**The International Regulatory Regime on Capital Flows and Trade in Services**

Federico Lupo Pasini

Countries often adopt various forms of restrictions in order to restrain capital flows or to reduce the negative effects associated with them. In parallel to the adoption of these various forms of controls, economists have been debating extensively the determinants of capital flows and on their macroeconomic repercussions. The economic implications of capital movement are varies and touch upon issues of macroeconomic stability, monetary policy, investment and trade policy, as well as international finance. Nonetheless, despite extensive academic research, it seems that there is still disagreement and lack of clarity on what free flow of capital precisely entails and on how to categorize these various restraints. The uncertainty is even more acute at the regulatory level. Capital flows have often been regulated domestically by central banks or in the framework of comprehensive investment or trade policies, and only recently it begun to emerge a timid and confuse international legal regime for capital movements[1]. As a consequence of the confusion and the lack of a clear discipline, there is virtually no legal literature examining the international regulation on capital flow.

Finding a coherent regulatory structure on which categorize uniformly all the applicable regulatory regimes on capital flows is not an easy task. First of all, economists still do not agree on what capital flows precisely entail, and on what kind of measures government can put in place to regulate them. Secondly, despite capital transactions being regulated by various multilateral and bilateral instruments, in international law there is no definition of capital movements to be applied uniformly across al the areas of law.

This paper will not analyze the economic implications of capital flows, which have been covered extensively by the economic literature, but rather, it will try to conceptualize capital flows from a regulatory perspective, mostly focused on the trade implications of capital flows. The research will not be limited only to regulations affecting the movement of capital as such, intended only as international capital account transactions and related payments. Rather, the investigation will take a broader perspective and will focus on the rules affecting the flow of capital, as comprising also payments and transfers for current international transactions. The reason to this is while capital

[1] Only very recently the International Monetary Fund begun to research on the various rules and regulations affecting the free flow of capital. For instance, see: IMF, The Fund’s Role Regarding Capital Flows, IMF, 2010

movements are only touched by measures that affect capital account transactions, capital flows are affected also by exchange measures that have an impact on the free flow of currency as a mean of payment for both current and capital account transactions. Furthermore, most of the legal instruments examined provide a regulatory structure that takes into account both kinds of movements.

## REGULATING CAPITAL FLOWS

From an international regulatory perspective the flow of capital and foreign currency is essentially regulated by four sets of instruments. Each of them set out slightly different rules on capital flows, crafted on the underlying economic or legal perspectives specific to each treaty. The Articles of the Agreements of the International Monetary Fund (the IMF Articles) has the fundamental aim of ensuring financial and monetary stability and it prescribes stringent rules on payment and transfers for current international transactions, while leaving a wider room for discretion for capital account transactions. Multilateral and preferential agreements on services, such as the GATS and various FTAs regulate current payment and transfers, as well as the capital movements to the extent that are incidental to the freedom of trade in services. International Investment Agreements or Bilateral Investment Treaties look at capital flows as one of the collateral conditions necessary for ensuring freedom of investment. Lastly, capital flows are regulated by regional treaties, such as the European Union, which require freedom of movement of capital as one of “four freedoms” of the single market, or by wider preferential agreements (the OECD Codes on Capital Movements and on Current Invisible Operations), which by far adopts the most comprehensive rules on international capital flows.

Capital flows can be restricted in three ways. First, by measures that operate directly on capital account transactions and directly affect the flow of financial and real assets among countries. Such measures comprise various forms of capital controls, which vary consistently from each other based on the kind of capital flow targeted by the measure, by the modalities adopted and by the final goal. It is impossible to try to categorize rigidly capital controls, although academics often operate some distinctions. From a regulatory perspective such measures, by targeting capital account transactions fall within the capital account regulations of each country. As it will be explained later, capital controls are generally not prohibited by international agreements, although some of them could pose specific restrictions. Second, capital flows can be affected by exchange restrictions that, similarly to capital controls operate on the capital account. Such measures affect only one kind of financial asset, money. Exchange restrictions target the ability of non resident to hold domestic currency deposits on-shore, the right of residents to hold off-shore deposits, the right of residents to hold foreign currency deposits on-shore, or measure that operate on the value of the currency transaction, such as tax or multicurrency arrangements. These restrictions operate on foreign currency, but only as a form of capital account transaction. For these reasons, they are subject to the same regulatory framework of capital controls and are usually allowed. Lastly, capital flows can be indirectly affected by measures that do not touch upon the capital account but nonetheless affect the ability of resident and non-resident to perform international payment and transfers associated with the underlying transactions operated on the capital account (for portfolio and FDI transactions) or on the current account (for trade of goods and services). The performance of international payments and transfers does not require the opening of the capital account but it does imply the use of foreign currency. Such measures comprise multicurrency arrangements and exchange restrictions, and are generally prohibited when they affect payment and transfers of current account transactions.

While capital controls can be imposed only on capital account transactions (often on movement of financial assets), currency restrictions can be imposed on capital account transaction involving foreign currency, or they can be imposed payments and transfers of both capital and current account transactions.

From a regulatory point of view, the most important distinction is between measures that affect capital account transactions, which are generally tolerated, and measures that affect current account transactions, which are generally prohibited. In this respect, the IMF Articles are the primary regulatory reference on both capital and current account transactions, as other international instruments usually refer to their regulatory regime.

**Defining Capital Movements**

In order to delimit the perimeter of the discussion it is useful to define in what consist the movement of capital from a regulatory perspective. In this respect, in spite of being capital movements the subject of one multilateral international treaty – the OECD Code on Capital Movement – and being mentioned in other international instruments, in international law there is no comprehensive definition of international capital flow. Clearly, the lack of precise legal boundaries on what entails the movement of capital is a major loophole in international economic rulemaking.

In international law the only reference on the meaning of capital movement is given indirectly by Article XXX(d) of the Articles of the Agreement of the International Monetary Fund that provides a definition of *"payments for current transaction"*, which are *"payments which are not for the purpose of transferring capital, and includes, without limitation:*

*(1) All payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;*

*(2) Payments due as interest on loans and as net income from other investments;*

*(3) Payments of moderate amount for amortization of loans or for depreciation of direct investments; and*

*(4) Moderate remittances for family living expenses".*

The IMF definition of current account transaction is very broad, and in some cases it comprises also transactions that economist usually inscribe to capital account, such as (i) payments of moderate amount for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit facilities[2]. From this definition is possible to reconstruct *a contrario* a rough and partial definition of capital movement, which can be defined as all the transactions that operate on the capital account and are not comprised in the list of Article XXX (d).

The distinction between capital account transactions, which imply capital movement, and current account transaction, which entails trade in goods and services, is of outmost importance from a regulatory perspective, as each transaction is subject to a complete different regulatory regime. The dichotomy between capital and current account transaction permeate the whole legal regime on capital movement, as the distinction is applied in all the international treaties concerning capital movements.

