POLICY SPACE FOR CAPITAL FLOW MANAGEMENT MEASURES: ARE THE IMF AND THE WTO INTERFERING?

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Capital account liberalization is a teleological goal that could only be achieved together with multilateral coordination for liquidity creation. These two goals are part and parcel of the chimera of an integrated world with coherent macro-economic policies. In the meantime, governments need to deal with a world where international reserve currencies are pumped into global markets with little or no consideration to spill-over effects.

Central banks from reserve-issuing countries have more than tripled their balance sheets and the Federal Reserve (FED) is still pumping 85 billion of fresh U$S per month to purchase long-term T-bonds and mortgages (the so-called "quantitative easing" (QE)). In late May, the sheer talk that the FED could start "tapering" these purchases triggered a rise of approximately 100 basis points in real interest rates and impressive capital outflows from emerging market economies and developing countries (EMEDCs). When the actual "tapering" starts, financial and foreign exchange markets could be seriously unsettled and reverberations could be particularly felt in EMEDCs. Governments, even those that would prefer not to use capital controls, may need to phase-in (or phase-out) capital restrictions as (and if) needed.

Many EMEDCs are negotiating trade preferential agreements than may contain investment provisions limiting their capacity to regulate capital inflows and outflows. The objective of this note is to raise awareness on the importance of preserving their policy space to regulate capital flows, as currently granted by IMF and WTO regulations.

The IMF and Capital Restrictions: no longer sinful?

In 2012 the IMF approved an "Institutional View" on capital flow management measures[2] (CFMs) acknowledging some intellectual respectability to capital restrictions. They were considered part of the tool-kit of measures to which governments could resort to, albeit only "temporarily" and after implementing macro-economic adjustment. Directors from EMEDCs criticized these two conditions, noting that all fiscal and monetary measures are of a temporary nature (consequently the "temporary" condition had no justification) and that CFMs would need to be implemented together or even before macro-economic adjustment so as to buy time for the adjustment to work. Following these criticisms, the "temporary" condition lost ground and found no space in the latest communiqués issued by the International Monetary and Financial Committee[3] (IMFC). The other condition to make CFMs "respectable" (to come after rather than together or before macroeconomic adjustment) is now more flexible; the latest IMFC

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[2] The Liberalization and Management of Capital Flows: An Institutional View. November 14, 2012.

[3] Theoretically it is has an advisory nature but it has ministerial level and is the IMF's most visible political organ.

communiqué states that “the necessary macroeconomic policy adjustment could be supported by (…) capital flow management measures”.[4]

The IMF still has a strong bias against capital restrictions; the benefits of capital flows are over-emphasized and its policy advice to cope with the spillover effects of ultra-loose monetary policies in advanced economies is focused on the macroeconomic adjustment of recipient countries, giving much less attention to the responsibility of source countries. However, the “institutional view” has consolidated some analytical progress. For instance, it is now clear that the Fund cannot request the removal of CFMs as a pre-condition for financial support.[5]

The “institutional view” was subsequently translated into an operational guidance for the IMF staff that still depicts capital account liberalization as the ultimate goal for emerging economies and stresses that, to manage inflow surges, priority should be given to exchange rate appreciation, reserve accumulation, and monetary policy easing before actually resorting to CFMs. The IMF staff is also asked to advice Members that, if they use CFMs they should avoid discriminating between residents and non-residents, despite the fact that it is sufficiently evident that non-residents were the first to reach for the door when interest rates in the US rose.

Very recently, in June 2013, the IMF executive board met to discuss the Global Impact and Challenges of Unconventional Monetary Policies (UMPs). Several Directors from EMEDCs noted that, given the volume of liquidity created by reserve issuing countries, exchange rate flexibility could not suffice to provide policy space for an independent monetary policy and that EMEDCs could need more than a conventional tool-kit to cope with the unwinding of UMPs. However, the Fund’s two most important publications, the World Economic Outlook and the Global Financial Stability Report, proposed that EMEDCs could face the unprecedented risks posed by the exit of QE by creating fiscal buffers (there was less recognition for reserve buffers[6]), implementing macro-prudential tightening measures, adding exchange rate flexibility (with currency intervention if necessary) and restricting growth in corporate leverage.

In sum, the Fund has moved quite a long way from its original position of recommending outlawing restrictions to capital movements[7], but it has done so reluctantly and dragged by facts. It would be almost obscene to applaud the lavish printing of money in reserve-issuing countries

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[4] The Communiqué of the Twenty-Eighth Meeting of the International Monetary and Financial Committee (October 12, 2013) stated that accommodative monetary policies in advanced economies “remain appropriate”.

[5] Paragraph 61 of the “Institutional View” clearly states that CFMs maintained “outside” the institutional view could not be considered measures that the Fund could require members to eliminate as a condition for the use of Fund resources.

