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G-24 Seminar on Compatibility of Capital Flow Provisions in Trade Regimes[1]

Vivek Arora and Katharine Christopherson[2]

We were asked to provide comments from the perspective of the Fund's institutional view on capital flows on the report's discussion about the incompatibilities between the General Agreement on Trade in Services (GATS) and the various trade and investment agreements on the regulation of capital flows. We were also asked to discuss the issue of the flexibility countries may need, depending on global and country circumstances, relative to the legal restrictions imposed on capital flow management (CFM) measures by trade or investment agreements.

I. CAPITAL FLOWS: THE NEED FOR A CONSISTENT APPROACH

The report is highly relevant as it deals with an issue that remains open. Countries' ability to regulate cross-border finance under many preferential trade agreements (PTAs) and bilateral investment treaties (BITs) are not always compatible with the GATS.

The Fund staff's work on capital flow and trade issues has recognized this problem for some time. A September 2010 Fund staff reference note on trade in financial services recognizes that some PTAs take liberalization commitments in financial services beyond the GATS.[3] Many PTAs and BITs do not contain the GATS' safeguards and exceptions that provide governments with short- and long-term policy space to accommodate balance of payments pressures, prudential considerations, and monetary and exchange rate policies. Some PTA/BITs restrict the use of capital controls during macroeconomic and financial distress and do not provide safeguard clauses.

The absence of safeguards poses problems. It effectively limits the ability of members to impose controls, even if such controls may be useful from a macroeconomic and financial stability perspective. Moreover, market access commitments may press a faster pace of liberalization (e.g., for financial services) than what is appropriate, based on a member's financial and institutional development and the need for a sequenced approach.

The factors pose particular challenges for the Fund, including for the Fund's role in providing financing to address balance of payments crises (including capital account crises, which in turn can be triggered by premature liberalization). The 2010 Fund staff

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[1] Discussion of the Pardee Center Task Force's Report on "Capital Account Regulations and the Trade System: A Compatibility Review" (the "Pardee report").

[2] Assistant Director, IMF Strategy Policy & Review Department, and Senior Counsel, IMF Legal Department, respectively. These remarks reflect our own views and should not be attributed to the IMF, its Executive Board, or its Management.

[3] "Reference Note on Trade in Financial Services" available at www.imf.org (September 3, 2010).

reference note highlighted two particular problems. First, a member's obligations under PTA/BITs may conflict with its obligations under the Fund's Articles of Agreement. Conflict arises to the extent that PTA/BITs cover payments for current international transactions. If a member, to avoid acting inconsistently with its PTA/BIT obligations, were to impose controls only on non-parties to the PTA/BIT, then doing so would discriminate among Fund members and therefore likely not be possible to approve under Article VIII. Second, if a member experiences a large, sustained capital outflow, then under Article VI, Section I of the Fund's Articles of Agreement, the Fund may request the member to exercise controls to prevent the Fund's general resources from being used to meet such large or sustained capital outflows. But prohibitions on such controls under BITs/PTA could conflict with the Fund's request. We should add that this provision has so far never been invoked but the Fund, but the potential problem would arise should the Fund want to invoke it in the future.

A better approach to dealing with capital flows would be to take into account the macroeconomic, balance of payments, and financial stability implications of capital flows. The IMF's institutional view represents a step forward in addressing the issues that the Pardee report highlights, as it takes into account these various considerations when considering the appropriate policies for the liberalization and management of capital flows. Although the view does not alter countries' rights and obligations under the Fund's Articles of Agreement or other international agreements, it could play a useful role in promoting a more consistent approach to how countries should approach capital flow issues in bilateral and regional agreements.

Because most current bilateral and regional arrangements that address capital flow issues do not take into account macro/financial stability considerations, the patchwork of such agreements is therefore not as conducive to international monetary system (IMS) stability or international coordination as a more consistent approach would be. The institutional view could help foster a more consistent approach to policy space for CFMs under bilateral and regional agreements. It would be useful for Fund members to take the institutional view into account when entering into future agreements, especially as the view takes into account macroeconomic, IMS, and global stability considerations. Similarly, the integrated approach to capital flow liberalization advocated by the institutional view could be useful for the pacing and sequencing of liberalization obligations, and re-imposition of CFMs in circumstances where these are warranted, in the agreements.

In addition to these general observations, we have some more specific reactions to the report's recommendations. The proposals generally go in the direction of trying to reconcile incompatibilities between commitments on capital flow policies under PTAs/BITs and the GATS. They strive to clarify more consistently the policy space for using CFMs. To the extent that existing commitments are not based on the full set of considerations that the institutional view sees as relevant (including macroeconomic and financial stability considerations), the proposals would help address an important gap. They would move toward more consistency, which is also what the institutional view advocates.