**Capital Account Transactions and the IMF Agreement**

Capital can flow among countries as an asset in a capital account transaction. In order to enable capital transactions it is necessary that the country open its capital account, which in a broad term requires the easing of restrictions on international purchases and sales of real and financial assets recorded in the capital account of the balance of payment. The assets that can be traded in the capital account are usually differentiated between portfolio and FDI. In this respect, foreign direct investment encompasses the acquisition of real estate and production facility and substantial equity investment in domestic companies, while portfolio investment involves the purchase of financial assets, such as stocks, bonds, foreign currency, derivatives and bank loans[3]. The opening of the capital account is not an "all or nothing" issue, but it can be gradual and, depending

[2] IMF, The Fund's Role Regarding Capital Flows, IMF, 2010

[3] C. J. Neely, *An Introduction to Capital Controls,* Federal Reserve Bank of St. Louis, 1999, p. 14

on the kind of assets traded, it requires different measures[4]. Usually FDIs are the first assets to be liberalized, as they are usually less volatile and do not pose much macroeconomic problems. On the opposite, portfolio transactions are considered more volatile and pose a number of problems from a macroeconomic perspective. When a country liberalize both FDI and portfolio flows it has adopted "capital account convertibility" which can be defined as the freedom to convert at the market rate domestic financial assets into foreign financial asset and vice-versa, and it broadly entails the possibility for foreigners and nationals to convert currency for operations affecting capital account (such as FDIs and portfolio), as well as for current payments[5].

As it was mentioned above, the distinction between capital account transaction (and related payments) and current account transaction is at the core of the analysis. The economic distinction between capital controls and exchange restrictions on capital transactions is for the most part not replicated at the regulatory level. In this respect, both the Articles of the Agreement of the IMF as well as other international treaties that refer to the IMF rules simply differentiate between capital account transactions and current account transactions. Conversely, the majority of international investment treaties and some free trade agreements (especially US FTAs) adopt a different approach and do not differentiate between exchange restrictions operated on the capital account and exchange restrictions operated on the current account.

In the preamble of Article IV of the Articles of the Agreement[6] for the first time it is clarified that also movement of capital is an element of the international monetary system, whose stability requires the IMF to oversee the policies of the members that affect it, and among them there is also movement of capital[7]. Following this consideration, it would be logic to look at the International Monetary Fund as the primary "regulator" of international movement of capital. In spite of the

[4] For example, it is possible to attract FDIs without excessive opening of the capital account, such ad through transfer of funds provisions. Williamson and Z. Drabek, Whether and When To Liberalize Capital Account and Financial Services, WTO, 1999.

[5] Royal Bank of India. 1997. *Report of the Committee on Capital Account Convertibility*. Mumbai

[6] The preamble states: "*Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates".*

[7] The IMF in various discussions in the framework of its works on international monetary reform in the 1969 and 1970s makes reference to the "international monetary system". According to the IMF the "International Monetary System" is composed by four elements: (i) The rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (ii) The rules governing the making of payments and transfers for current international transactions between countries; (iii) The rules governing the regulation of international capital movements; (iv) and The arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements. For an overview: International Monetary Fund, *Annual Report,* IMF, 1965; and, International Monetary Fund, *The Fund's Mandate – The Legal Framework,* IMF, 2010

overall competence of the Fund on the international monetary system, the movement of capital is not under the direct competence of the IMF, and each Member still largely regulates it independently.

The main provision on capital movements in the Article of the Agreement of the IMF is contained in Article VI, Section 3, which stipulates that Members may exercise controls that "are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(*b*) and in Article XIV, Section 2". Thus, for what concerns the IMF jurisdiction, this provision structures a regulatory dichotomy between current account and capital account measures, with the former generally strictly regulated by the IMF, while the latter are generally under the competence of the members states.

According to the rules of the IMF, generally Members retain their exclusive competence in imposing and regulating both inward and outward capital movements and in deciding whether their imposition is "necessary". In spite of their comprehensive autonomy in regulating capital movements, IMF members are bound by few provisions of the IMF treaty that ensure a limited competence of the IMF on capital controls. In this respect, the IMF has the power to intervene and to provide guidance to Members on the adoption of measures that affect the capital account in three distinct occasions.

First, a Member cannot use Fund resources to meet a *large or sustained outflow of capital*[8]*.* The reason to this is that Fund's resources are primarily directed at correcting current account deficits, which fall within the mandate of the IMF. Such financing will allow eliminating current account restrictions. The jurisprudence of the Fund has never clarified the precise meaning of "large or sustained outflow", either from a conceptual or temporal point of view. Nevertheless, the practice of the Fund was to determine the concept of large or sustain outflow with regard to the overall mandate of the fund in providing financial assistance, and therefore, by looking at the underlying reasons that lead to the outflow. In this respect, if such outflow of capital was due to problems in fiscal or exchange policy, which are in the mandate of the Fund, the Fund would primarily look at

[8] Article VI, Section 1 provides as follow: "*(a) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund. (b) Nothing in this Section shall be deemed:*
*(i) to prevent the use of the general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business; or*
*(ii) to affect capital movements which are met out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund".*

whether the use of Fund's resources would resolve the underlying fiscal or monetary difficulties[9].

Another issues is whether the Fund can request a Member either to impose capital controls or eliminate capital controls as a condition for the use Fund's resources. The nexus between capital controls and Fund's conditionality is provided by Article V, Section 3, which provides that the Fund shall adopt policies in the use of its resources that will help Members to solve their balance of payment difficulties in a manner consistent with the provisions of the IMF Agreement and that will establish adequate safeguards for the temporary use of the Fund's general resources. According to this provision the Fund is entitled to require the Member to adopt capital controls as a condition to access the Fund's resources. This is confirmed also in the above-mentioned Article VI, Section 1(a) that allows the Fund to require a Member to adopt capital controls in order to prevent a large or sustained capital outflow as a preliminary condition before being allowed to apply for the resources of the Fund (provided that such controls resulted ineffective in limiting the outflow). In case the Member do not adopt capital controls, as requested by the IMF, it will be not allowed to access the resources[10]. Conversely, the lack of jurisdiction of the Fund in capital account transactions is generally indented as preventing the Fund from requesting a Member to remove capital controls as a condition to access Fund's resources. However, one exception to this practice does not allow Members using Fund resources to apply capital controls in a manner that will give rise to external payment arrears[11].