[6] In spite of the recognition in Chapter 4 of the WEO that countries with higher levels were more resilient between 2007 and 2009 and that reserves accounted for 20 percent of the accommodation in response to a fall in capital inflows.

[7] The Economist in a recent special report on globalization recalled that it was only in 1997 when the IMF was formally proposing amending its charter to promote capital-account liberalisation, calling it "an essential element of an efficient international monetary system in this age of globalisation". Special Report on World Economy. The Gated Globe; “Just in Case”, page 11, October 12-18, 2013.

(as the IMFC still does[8]) while asking EMEDCs to condition their fiscal and monetary policies to the humors of short-term capital flows.

I finish the first part of this note with a positive note for policy makers in EMEDCs. During the last IMFC meeting, Ministers agreed (at Brazil's insistence) that it was necessary to pursue "policy coherence and concerted action to manage spillovers (stemming from the normalization of) monetary policy".[9] To my knowledge this is the very first time that the IMFC has called for "concerted action" on this subject. The IMF will now need to translate this into action.

Is the World Trade Organization preventing the use of CFMs? [10]

According to Art XV.9 (a) of GATT 1994, WTO Members imposing measures restricting capital transfers that are *not* IMF inconsistent are—in principle—*not* in breach of their trade obligations.[11]

The IMF only bans restrictions on capital transfers that are for the purpose of settling current transactions. Transfers of capital that are not for that purpose can be restricted.[12] However, certain capital restrictions not imposed on current transactions could give rise to a breach of WTO obligations. This would be the case when restrictions in access to foreign currency are used to enforce multiple currency practices.[13] According to the Note to Article VI paragraphs 2 and 3, 2 of the GATT, "Multiple Currency Practices" (practices by governments or sanctioned by governments) "can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties or can constitute a form of dumping. However, the risk is minimal because multicurrency practices are not allowed in the IMF".[14]

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[8] The Communiqué of the Twenty-Eighth Meeting of the IMFC (October 12, 2013) stated that accommodative monetary policies in advanced economies "remain appropriate".

[9] Ibid.

[10] The analysis on WTO rules is drawn from a previous paper from the author, "Capital Controls Can Smoothen Trade Tensions", in Capital Account Regulations and the Trading System: A Compatibility Review", Pardee Center, Task Force Report, Boston University, March 2013.

[11] GATT 1994 Art XV.9 (a) states that nothing in that agreement could preclude Members from using "exchange controls or exchange restrictions in accordance" with the IMF's charter.

[12] Admittedly international payments for current transactions do require capital transfers but not just for the purpose of transferring capital but rather to settle trade transactions, as well as interests on loans, net income from investment, payments of "moderate" amount for amortization of loans of FDI and "moderate" remittances for family expenses.

[13] IMF Decision 955-(59/45) established that "a direct governmental limitation on the availability or use of [foreign] exchange as such" should be considered "a restriction on payments and transfers (to settle) *current transactions*"; hence, arguably not a restriction on capital transaction. This definition was echoed in the GATT by the panel in "Dominican Republic – Import and Sale of Cigarettes" (Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes. Report of the Panel, page 144; 7.144, 7.145).

[14] At the IMF, multicurrency practices (outlawed, except when authorized) arise when, due to government action, the are two or more exchange rates for spot foreign exchange transactions prevailing in the country that deviate by more than 2 percent (see Policy on Multiple Currency Practices, Decision No. 649-(57/33), June 26, 1957). Article VIII, Section 3 of the AoA establishes that "no member shall engage in, or permit any of its fiscal agencies (…) to engage in, any discriminatory currency arrangements or multiple currency practices".

The aforementioned risk is further minimized by the fact that the IMF polices its members compliance with obligations. The Fund's staff could and should—*ex-officio*—require Members to remove restrictions affecting current transactions or giving rise to multicurrency practices regardless of whether they affect another Member and regardless of whether any other Member has submitted a complaint requesting the removal.[15]

What about capital restrictions that affect WTO commitments on financial services?

Under the General Agreement on Trade in Services (GATS) all scheduled commitments are made under mechanism of "positive lists" [16], therefore, WTO Members only undertake market access and national treatment commitments in the areas (and in the trade "modes"[17]) enumerated in their lists, which also frequently include limitations on each commitment.[18]

Article XI.1 of the GATS provides that Members "shall not apply restrictions on international transfers and payments for current transactions relating to specific commitments".[19]
Furthermore, Article XI.2 of the GATS (echoing Art XV.9 (a) of GATT 1994) establishes that "provided that a Member (does not) impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions" nothing in the GATS shall affect its rights and obligations under the IMF Articles of Agreement (AoA).
Footnote 8 to Article XVI of the GATS goes a step further, clearly outlawing restrictions to certain capital transactions. If a WTO Member undertakes a commitment to allow for a cross-border service (Mode 1) then cross-border movement of capital (inflows and outflows) may be an essential part of the service itself and the Member cannot restrict it.[20] In the same logic, if a WTO Member undertakes a commitment to allow for the commercial presence of the service provider (Mode 3) then the Member "is thereby committed to allow related transfers of capital *into* its territory" (emphasis added).[21] This is just a matter of good faith.

