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The Trans-Pacific Partnership and Regulating Capital Flows

Recommendations for Strengthening Proposed Safeguards in the Leaked TPP Investment Chapter

The Global Economic Governance Initiative is a project of Boston University's Pardee School of Global Studies, the Pardee Center for the Study of the Longer-Range Future and the Center for Finance, Law and Policy. GEGI was founded in 2008 to advance policy-relevant knowledge about economic governance for financial stability, human development, and the environment.

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The leaked text of the Trans-Pacific Partnership (TPP) Agreement's investment chapter reveals that negotiators are giving serious consideration to a safeguard intended to allow nations to regulate capital flows.[2] It is critical that the safeguard be drafted in such a way that governments have sufficient policy flexibility to prevent and mitigate financial instability.

Since the 2007-2008 financial crisis, the International Monetary Fund (IMF) and a growing array of economists have come to recognize that measures to regulate the inflow and outflow of short-term capital flows are legitimate policy tools for preventing and mitigating financial instability. Despite this emergent consensus, the leaked TPP investment chapter replicates the standard "free transfers" obligations of past U.S. pacts, which deny governments the ability to regulate capital flows. However, an annex to the chapter includes two safeguard proposals—the original proposal (Annex CCC.3) and an "alternative working compromise text" (referred to here as the CCC.3 alternative).

Including a safeguard would be a significant improvement over most past U.S. trade agreements and bilateral investment treaties. Since 1994, no United States trade pact has included such a safeguard provision.

But the details matter. And while the original proposal in the leaked text is far stronger than the alternative, both have limitations and neither would sufficiently safeguard a range of appropriate measures enacted to prevent or mitigate financial instability.

> "Measures to regulate the inflow and outflow of short-term capital flows are legitimate policy tools for preventing and mitigating financial instability."

Rather than trying to water down the original proposal, TPP negotiators should work to improve upon it. This short policy brief outlines some of the shortcomings in both safeguard proposals under negotiation and offers an alternative proposal.

1. Limits of Annex CCC.3 "Temporary Safeguard Measures"

The CCC.3 safeguard is very similar to the GATS safeguard for the balance of payments. While a major step in the right direction, several legal scholars have raised the following concerns about this approach:

- Restricts preventative measures
- Restricts regulations of capital flows
- Necessity test restricts policy space
- May not give nations time to regulate

- **Restricts preventative measures.**

The proposed BOP safeguard would likely only allow regulating capital outflows, rather than both inflows and outflows. In CCC.3 this is evident in 2. (a) where restrictive measures to regulate the movement of capital could be applied "in the event of serious balance of payments and external financial difficulty or the threats thereof" and in 2. (b) where such measures can only be used in "exceptional circumstances" that "cause or threaten to cause serious difficulties for macroeconomic management".[3] This conflicts with a growing consensus in the IMF and the economics field regarding the need to allow policy tools that can both prevent crises and the subsequent need to regulate outflows of capital.

- **Restricts regulations of capital flows undertaken for other legitimate policy objectives.**

As recent research in economics and the IMF has shown, regulating the inflow of capital may be important to maintain financial stability—not only for macroeconomic management and potential balance-of-payments crises but also to stem asset bubbles and the build up of debt in an economy.[4] For such legitimate policy objectives, this "safeguard" would appear inapplicable.

- **Necessity test restricts policy space.**

Under the Temporary Safeguard Measures in CCC.3, the initial burden of proof is on the respondent to show that capital controls are "necessary." In other words, they are not "self-judging" and restrict the host state to a narrow "necessity test". The host state would need to prove that the measures taken did "not exceed those necessary" to deal with the problem at hand. Proving the "necessity" of a public policy has been a fraught effort in international trade cases. For example, the primary reason that governments have repeatedly failed to use the GATS/GATT "general exception" to defend challenged policies is that WTO tribunals have consistently deemed the policies as failing to meet the high threshold of the general exception's necessity test.[5]

- **May not give nations ample time to regulate; might conflict with IMF recommendations.**

Under 3 (e) the CCC.3 notes that measures shall be "temporary and be phased out." As stressed in the economic literature and in numerous IMF documents, it is prudent for regulations on the inflow and outflow to be temporary, but some capital inflow surges and capital outflow crises last longer than others.

2. Limits of CCC.3 alternative

The "alternative" text includes the areas of concern listed above and also introduces five other limitations that would render the safeguard to be of little use in preventing or mitigating financial crises.