Lastly, Article IV, Section 1 of the IMF Agreement[12] provides the general obligations on the Members to "*avoid manipulating exchange rates or he international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members*". In spite of its wide obligations, Article IV has been considered as hortatory in nature and not being directly enforceable. According to the jurisprudence, the breach of a Member of one of the provisions of Section 1 will be considered only as a breach of the general obligation to collaborate, without giving rise to any specific action. In case a member violates one of he provisions, the Fund will be allowed to recommend the Member to take or refrain from taking additional actions, as it deems appropriate. Nevertheless, the provision of Section 1(iii) has been intended as covering also movement of capital. In particular the unclear meaning of "manipulating exchange rate or the international monetary system" has been

[9] IMF, The Fund's Role Regarding Cross-Border Capital Flows, IMF, 2010, p. 51
[10] The Fund has included in its economic programs during economic crises controls on capital outflows where large outflows have threatened to overwhelm emergency financing (including under Fund arrangements) and deplete international reserves. Examples include Argentina in 2002 and Iceland in 2008. IMF, 2010
[11] IMF, The Fund's Role Regarding Cross-Border Capital Flows, IMF, 2010, p. 51

intended as comprising also excessive intervention in the exchange rate markets or the imposition of capital controls. For this reason capital controls deemed to be used as a way to prevent balance of payment adjustments or to gain and unfair competitive advantage on other members would be likely to trigger the "soft" intervention of the Fund[13].

**Current Account Transactions and The IMF**

Current account transactions involve trade of goods and services that are recorded in the current account of the balance of payment. Current transactions as such do not imply any capital movements because there is no transaction operated in the capital account. Nevertheless, the making of payment and transfers associated with such transactions involve the free use of foreign currency, which leads to an international flow of currency among countries in order to allow the payment of the transaction. When countries allow international payment and transfers for current account transactions, they adopt current account convertibility, which allows residents to receive foreign currency for exports of goods and services, and to pay in foreign currency for the import of goods and services.

Capital flow related to the payment and transfers associated with current account transaction can be affected by exchange restrictions and multicurrency arrangements. Such measures are similar to that applied to capital account transactions, but unlike those applied to capital transactions, they are generally forbidden by the IMF, and by other international treaties.

The limited competence of IMF with regard to capital account transactions stands in contrast with the parallel full competence on current account transactions. Indeed, Article VIII, Section 2(a) imposes the Members to refrain from imposing restrictions on the making of payments and transfer for current international transactions[14]. The definition of "payments and transfers for current international transaction" is provided by Article XXX(d) and it is broader than the definition used by economists or balance of payment statisticians[15]. For this reason the jurisdiction of the Fund on current transaction encompasses also certain assets that are capital in nature, such as (i) payments of moderate amount for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit

[13] For an overview of the jurisprudence on Article IV: IMF, *Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework,* IMF, 2006.

[14] IMF Agreement, Article VIII, Section 2(a)

[15] According to the IMF, one first differentiation would be on operations that economist would inscribe as capital account transaction. Another important note is that Article VIII, Section 2(a) does not cover the underlying transaction. Hence, Members are not affected by this provision when deciding to prohibit certain imports, and consequentially also the prohibitions to use foreign exchange related to the payment of such transactions are allowed. For a quick look: H. Helizalde, The International Monetary Fund and Current Account Convertibility, in *Current Developments in Monetary and Financial Law*, Volume 4, IMF, 2004

facilities[16]. Hence, these transactions, despite being capital account transactions are considered as payment and transfer for current international transactions and therefore are subjects to their discipline. Therefore, according to Article VIII Members cannot impose any control or prohibition on these transactions unless they are authorized by the Fund[17].

Article VIII:2 of the Articles of the IMF Agreement forbids exchange restrictions on current payments. This provision imposes two obligations on Fund members. First, members must not limit or impede any of its residents from obtaining the foreign currency necessary for making payment to non-resident in settlement of the underlying current transactions. Second, members must permit non-residents that have acquired balances of the country currency by engaging in international current transaction with members, to transfer that currency or convert them at a freely usable currency and transfer it abroad, as long as this does not represent a capital movement[18]. Article VIII, Section 2(b) provides that exchange contracts involving the currency of any other member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with the Articles of Agreement shall be unenforceable in the territories of that member. The previous consensus was that in the case capital restrictions in form of exchange controls that affect current payment would be considered as falling within the ambit of application of this provision, and therefore being unenforceable. Nevertheless, the German national court called to interpret this provision has held that the lack of competence of the IMF on capital transactions renders this provision applicable only to contracts involving exchange controls restrictions on current transactions[19].

Article VIII, Section 3 prohibits the Members to engage in discriminatory currency arrangements or multicurrency practices[20], that occur when different groups of foreign exchange transactions are conducted at different exchange rates, resulting in a spread of more than 2% between buying and selling rates for spot exchange transactions. According to the jurisprudence of Article VIII the prohibition apply only to multicurrency practices that relate only to current account transactions and the Fund has clarified that multicurrency arrangements that apply to capital transactions can be adopted by Members whenever they may be reasonably needed.

In spite of the overall competence of the IMF on current account measure, members are allowed to

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[16] IMF, The Fund's Role Regarding Cross-Border Capital Flows, IMF, 2010, p 49.
[17] IMF Agreement, Article VIII, Section 2(a)
[18] H. Helizalde, The International Monetary Fund and Current Account Convertibility, in *Current Developments in Monetary and Financial Law*, Volume 4, IMF, 2004.
[19] H. Helizalde, The International Monetary Fund and Current Account Convertibility, in *Current Developments in Monetary and Financial Law*, Volume 4, IMF, 2004, p. 33
[20] The IMF Decision No. 6790-(81/43) of March 20, 1981 defines multicurrency practices as "action by a member or its fiscal agencies that of itself gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions between the member's currency and any other member's currency would be considered a multiple currency practice and would require the prior approval of the Fund."

impose restrictions on current payments and transfers when they have been temporarily approved by the Executive Board for balance-of-payments reasons, or when their maintenance is authorized under the transitional provisions under Article XIV of the Fund's Articles[21]. The balance of payment clause act as a safety valve in case of serious economic crises, and, with the exception of US FTAs and BITs, it is replicated in almost all the international legal instruments regulating capital flows.

[21] IMF, *Reference Note on Trade in Financial Services,* IMF, 2010

## MOVEMENT OF CAPITAL AND SERVICES

International trade in services and movement of capital are tow distinct issues, although in some cases they might overlap. The difference consists in the different role of the services transaction and the capital transaction when recorded in the balance of payment. While the services transaction is to be inscribed into the current account, the movement of capital implies a capital transaction that is to be inscribed in the capital account.