It is important to distinguish between means and ends. For example, the 4th proposal, which calls for new rules for future treaties is consistent with the view that members should develop a more consistent approach to capital flow policies going forward. The goal is,

therefore, a good one. But, on the specific ways in which this goal is achieved (refrain from further GATS commitments, amend existing treaties, adopt "interpretations" of existing language), it is important for members to work collaboratively and with a common understanding of the problems. Efforts should avoid constricting global trade, particularly at a time when the global economy is already so weak.

An overall point to note is it is still an open question whether capital flow policies should appropriately be part of trade treaties. While there are arguments in favor of doing so, particularly since capital flows often have trade consequences and vice-versa, an alternative view is that they are better decided by national regulators, possibly with some input from international institutions. There is much less consensus on capital flow issues than trade issues, so putting capital flow issues into dispute resolution process used for trade issues seems particularly challenging.

The characterization of the Fund's institutional view in parts of the reports and comments is somewhat outdated. It refers to the 2011 paper on capital flows, which has been overtaken by the December 2012 paper on the Fund's institutional view that included several changes and additions.[4] For example, there is no reference in the institutional view paper to CFMs being a "last resort." The December 2012 paper clearly distinguishes between CFMs and macro-prudential measures (MPMs) while acknowledging the circumstances in which the two can overlap. It does not say that full capital flow liberalization is appropriate for all countries at all times. Several other characterizations of the paper similarly are not fully accurate.

II. Legal Aspects

The issue of the need for inclusion of the so-called "temporary safeguards clauses", including "BoP derogation clauses", in trade and investment agreements is not new. This specific issue was discussed within the Fund in 1990s. Indeed, the Fund analyzed relevant issues and supported the inclusion of such a clause in the context of the Multilateral Agreement on Investment (MAI) that was negotiated under the auspices of the OECD. In particular, in the context of the MAI negotiation, which was an attempt to establish a universal agreement to govern international capital flows, the Fund as well as delegations of OECD member countries supported the inclusion of temporary safeguards clauses that would allow a member to introduce restrictions on capital movements for reasons of serious balance of payments difficulties. Ultimately, the final negotiating text of the MAI provided for safeguards for reasons of "serious balance of payment and external financing difficulties", as well as "serious difficulties for macroeconomic management, in particular monetary and exchange rate policies". [See Clauses 1(a) and (b) on p. 78 of the April 22, 1998 MAI draft consolidated text]

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[4] See, "The Liberalization and Management of Capital Flows: An Institutional View" available at www.imf.org (December 3, 2012).

Even though the MAI was not adopted, given that the MAI was modeled closely after the OECD Code, it was expected that OECD members would follow the approach of more systematically including in bilateral or regional investment and free trade agreements of the above-mentioned "safeguards" clauses, giving countries the right to temporarily impose restrictions on capital flows where necessary for serious BOP or macroeconomic management difficulties. However, this has not been the case as such agreements generally continue not to include said safeguards clauses.

An important element that the Fund has always advocated for in the design of these types of safeguard clauses is that such measures be *temporary* and *non-discriminatory*. *Temporary* restrictions, because the member needs to implement the necessary adjustment policies and restrictive measures, which should not be a substitute for such policies, may be needed temporarily until said policies take hold. Further, these measures need to be temporary because the longer these are in place they become less effective. *Non-discriminatory* restrictions, because resolving the BoP or macroeconomic crisis would require not only adjustment policies, but also external financing, normally from the Fund and other multilateral and bilateral creditors. Thus, such a burden sharing strategy would be undermined if restrictions were imposed selectively on investors of some countries and not on others.

The issue of the need for safeguards clauses has been discussed within the Fund again more recently, as for instance, in the 2010 paper on the *Fund's Role Regarding Cross-Border Capital Flow*. In this paper, staff proposed as a possible initiative to undertake efforts to build consensus for a more systematic inclusion of "safeguards clauses" allowing the use of CFMs for balance of payments and financial stability purposes in bilateral and regional investment and trade agreements. However, a more comprehensive examination and analysis of the key agreements in this area would be necessary to take further steps in this area. Furthermore, in the recent discussions that lead to the Fund's institutional view on capital flows the Fund's Executive Board noted that the institutional view could help the Fund play a useful role in promoting a more consistent approach toward the treatment of CFMs under other international agreements such as the design of policy space for CFMs under these agreements. The Fund however is yet to discuss and adopt a position as to how better to promote such an approach.