- **Exempts equities from regulation.**

By far the most concerning of all the measures in the alternative text is paragraph 3. "Measures referred to in paragraph 1 shall not apply to transfers associated with equity investments." The leaked text defines "equity" as "shares, stock and other forms of equity participation in an enterprise", in contrast to an enterprise itself, and most importantly, "bonds, debentures, other debt instruments and loans", as well as "futures, options and derivatives". When capital flows management measures are put in place, like for instance Brazil's IMF-approved taxes on stock market purchases (inflows), investors can quickly convert their positions into equities. Thus, Paragraph 3 is a loophole that could be exploited to render the rest of the safeguard of little effectiveness. Moreover, measures directly targeting certain classes of bondholders, like those adopted by Iceland in 2008, would not be legitimate (to reduce pressure on the króna and the flight of foreign currency, foreign investors in the so-called "glacier bonds" were prevented not only from divesting, but also from converting coupons matured into foreign currency and transfer them abroad).[6]

- **Further restricts time horizon for crisis prevention and mitigation.**

Paragraph 2(e) adds that measures "in no case shall exceed one year in duration." For reasons described above, this addition would be detrimental to the efforts of nation states and the IMF to mitigate a financial crisis. Instability can last for months, but it can also last for years. In terms of inflows, from 2009 to 2012 when interest rates were low in the United States and high in emerging markets, many emerging markets put in place regulations on capital inflows for that full period. Indeed, the IMF voiced approval for regulations of that duration in South Korea and Brazil during that period. Moreover, during a crisis the regulation of outflows can also vary.[7] The IMF has insisted that Iceland maintain its regulations on capital outflows through 2015, despite being put in place under an IMF program in 2009.[8]

- **Price-based regulations are not always sufficient.**

Paragraph 2(f) in the alternative text requires that any regulation be "price-based." As the IMF has recently noted, price-based regulations are preferable but there are cases when nations will have to have quantitative limits on the inflow or outflow of capital.[9] Indeed, Iceland's regulations on the outflow of capital have been quantity-based under their IMF program.

- **Legitimate regulations to address instability could be deemed "confiscatory."**

This clause should be read together with the expropriation provision, which does not contain any reference to preserve the right of a contracting party to impose or collect a tax by withholding or other means.

It follows that the sovereign right to impose taxes and to adopt fiscal measures will be subject to the "non-confiscatory requirement". In financial law and in previous tribunals even taxes have been deemed "confiscatory" if they are seen as unreasonable interference with the investor's property rights.[10] For instance, the imposition of taxes can amount to a confiscatory measure if they single-out individual investors and far from normal tax practice (punitive). While a small tax or restriction may not be seen as confiscatory, it is also more likely not to meet its desired objective. Brazil's recent taxes on inflows were only partly effective because the tax rate was relatively small. Larger taxes, or quantitative limits, could be deemed confiscatory.

Indeed, there is some danger that Chile's law (currently not in force) allowing unremunerated reserve requirements (the "encaje") would be jeopardized under this clause. The "encaje" program calls for a certain percentage of an investment to be stored in a non-interest bearing account for a period of 3 to 6 months in the central bank. If there is major capital flight during that 3 to 6 months, the investment still needs to be held in the central bank. An investor could claim that a portion of the investment was confiscated. The decision would be left to the ample discretion of an ISDS tribunal. It is thus no surprise that, according to Annex II-E of the leaked TPP investment chapter, Chile has requested an exception for the encaje. This, however, does not protect other governments" authority to deploy similar policies.

3. Regulating Capital Flows in the TPP

It is paramount that 21st Century trade and investment treaties provide all parties to the agreement the flexibilities necessary to prevent and mitigate financial instability. In proposing language based on GATS exceptions at the WTO, some TPP negotiators have taken a strong first step in the right direction. However, rather than improving upon the limitations of the older GATS language, the "alternative" text appears to further weaken the ability of member states to regulate capital flows.

As we argued in an earlier policy brief, a stronger safeguard would grant member states the proper policy space to prevent and mitigate financial instability, allow the regulation of both the inflow and outflow of capital, be self-judging with respect to the "necessity" of implementing such reform, and grant nations and the IMF ample time to regulate.

Below is a proposed set of recommended changes to the CCC.3 clause based on earlier proposals we drafted for a policy brief for the G-24 finance ministers in 2013.[11] This proposal, which is still based on the GATS safeguard and would be self-judging, would grant nations the flexibility they need to prevent and mitigate financial instability and honor their commitments to other international financial regimes.

4. Recommendations for Strengthening Annex CCC.3

Recommendations are embedded in the original text, using the color black for additions and the color red for deletions.

TPP Draft Article CCC.3: Temporary Safeguard Measures

1. Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining restrictive measures with regard to transfers or payments for current account transactions in the event of serious balance of payments and [[*or*]] external financial difficulties or threats thereof.