Trade in services always involve international payments and transfers associated with underlying current international transactions. On the opposite, services trade do not always give rise to capital movements. Broadly speaking a service transaction involve the international supply of a service by a domestic service provider to a consumer abroad or the *access* of domestic consumers to a *service* provided by a foreign supplier. Such transaction is to be recorded in the current account and give rise to payments of *service fees, charges, and commissions*. On the other hand, capital account transactions, do not necessarily involve the provision of a services, but they simply imply the creation, transfer of ownership or liquidation of capital assets and the payment and transfer associated with such transaction[22]. Among various kinds of capital assets that could form a capital transaction, financial assets are those closely associated with a provision of a service. In this respect, both the use of foreign capital by domestic consumers or the use of domestic capital by non-resident, imply the access to a banking service, which also results in payment of a services fee[23].

**Dissecting Capital Movements from Services Trade[24]**

Kono and Schuknecht provide a clear example on the difference between a supply of a service that entails capital flow and a pure service transaction without capital movement. In the example there are six situations that can apply: 1) a lending transaction between a domestic financial service provider located in its own country and a domestic customer. In this case there is neither trade in services nor capital movement; 2) a lending transaction (mode 1) in domestic currency between a domestic financial service provider (located abroad) and a domestic customer. In this case there is no movement of capital and no trade in services; 3) a lending transaction (mode 1) in foreign currency between a domestic financial service provider (located abroad) and a domestic customer. In this case there is movement of capital and no trade in services; 4) a lending transaction in foreign currency between a foreign financial service provider established in the host country (mode 3) and a

[22] S. J. Key, *The Doha Round and Financial Services Negotiations*, AEI Press, Washington, 2003
[23] A. Lehmann, N. T. Tamirisa and J. Wieczorek, International Trade in Services: Implications for the IMF, International Monetary Fund, 2003
[24] This box draws from Kono and Schuknecht, "Financial Services Trade, Capital Flows, and Financial Stability", WTO, 1999.

domestic customer. In this case there is trade in services and capital movement, as the lending transaction is operated with foreign currency; 5) a lending transaction in domestic currency between a foreign financial service provider established in the host country (mode 3) and a domestic customer. In this case there is trade in services but no capital movement, as the lending transaction is operated with domestic currency; 6) a lending transaction (mode 1) operated by a foreign bank (located in its own country) and a domestic customer. In this case there is both trade in service and capital movement. From these examples it is clear that pure trade in services is in situation 5, pure capital movement is in situation 3, while trade in service and capital movement is in situation 4 and 6.

The direction and the kind of capital moved depend highly on the typology of the service and its mode of supply. In this respect, the establishment of the commercial presence (mode 3) of a foreign service supplier requires the movement of capital necessary to acquire an existing firm or to purchase land and any other assets necessary to set up the operation of the company. Indeed, if a country commits to allow foreign service supplier to acquire 100% equity in a domestic bank, or to establish a de novo subsidiary, it essentially allow an inflow of capital to perform the operation. If a country wishes to block any inflow of capital, it must also block any FDI in the financial services sector. Even after that phase, there is a high possibility that the day-to-day operations of the subsidiary would involve a movement of capital. This will happen if the activities of the subsidiary would imply transactions in foreign financial assets with host-country residents. Similarly, also the creation of branches and ther day-to-day activities almost invariably involve capital movements necessary to perform the initial investment and to conduct portfolio transactions with the head office[25]. It is important to note that for what concerns the GATS, the movement of capital related to the establishment of a commercial presence is only inward[26]. This means that, unlike BITs or FTAs, the GATS does not control or regulate the outward movement of capital resulting from the operations of the foreign invested company, such as repatriation of profits or transfer of funds. Furthermore, once a foreign service supplier is incorporated in the host country it is generally considered as a domestic company and therefore subject to the domestic laws on capital movement. Therefore, in spite of the fact that the operations of the company involve international movement of capital, as long as it does not negatively discriminate between foreign and domestic companies, a Member can impose restrictions on the outflow of capital involving (also) a foreign service supplier without violating any GATS rule.

Another mode of supply that gives rise to substantial capital movement is mode 1. The cross border supply of a service, when it entails movement of capital, can give rise to both inflow and

[25] Ibid.

[26] M. Kono and L. Schuknecht, Financial Services Trade, Capital Flows, and Financial Stability, WTO, Geneva, 1999

outflow capital flows. The cross border movement of capital is typical of financial services. One example could be the making of loans or the acceptance of deposits provided by a domestic bank to non-residents consumers. Similarly, in the securities sector, most international portfolio transactions are usually associated with securities trading or asset management services provided by a host bank to a non-resident investor. Capital movements could be theoretically covered by mode 2, when a consumers move to another country to enjoy a service, bringing its own money to pay for the service. In this case, the GATS does not cover possible restrictions on the outflow of capital as they are pure internal measures not directed on the services itself.

**Regulating Capital Flows in the GATS**

The GATS essentially provides for a regulatory platform on which countries can exchange and commit to mutual market access concessions for the supply of services. More specifically, WTO Members can commit in the GATS to allow foreign services providers to supply their services through any of the four modes of supply. Based on the specific and horizontal commitment, the scheduled services must abide by the rules provided in the GATS.

Among the WTO Agreements, the GATS is the only Agreement that regulates both transfers and payment for services transactions as well as pure capital movements. More specifically, the regulatory regime adopted by the GATS envisages capital flows in the form of current payment and transfers required to perform a services transaction, as well as pure capital movements as a necessary element to most of financial services trades.

From the provisions of Article XI and XII it is possible to argue that even in the GATS, similarly to the IMF, it is replicated the dichotomy between capital account transactions and current account transactions. With the latter being heavily controlled and subjects to the regulations of the IMF, and the former being substantially liberalized and subject only to balance of payment or prudential restrictions, as stipulated in the GATS.

Article XI of the GATS stipulates that:

> *1. Except under the circumstances envisaged in Article XII, a* ***Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments****.*
>
> *2. Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided* ***that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund****.*

**Capital Movements**

The GATS does not provide any regulatory platform for movement of capital as it does for services. In this respect, countries cannot seek market access and regulatory conditions for their capital, as it is provided in the OECD code of Capital Movement. Nevertheless, as it was said before, capital movements are sometimes implied in financial services trade as one of the necessary elements of the transaction. The GATS ensures that restrictions on movement of capital would not undermine the freedom of trade of the other Members, according to the specific commitment applicable.

The most important and the only provision that regulates directly movement of capital is a footnote to the Market Access provision of Article XVI (1), which stipulates that

> *"With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule"*

A footnote to this provision provides:

> *"If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I, it is thereby committed to allow related transfers of capital into its territory".*

According of the combination of these provisions, the movement of capital is regulated only partially and only to the extent that is a necessary element for the supply of the services itself. The first paragraph of the footnote contains the first limitation, which restrict the freedom of capital movement only to the services sectors committed by the Members, as scheduled in terms of sectoral coverage, modes of supply, and specific reservations. The footnote provides another important limitation, this time specifically linked to the modes of supply of the services. In this respect, the footnote obliges the Members to allow the movement of capital only in relation of the market access commitments (not on non discrimination), when the cross border movement of capital is "an essential part of the (mode 1) service itself", or when the obligation to allow commercial presence implies the related transfer of capital in the territory.