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[15] This contrasts with the WTO where Members are required to withdraw a measure only after it is found to be in breach of its obligations, following the adoption (by the Dispute Settlement Body) of a report produced by a Panel or by the Appellate Body. At the Fund, a breach of compliance can be brought by staff, management (or by any executive director) to the attention of the Executive Board.

[16] "Positive lists" opposed to the modality of "negative lists" in which only exceptions to trade liberalization are enumerated. Preferential Trade Agreements with investment obligations are frequently negotiated on the basis of "negative lists".

[17] Trade in services could be supplied in four "modes"; Article 1.2 of the GATS.

[18] Commitments to liberalize financial services associated with financial flows do not imply that the financial service in question will be "de-regulated" but rather that the applicable regulation will grant national treatment to foreign providers (on top countries may include limitations in their country schedules).

[19] Except when justified to safeguard the Balance of Payments, see Article XII of the GATS.

[20] Lending on "Mode 1" would be such a case, as cross-border movement of capital would be essential to supply the service. To the extent that a WTO commitment includes a financial service transaction which involves an international capital transaction, then the capital account needs to be opened for the former to take place. (Kireyev 2002).

[21] GATS does not require free cross-border movement of capital (inflows and outflows) for commitments undertaken under Modes 2 and 4, nor liberalization of capital outflows for commitments undertaken under Mode 3.

However, the GATS also includes a provision that allows Members to derogate their liberalization commitments on capital flows. This is the so-called "prudential carve-out", which establishes that "notwithstanding *any* other provisions of the GATS" (emphasis added) a WTO Member is not prevented from "taking measures for prudential reasons" or "to ensure the integrity and stability of the financial system".

As we just noted, limitations to impose capital controls in the GATS are only derived from voluntary commitments on market access adopted by countries mostly in (some[22]) financial services where cross-border movement of capital is an essential part of the service itself in cross-border services. The same goes for commitments that require the commercial presence of the provider (Mode 3) in which case limitations could be imposed on outflows but not for inflows. And even then, notwithstanding *any* provision of the GATS (which includes the schedules of these specific commitments[23]), WTO Members preserve policy space to take measures for prudential reasons or to ensure the integrity and stability of *the* financial system.[24] The only limitation to Members' policy space is that, when measures adopted for these two purposes depart from the GATS provisions, they should not be *used as a means* of avoiding Members' commitments or obligations under the Agreement.[25] In other words, the *purpose* of the limitation should not be to avoid the commitment but to take prudential measures or to ensure the integrity and stability of the financial system. This is also a matter of good faith.

The flexibilities embodied in the WTO agreements are in sharp contrast with many PTAs with investment provisions (and bilateral investment agreements (BITs)) which normally do not contemplate "appropriate safeguards or proper sequencing of liberalization"[26] and provide only very limited policy space to apply CFMs.[27] It is important to underscore that despite its distaste for CFMs, the IMF has shown concern for the undercutting of policy space by PTAs (and BITs) that restrict the possibility of imposing capital controls during macroeconomic and financial distress.[28]

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[22] "Some financial service transactions are not accompanied by capital movements, such as financial consultancy and information services." Marchetti (2010).

[23] Article XX.3 of GATS.

[24] The wording of the carve-out suggests that in using it WTO Members are not limited to preserving the integrity and stability of "*their*" financial system.

[25] This provision has not yet been interpreted. However, it is interesting to note that the prudential carve-out does not require that measures adopted for the purpose of prudential reasons or to ensure the integrity and stability of the financial system have no effect on Members' commitments or obligations; but rather that, in implementing them, Members should not use them as means to depart from their obligations.

[26] IMF, 2012, "Liberalizing Capital Flows and Managing Outflows.", page 8 (Washington D.C.: *International Monetary Fund.)*

[27] Ibid paragraph 34

[28] International Monetary Fund (IMF) (2010) "Reference Note on Trade in Financial Services." *IMF Reference Note.* Washington D.C.: *International Monetary Fund.* Limitations to impose capital controls included in PTAs and BITs could conflict with two IMF provisions. Article VI, Section 1 establishes that the Fund's general resources cannot be used to meet "large of sustained outflow of capital"; however, in the absence of a safeguard provision in the PTA or the BIT , a Fund member may feel legally bound to use IMF resources to transfer capital to its PTA/BIT partner. On the other hand, obligations under PTAs/BITs may conflict with Article VIII, Section 2 (a) of the IMF charter. According to this provision a member may, with the approval of the Fund, impose restrictions on payments and

transfers for current international transactions. In the event of a financial crisis, problems of discrimination among Fund members could arise if a party were to impose controls on nonparties to the PTA/BIT. (Ibid, paragraph 27).