2. Nothing in this agreement shall be construed to prevent a Party from adopting or maintaining restrictive measures *[[that it considers necessary]]* with regard to [the movement of capital, or] payments or transfers relating to the movements of capital:

(a) in the event of serious balance of payments and *[[or]]* external financial difficulties or threats thereof; or

(b) where, in exceptional circumstances, [the movement of capital, or] 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. Any measure adopted or maintained under paragraphs 1 or 2 shall:

(a) be applied on a non-discriminatory basis such that no Party is treated less favorably than any other Party or non-Party

(b) be consistent with the Articles of Agreement of the International Monetary Fund;

(c) avoid unnecessary damage to the commercial, economic, and financial interests of any other Party;

(d) not exceed those necessary to deal with the circumstances described in paragraphs 1 or 2; and

(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, [in order to safeguard the external financial position and balance of payments of Parties,] Article XII of the GATT and the Understanding on the Balance of Payment Provisions of the GATT 1994 are incorporated mutatis mutandis.

[5. In the case of trade in services, nothing in this Agreement shall be construed to prevent a Party from adopting trade restrictive measures in order to safeguard its external financial position and balance of payments. These restrictive trade measures shall be in accordance with the General Agreement on Trade in Services (GATS).]

[In the case of trade in services, [in order to safeguard the external financial position and balance of payments of Parties,] paragraphs 1, 2 and 3 of Articles XII of the GATS are incorporated mutatis mutandis.]

6. A Party adopting or maintaining measures under [paragraphs 1, 2 or [4] [or 5] [paragraphs 1 or 2] shall:

(a) promptly notify the other Parties of the measures, including any changes therein; 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, provided that 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 and dispute settlement. These may include a prudential exception clause drafted along these lines:

TPP 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. Coupled with stronger and clearer language such as that proposed above, dispute processes like these would do a better job of granting TPP parties the flexibility they need to prevent and mitigate financial instability.

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3. IMF analysis of this language confirmed the limited ability to regulate inflows under these provisions. See "130 A Pardee Center Task Force Report | March 2013. Hagan, Sean (2000). "Transfer of Funds." UNCTAD Series on International Investment Agreements. New York and Geneva: United Nations Conference on Trade and Development. Accessed at http://unctad.org/en/docs/psiteiitd20.en.pdf. This is also well established in the academic literature, See Viterbo, Annamaria (2012). International Economic Law and Monetary Measures, Limitations to States" Sovereignty and Dispute Settlement, London: Edward Elgar. For further analyses see Gallagher, Kevin P. and Leonardo Stanley (2012), Capital Account Regulations and the Trading System: A Compatibility Review, Boston University, Global Economic Governance Initiative.

4. See International Monetary Fund (2013). The Liberalization and Management of Capital Flows: An Institutional View. Available at http://www.imf.org/external/pubs/ft/survey/so/2012/POL120312A.htm, also Gallagher, Kevin P. and Jose Antonio Ocampo (2012), Regulating Capital Flows for Long Run Development. Boston University, Global Economic Governance Initiative.

5. See Viterbo (2012) and Gallagher et al (2012) for in-depth treatment of GATS safeguard and necessity test.

6. See Viterbo (2011) "The Return of Capital Controls as Emergency Tools to Counter Financial Crises. Iceland's Crisis and the Constraints Imposed by the EEA Agreement", in Capital Markets Law Journal, 2011, vol. 6, n. 2, pp. 214-237

7. See Gallagher, Kevin P., and Yuan Tian, "Regulating Capital Flows in Emerging Markets: The IMF and the Global Financial Crisis," Boston University GEGI Working Paper, http://www.bu.edu/pardee/research/global-economic-governance-2/regulatingcapitalflowsworkingpaper/

8. See Valdermarsson, Omar (2015) "Iceland Capital Controls in Place through 2015" Bloomberg, November 19, 2012 http://www.bloomberg.com/news/articles/2012-11-19/iceland-capital-controls-seen-in-place-through-2015-imf-says; for indepth analysis of Icelands controls and the IMF see Silla Sigurgeirsdóttir & Robert H. Wade (2015),"From control by capital to control of capital: Iceland's boom and bust, and the IMF's unorthodox rescue package," Review of International Political Economy, Volume 22, Issue 1, 2015 , 103-133.

9. See Ostry, Jonathan (2011), Managing Capital Inflows: What tools to use? IMF Staff Discussion Note, April 5, 2011 SDN/11/06, Washington, International Monetary Fund.

10. See Darby, Joseph, he American Journal of Comparative Law, Vol. 38, Supplement. U. S. Law in an Era of Democratization (1990), pp. 545-555; ICSID tribunals have ruled that taxes have been confiscatory, as in the case of Lao Holdings NV v The Lao People's Democratic Republic ICSID Case No ARB(AF)/12/6

11. Gallagher, Kevin P., Sarah Anderson, and Annamaria Viterbo (October 2013). "Capital Flow Management and the Trans-Pacific Partnership Agreement," G-24 Policy Brief No. 79. Accessed at: http://173.254.126.101/~gtwofouo/wp-content/uploads/2014/03/G24-Policy-Brief-79.pdf

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