Both the first and the second sentence of the footnote to Article XVI mention the movement of capital as an essential part of the service supplied on a cross border basis, and as a transfer related to the establishment of the commercial presence of a service supplier. In this respect, the movements of capital covered in the GATS are of two kinds: first, only to the inflow of capital related to the establishment and the continuation of a commercial presence (i.e. the amount of assets necessary to establish the business, possibly acquire land). Second, the cross border movement of capital, which is necessarily required by the supply of a service through mode 1. In this case, the provision allows for both inflow and outflow of capital from the country.

Based on these provisions, the movement of capital allowed in the GATS is fully covered only in one mode (mode 1) and partially covered in mode 3 (only inflow). The GATS do not cover the outflow of capital related to the investment, which is heavily regulated in Bilateral Investment Treaties and in some FTAs. Furthermore, being the GATS a treaty regulating only the international supply of a service, there is no rule on possible capital controls applied to domestic services suppliers providing a service abroad (through mode 2), or on domestic consumers travelling abroad to enjoy a service.

| | **Mode 1** | **Mode 2** | **Mode 3** | **Mode 4** |
|---|---|---|---|---|
| **Inflow** | yes | no | yes | no |
| **Outflow** | yes | no | no | no |

Following this, the movement of capital provision of Article XVI seems to suffer from two main limitations. First, the linkage to the scheduled market access commitments and the modes of supply does not cover the full extent of cross border capital flows. Second, the provision does not clarify what is “cross border capital” and when it is “an essential part of the service itself”.

The obligation of not to impose any restriction on the services scheduled is to be read not as an overarching provision prohibiting any restriction (inflow and outflow) in all four modes of supply, but it must be read in conjunction with the note to Article XVI, which restrict the ambit of application only to restrictions on capital inflow for sectors scheduled in mode 1 and 3, and for restrictions on capital outflow for sectors scheduled in mode 1. For the sectors and modes covered by the general prohibition of adoption of capital controls, there are still three exceptions that can apply.

The first exception is provided in the second paragraph of Article XI, which allow Members to impose restrictions for balance of payment reasons, as stipulated by Article XII. The second exceptions refers to a specific request to impose capital restriction from the IMF. In this regard, in spite of the general lack of competence of the Fund in capital account transactions, Article VI Section 1 of the Fund's Articles authorizes the Fund to request a Member to impose capital controls in order to prevent a large or sustained outflow of capital. Accordingly, this provision provides the IMF with the authority to authorize a WTO Member to derogate to its GATS commitments when such Member is suffering from a large or sustained outflow of capital. Note that the authority of the Fund extends not only to the sectors and modes covered by the footnote, but it covers the right to impose capital controls as such. Lastly, capital movements could be restricted based on prudentiary reasons, based on the letter of the "prudential carve-out" of Article II of the Annex on Financial Services.

**Current Account and Exchange Restrictions**

According to the letter of Article XI, current account transactions and capital account transactions are treated differently. The first paragraph of Article XI stipulate that for all those services sectors that are committed by a Member, it is not possible to apply any restriction on international transfer and payment for the underlying current transaction. This provision, however, suffer from two limitations. The first limitation is set out in paragraph 2 of the same Article, which carves out from the prohibition those exchange measures that are in conformity with the Fund's Article[27]. The second limitation is provided in Article XII of the GATS that allow restrictions on current international transactions (and the related payments) for balance of payment purposes. In spite of the limited possibility for Members to adopt current account restrictions provided by the GATS, it is important to remind that WTO Members that are also members of the Fund are bound by the general prohibition of Article VIII of the Fund's Agreement that impose an obligation on the members not to adopt any current account restriction. This means that even if a Member wishes to impose a restriction of a sector not committed in its services Schedule, it would be nevertheless bound by its IMF obligations. In this respect, the reference to the IMF Articles allow a limited possibility to impose restrictions on current payment and transfers for balance of payment reasons , provided that they have been temporarily approved for by the Executive Board, or their maintenance is authorized by Article XIV of the Fund's Articles.[28]

According to the IMF, the definition of current account transaction, which is provided in Article XXX of the Article of the Agreement, encompasses also transactions that economist would inscribe to capital account. These transactions are: (i) payments of moderate amount for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit facilities[29]. Such transactions are therefore heavily restricted and restrictions on them can be imposed only when allowed by the IMF rules.

[27] The GATT Article XV:9 provides for a similar exception.
[28] IMF, *Reference Note on Trade in Financial Services,* IMF, 2010
[29] IMF, The Fund's Role Regarding Capital Flows, IMF, 2010

Paragraph 2 of Article XI contains a general provision that ensures the prevalence of IMF rights over GATS obligations. Among the rights of the Fund's Members under the Articles of the Agreement there is the use of exchange actions. Deborah Siegel, once IMF general counsel, considers such obligation to include "*the requirement to refrain from imposing exchange restrictions on payments and transfers for current international transactions, multiple currency practices, and discriminatory currency arrangements unless approved by the Fund or maintained under Article XIV*"[30]. One important note is that exchange restrictions impose a direct limitation on the availability of foreign currency or on their use and transfer and could cover both current and capital account transactions (as well as the underlying payment). While exchange restrictions affecting current transaction are generally prohibited by the Fund's Article, and therefore are not allowed also by the GATS, the same does not apply to exchange restrictions on capital transactions. Indeed, those restrictions are not allowed only on the sectors and modes of supply schedules by the Members.

**Policy Space for Capital Controls**

Capital and exchange controls represent a deviation from the freedom of capital movement based on financial or macroeconomic considerations. Indeed, from the experience of various countries in the recent years it can be draw the conclusion that the underlying reason was almost uniquely the protection of the stability of the financial system. Provided that this is the main reason, then the question to ask is whether the GATS offer any policy space for Members to deviate from their commitments and block movements of capital. Before explaining the issue, it is important once again to stress one important point. While capital transactions enjoy a high degree of flexibility, this is not the same for controls on current payment and transfers, who are generally prohibited and whose legitimacy at the WTO can only derive from an approval of the Fund or by the balance of payment provision of Article XII.

Members have various ways to impose restrictions on capital flows. Besides the possibility to impose controls on capital movements when requested by the IMF, Members can restrain capital flows, both current payment and capital movements, based on balance of payment considerations and on prudentiary reasons.

