial interests of the other Parties;
(d) not exceed those necessary to deal with the circumstances described in paragraphs 1 or 2;
(e) ~~be temporary and~~ be phased out progressively as the situation specified in paragraphs 1 or 2 ~~improves~~ permits.

4. In the case of trade in goods, nothing in this Agreement shall be construed to prevent a Party from adopting restrictive import measures in order to safeguard its external financial position and balance of payments. These restrictive import measures shall be in accordance with the General Agreement on Tariffs and Trade (GATT) 1994 and the Understanding on Balance of Payment Provisions of the GATT 1994.

5. The Party undertaking measures referred to in paragraphs 1,2 or 4 shall:
(a) promptly notify the other Parties; and
(b) promptly commence consultations with the other Parties in order to review the measures adopted or maintained by it.
(i) In the case of capital movements, respond to any other Party that requests consultations in relation to the measures adopted by it, if such consultations are not otherwise taking place outside of this Agreement.
(ii) In the case of current account transactions, if consultations in relation to the measures adopted by it are not taking place at the WTO, a Party, if requested, shall promptly commence consultations with any interested Party.

Governments may also want to consider additional revisions in the areas of the prudential exception, dispute settlement, and the definition of investment. These may include a prudential exception clause drafted along these lines:

Article xxxxx: Prudential Measures

1. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures for prudential reasons with respect to financial services, such as/including:
(a) measures for the protection of depositors, financial market participants and investors, policy holders, policy claimants, or persons to whom a fiduciary duty is owed by a financial institution;
(b) measures for the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions; (c) measures aimed at ensuring the integrity and stability of a Party's financial system.

2. (a) Nothing in this Agreement shall apply to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit policies or exchange rate policies. (b) For the purposes of this paragraph, "public entity" means a central bank or monetary authority of a Party.

With regard to dispute settlement, governments may consider including only a state-state process (as in some existing trade agreements between TPP governments) as a protection against lawsuits brought by foreign investors who have little regard for the public interest. If investor-state dispute settlement is included, it would be advisable to require that investors first exhaust domestic legal remedies and to provide a diplomatic screen so that governments can work together to prevent claims that are inappropriate, without merit, or would cause serious public harm.

As for the definition of investment, governments may find appropriate to further safeguard policy space by excluding some types of financial transactions (e.g. portfolio investment or short-term speculative financial flows and government debt securities) from the scope of the Agreement, while including foreign direct investments in productive assets.

Kevin P. Gallagher *is Associate Professor in the Department of International Relations at Boston University, where he co-directs the Global Economic Governance Initiative. He is author of the forthcoming book titled "Countervailing Monetary Power: Emerging Markets, New Economic Thinking, and the Re-Regulation of Cross-Border Finance" and is co-chair of the Pardee Task Force on Regulating Capital Flows. In 2009, he served on the U.S. Department of State's Advisory Committee on International Economic Policy to review U.S. trade and investment treaties. Contact: kpg@bu.edu.*

Sarah Anderson *directs the Global Economy Project at the Institute for Policy Studies in Washington, DC. In 2009, she served on the Investment Subcommittee of the U.S. State Department's Advisory Committee on International Economic Policy, tasked with reviewing the U.S. Model Bilateral Investment Treaty. Contact: sarah@ips-dc.org.*

Annamaria Viterbo *is Assistant Professor of International Law at the University of Turin, Italy. She obtained a Ph.D. in International Economic Law from the Bocconi University of Milan. After a legal internship at the European Central Bank, she served as a Jean Monnet Fellow at the European*

University Institute, Florence and was a Visiting Scholar at the IMF's Legal Department. In 2012, she published a book titled "International Economic Law and Monetary Measures: Limitations to States' Sovereignty and Dispute Settlement". Contact: anna.viterbo@unito.it.

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[2] Anderson, Sarah (2013). "Trans-Pacific Partnership and Hot Money: How the Region's Existing Agreements and the Draft TPP Investment Chapter Treat Capital Account Regulations," Institute for Policy Studies, October, available at http://bit.ly/1hfI9L6

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