[30] D. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Article of Agreement and the WTO Agreements*, American Journal of International Law 96:561, 2002

| | CAPITAL MOVEMENT (and Capital Payments & Transfers) | CURRENT PAYMENTS AND TRANSFERS |
|---|---|---|
| COVERAGE | Only Mode 1 and 3 and only services scheduled in those modes | All modes and Services |
| EXCHANGE RESTRICTIONS | Prohibited | Only for mode 1-3 and services scheduled |
| BALANCE OF PAYMENT | Yes | Yes |
| PRUDENTIAL CARVE-OUT | Yes | Yes |
| REQUEST BY THE IMF | Yes | No |

**The Balance of Payment Derogation**

Article XII then provides for the conditions under which a Member can derogate from its obligations in case of balance of payment difficulties.

> *1. In the event of **serious balance-of-payments and external financial difficulties or threat thereof**, a Member may 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. It is recognized that particular pressures on the balance of payments of **a Member in the process of economic development or economic transition 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 or economic transition.*
>
> *2. The restrictions referred to in paragraph 1:*
>
> *(a) Shall not discriminate among Members;*
>
> *(b) Shall be consistent with the Articles of Agreement of the International Monetary Fund;*
>
> *(c) Shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;*
>
> *(d) Shall not exceed those necessary to deal with the circumstances described in paragraph 1;*
>
> *(e) Shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.*

This provision allow Members to deviate from their commitments in both capital movement and current account transactions in the event of both a current serious balance of payment or external financial difficulties and also in the case of a threat of a crisis. Particular consideration is then given to developing countries, which are considered more prone to monetary instability associated with the opening of the capital account. In order to invoke Article XII Members must demonstrate: the measure does not discriminate among Members; is consistent with IMF article, which restrict the policy space only to capital account restrictions (allowed by the IMF) and to current account restrictions approved by the IMF[31]; does not cause unnecessary damage to other Member; shall not be unnecessary in respect to the conditions set out above; and shall be only temporary. Sean Hagan, IMF General Counsel, considers that the BoP clause of Article XII would be difficult to invoke in a number of circumstance. Hagan argues that while the BoP had been crafted to protect the entire economic system of the country, in most of the cases controls had been imposed only to protect a particular industry. Furthermore, Hagan is dubious as to whether the clause would cover also preventive measures targeting capital inflow, as the restrictions are normally imposed on the underlying transaction rather than on the payment and transfer associated with that transaction[32].

**The Prudential Carve-Out**

The Annex on Financial Services is a specific agreement to the GATS that clarifies existing GATS rules as they apply to the specificities of the financial services sector. Thus, the regulatory constraints entailed in the trade of financial services products, as regulated under the GATS, obliged negotiators to inscribe in the Annex a provision that would prevent that a strict obedience to the rules of the GATS would undermine the stability of the financial system. For this reason it was inserted in the Annex a provision that would guarantee the freedom of the Members to adopt any measure apt at maintaining the soundness of the financial system despite its possible incompatibility with the provisions of the GATS. This provision is commonly known as the "prudential-carve out" and it provides as follows:

"*Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement*"[33].

In this respect, any domestic measure that might be inconsistent with Article XVI or Article VI of the GATS, as in the case of financial safety measures, can be none the less justified on prudential grounds once it is proven that it has been adopted to accomplish prudential objectives. In brief, this clause operates as an escape clause that derogate to the general obligation of the GATS, based on the prevalence of macroeconomic stability against the positive effects of trade liberalization.

[31] One example is the current and capital account restrictions approved by the IMF on Iceland during the financial crisis of 2008. In order to be approved Iceland had to comply with the recommendations of the Fund.

[32] S. Hagan, Transfer of Funds, IIA Issues Paper Series, UNCTAD, New York and Geneva, 2000

[33] Annex on Financial Services, Paragraph 2(a)

Based on the prudential carve-out Members could impose restrictions on capital flows when based on prudential reasons. The definition of prudential reasons, which is subject of an infinite academic debate, would define the perimeter of legitimacy of the measure. As of today there have not been any dispute clarifying the actual ambit of the provisions or which kind of measures are considered to be of a prudential nature. From the letter of Article 2, capital controls could be justified only to the extent that they would ensure the stability of the financial system. A possible interpretation of this provision would limit the possible measures only to those that are strictly linked to the stability of the banking system, leaving outside other macroeconomic or balance of payment considerations. Based on this interpretation the regulatory space offered by Article 2 is somehow different from that of Article XII. Indeed, while capital controls adopted for balance of payment reasons are essentially covered by the BoP derogation, the prudential carve out is limited to issues of financial stability, and for this reasons, more suitable for the adoption of controls on short-term capital flows or on risky financial products[34].

**Any Possibility to Reschedule under Article XVIII?**

Article XVIII of the GATS allow Members to schedule and bound as additional commitments restrictive measures that are not specifically covered by the market access and non-discrimination provision of Articles XVI and XVII. This provision, which was initially thought for derogations with regards to qualifications, standards or licensing matters, could nonetheless be extended also to restrictions on capital flows. Members could grant themselves some policy space for capital controls by scheduling a specific possibility to impose restrictions on the outflow of capital, which is neither covered by the market access provision, nor by the obligations of non-discrimination. Similarly, Members could schedule prudential restrictions, such as restrictions on derivatives contracts, borrowing of local currency from offshore banks, or maturity mismatched between long and short-term capital flows.

[34] Differentiating capital controls based on balance of payment considerations or on financial stability reasons is a complex issue, which has never been covered by the literature, at least from a regulatory perspective, and would definitely be a future area for research.

## A PREFERENTIAL AGENDA FOR CAPITAL FLOWS

The internal resistance of the countries to retain controls on their capital account policies constituted an insurmountable difficulty for the process of international financial and monetary rulemaking on capital flows. The IMF, which in the mid nineties pushed for more stringent regulations on capital movement, failed to convince countries to give up their sovereignty on capital account policies. Similarly, in Geneva during the Uruguay round negotiations on services and financial services, capital flows were left out of the WTO Agenda. Nonetheless, countries progressively engaged in preferential arrangements in which capital controls were part of the regulatory undertaking.

Given the complexity of the task and the differences in policy space with regards to restriction of capital flow among the agreements, a comprehensive analysis of the regulations of capital flows in preferential trade and investment agreements would take a chapter itself. Nonetheless, it would be important to briefly introduce some considerations that would offer the ground for future research.

At the preferential level capital flows are regulated by three sets of agreements, each of them tackling capital movement from a specific angle.

**Free Trade Agreements** often cover capital flows either as a stand-alone chapter, as in the case of EU FTAs, or in the framework of services and investment chapters. One common treat is the services dimension of EU and US FTAs that offer GATS-like approach whereby countries are required to liberalize the capital movements associated with the services commitments. In addition to this, countries are required, similarly to the GATS, to liberalize the payments and transfers associated with the transactions based on the requirements of Article VIII of the Articles of the Fund's Agreement. Besides these similarities, among various FTAs there is a difference in the level of opening to capital flows and on the potential use of safeguards. Indeed, while EU, Canadian and Japanese FTAs provide balance of payment safeguards or regulatory carve-outs on host country capital account legislations, US FTAs, with the notable exception of NAFTA, are more prone towards full liberalization of capital movements and usually do not provide for balance of payment exceptions[35]. Indeed, as it will be explain later, the main difference between US FTAs and BITs and other FTAs is in the adoption of safeguards against possible negative effects of capital

[35] One notable feature is contained in the US-Chile FTA, and has been replicated in US FTAs with Colombia, Peru and Singapore. In these agreements is present a "cooling off" provision which allow countries to violate the terms of the treaty on capital movements, albeit limited only to those in the investment chapter, without the threat to be sued by the United States for a period of one year after the measure have been deployed. The "cooling off" provision is somehow limited in practice, as it does not apply to restrictions on current transfers and on payment for equity investments, bonds or loans. On top of this, after one year the violating party would have to respond in an international tribunal. The aim of this provision was to provide countries some with some policy space during economic crises, by allowing them to violate to the terms of the treaty without the pressure of an incumbent dispute.

flows.

**International Investment Agreements,** whether in the form of Bilateral Investment Treaties or as a stand-alone chapter in an FTA, provide for strong discipline for capital movements, albeit with a narrower focus than services agreements. While trade agreements promote the inflow of capital as an element of the services package leaving the free outflow only to financial services in mode 1, most bilateral investment treaties leave aside the market access/pre establishment aspect (although there are notable exceptions) and regulate the movement of capital from an investor perspective at the post establishment phase. Hence, the regulatory framework offered by International Investment Agreements usually cover only outflow of capital. In IIAs capital movements can be regulated in two ways: first capital can be considered as a form of investment itself, thereby enjoying the protections offered by the treaties; second, capital can be considered as one of the essential elements of an investment.

The definition of investment is one of the elements that determine the coverage of the treaty. In this respect, a common definition of investment does not comprise only physical assets located in the host country, but also other intangible assets of particular value for the investors, such as mortgages, liens, pledges as well as portfolio investment in the form of shares, stocks, debts, or interests in the property of local companies[36]. Provided that the treaty covers also financial assets, then the question is how portfolio investment is regulated. In this respect IIA provides with a number of clauses that aim at ensuring that investors are protected against the powers of the host state. Among the most important clauses that have an effect, there are the Most Favoured Nation clause, the Non-Discrimination clause, the Fair and Equitable Treatment clause, the Expropriation clause, the so called “Transfer of Fund” provision and, in some cases, the balance of payment clause. Such clauses have the goal of ensuring that foreign investors are not treated arbitrarily or in a discriminatory way by the host government and, depending on the specific provisions in the treaty, they could undermine the possibility for the host government to adopt a capital or exchange controls. For example, the decision of the host State to adopt currency exchange restrictions could be considered as a form of indirect expropriation as it could diminish substantially the value of the investment[37].

[36] As an example, Article 1(3) of the ASEAN Agreement for the Promotion and Protection of Investment defines the term “investment” as “every kind of asset and in particular shall include though not exclusively:
a) Movable and immovable property and **any other property rights such as mortgages, liens and pledges;**
**b) Shares, stocks and debentures of companies or interests in the property of such companies**;
c) Claims to money or to any performance under contract having a financial value;
d) Intellectual property rights and goodwill;
e) Business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources.”

[37] A. Kolo and T. Walde, Capital Transfer Restrictions Under Modern Investment Treaties,

When the international investment agreement does not cover portfolio investment, financial assets do not enjoy the protection of the treaty. Nevertheless, capital flows are still partially regulated as a collateral element of the investment. The free transfer of fund provision is a common feature of IIAs and it ensures the right of investors to repatriate their assets at all time against possible restriction imposed by the host State. Free Transfer of Fund provisions, if not matched by other safeguard measures, could substantially limit the monetary sovereignty of the countries, especially in their right to control their balance of payment (both current and capital account).

Free Transfer of Fund provisions differ widely among agreements. One common treat is that they almost all apply only to outflow of capital and only rarely cover the freedom of investors to bring in their capital[38]. A broad classification of transfer of fund provisions has been provided by Sean Hagan, which divides Free Transfer of Fund clauses into three categories. The **first category** consists of the *outward transfer of amounts derived from or associated with protected investments.* The **second category** entails *outward transfer of amounts arising from the host country's performance of other investor protection obligations under an agreement*[39]. The **third category** covers *inward transfer of amounts to be invested by a foreign investor*, which covers those transfers that are made for purposes of making a new investment, as well as *those* that are made to develop or maintain an existing investment[40].

It is important to note that a corollary of FTF provisions is the obligation on the government to allow the repatriation of funds at a market determined exchange rate. Indeed, Governments usually tent to allow the repatriation of profits at a market rate that is above the market price rate. This tendency does not fall under the IMF's general prohibition of multicurrency practices, as Article VIII, Section 3 of the IMF Articles only prescribes non-discrimination between current transfers or capital transfers. For this reason, many BITs provides for a guarantee that the exchange rate is at the market price[41].

**Balance of Payments and State of Necessity clauses** are sometimes included in FTAs and in few BITs in order to safeguards the stability of the financial system against some economic disequilibria. Such clauses allow derogating from the commitments for a certain period of time provided that the member adopting such measure demonstrates that "movements of capital cause,

[38] R. Dolzer and C. Schreuer, *Principles of international investment law* (2008) 192
[39] Usually FTF would cover: (i) payments received as compensation for a host country's expropriation of the investment; (ii) payments received as compensation for losses suffered by an investor as result of an armed conflict or civil disturbance; (iii) payments arising from the settlement of disputes; and (iv) payments of contractual debts owed by the Government of a host country to the foreign investor.
[40] UNCTAD and S. Hagan, *Transfer of Funds*, UNCTAD Series on Issues in International Investment Agreements (2000).
[41] M. Weibel, BIT by BIT the Silent Liberalization of the Capital Account, in C. Binder, U. Kriebaum, A Reinisch and S. Wittich (eds), International Investment Law for the 21st Century, Oxford University Press, Oxford, 2009, p. 15

or threaten to cause, serious economic or financial disturbance in the member[42]" and that the measure is adopted on a temporary and non-discriminatory basis. In some agreements, the BoP safeguard is crafted in order to guarantee that the measure would be in conformity with Articles VI and VIII of the Articles of Agreement of the IMF[43].

The EU-Korea FTA provides a set of conditions for the measure to be considered legitimate. Foot note to article 8.4 provides that "*safeguard measures provided for in this Article should be applied in such a way that they:*

*(a) are not confiscatory;*

*(b) do not constitute a dual or multiple exchange rate practice;*

*(c) do not otherwise interfere with investors' ability to earn a market rate of return in the territory of the Party who took safeguard measures on any restricted assets;*

*(d) avoid unnecessary damage to the commercial, economic or financial interests of the other Party;*

*(e) are temporary and phased out progressively as the situation calling for imposition of such measures improves; and*

*(f) are promptly published by the competent authorities responsible for foreign exchange policy*".

European Union's free trade agreements often provide for a carve out of the national legislation on capital movements and current payments that has the effect of putting any domestic measure falling within the ambit of application of the exception to be automatically in compliance[44]. An example is Article 2 of Chapter (8 of the EU-Korea Free Trade Agreement that provides that "*With regard to transactions on the capital and financial account of balance of payments, the Parties undertake to impose no restrictions on the free movement of capital relating to direct investments made in accordance with the laws of the host country, to investments and other transactions liberalised in accordance with Chapter Seven (Trade in Services, Establishment and Electronic Commerce) and to the liquidation and repatriation of such invested capital and of any profit generated therefrom*".

**OECD Members are parties to the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations**. Together these codes offer a regulatory platform that bind Members to substantially liberalize both types of international capital flows, whether from the current or capital account. The Capital Code represents the most comprehensive instrument regulating movement of capital and it offers a complete regulatory platform for both investors as well as domestic operators. Unlike other instruments, the Capital Code focuses on the specific transactions to be liberalized, thereby covering both capital transactions made by non-

[42] Article 16 of the ASEAN Agreement.
[43] Look, for instance, at Article 2104 of the NAFTA
[44] This clause is present in the Korea, Chile, Colombia and Peru

residents and those made by residents, as well as on their underlying payment and transfers. Furthermore the Code applies to both inflow and outflow of capital. Despite its regulatory width the Code offers the Member room for various derogations from the commitments. Indeed, besides the exceptions scheduled by Members at the time of the entry into force, OECD Members can derogate at any time from their commitments with regards to short term financial transactions. On top of this, the Code presents two exceptions that allow Members to suspend their commitments and impose controls on capital outflows for balance of payments reasons, as well as controls on inflows for reasons arising from "serious economic and financial disturbances". The OECD codes in some instances overlap with the provisions in other FTAs/BITs giving rise to a regulatory discrepancy, such as in the case of the FTAs negotiated by the US.

## CONCLUSIONS

This brief introduction to the regulatory regimes for capital flows briefly introduces the complexity of the subject. As it was explained, capital flows are regulated under various regulatory instruments, each of them targeting a particular aspect of the measure. The underlying question is to what extent is possible to have a similar measure, for instance a regulation prohibiting outflow of capital, to be treated differently based on the regulatory discipline considered.

The first difference is in the coverage of capital flow in terms of direction of capital flows and targeted measure. While all the instruments always cover current payments and prohibit any exchange restrictions and multicurrency arrangements, each treaty covers the movement of capital only partially and differently. In this respect, the OECD Capital Code is the most comprehensive treaty, setting out precise obligations with regards to both inflow and outflow of capital incidental to the listed operations. The GATS, and FTAs cover only the capital movements incidental to the scheduled services commitments. This implies a reduced coverage, often limited to the inflow and outflow of capital incidental to mode 1 and the inflow of capital necessary to establish a commercial presence. Investment Agreements are even more restrictive, covering mostly only the outflow of capital in the form of profits and interests incidental to the investment. Lastly, the IMF Articles do not cover capital movements as such, but provide a supervisory role of the Fund in the capital account policies of the members.

Most of the regulatory problems come from the possibility to resort to the adoption of safeguards in case of macroeconomic or financial turbulences. In this respect, the OECD Code offers to signatories the widest policy space to impose restrictions and deviate from the commitments. Similarly, the GATS and most of non-US FTAs allow members to impose restrictions on both capital movements and current payments in case of balance of payment difficulties or when justified for prudential reasons. On the contrary, US FTA/BITs[45] and most of the Bilateral Investment Treaties do not envisage any possibility to restrict the outflow of capital, when linked to an investment.

This disparity results in potential overlap of norms and in regulatory uncertainty. Take, for instance the case of Korea, which is a OECD and IMF Member and has entered into an FTA with US and with the EU. In case Korea experience severe macroeconomic turbulences, the adoption of capital controls would be allowed under the OECD Code of Capital Movement, the IMF rules and by the EU-Korea FTA, but it would not be allowed by the US-Korea FTA. Being impossible to select capital controls based on the origin or destination of the capital flow, the country adopting the measure would be in a regulatory dilemma that would ultimately result in the choice between macroeconomic stability versus violation of the US FTA

| | CAPITAL MOVEMENTS | | | CURRENT PAYMENTS | |
|---|---|---|---|---|---|
| | **Coverage** | **Measures** | **Safeguards** | **Measures** | **Safeguards** |
| **GATS** | Inflow (mode 1-3) and Outflow (mode 1) | Capital Controls and Exchange Restrictions | Yes | Exchange Restrictions, Multicurrency Arrangements | Yes |
| **OECD** | Inflow and Outflow | List of Various Operations on the Capital Account, covering both FDI and Portfolio flows | Yes | Exchange Restrictions, Multicurrency Arrangements | Yes |
| **IIAs** | Mainly Outflow | Capital Controls and Exchange Restrictions | Partial | Exchange Restrictions, Multicurrency Arrangements | Partial |
| **US FTAs** | Inflow (mode 1-3) and Outflow (mode 1) | Capital Controls and Exchange Restrictions | No | Exchange Restrictions, Multicurrency Arrangements | Yes |
| **Others FTAs** | Inflow (mode 1-3) and Outflow (mode 1) | Capital Controls and Exchange Restrictions | Yes | Exchange Restrictions, Multicurrency Arrangements | Yes |

[45] The only exception for United States is NAFTA, which contains a BoP clause.

| | | | |
|---|---|---|---|
| **IMF** | Not Covered | Exchange Restrictions, Multicurrency Arrangements | Yes |

With regard to trade in services, the current regulatory regime in the GATS suffers from two major loopholes.

The footnote to Article XVI, while making reference to movement of capital, does not define in what it consists. If we assume that the meaning of "capital" would be similar to that described in the IMF Articles, then some kind of capital transactions, such as payments of moderate amount for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit facilities, which are usually described by the economists as capital movements, would be treated as current transfers, and therefore being subject to the strict regulatory regime. Countries would not be able to adopt any kind of restrictions on such transactions, unless approved by the IMF or unless justified by serious balance of payment considerations. Another problem might be the treatment of controls on capital movements related to FDIs. The usual definition of capital controls is not limited only to financial assets, but it envisages also controls on foreign direct investment. If we assume that the policy space given by the GATS to impose restrictions on capital movement would extend to FDIs, then countries would be able to deviate on all their market access commitments on mode 3.
In this respect, one of the priorities would be to clarify the extent of the GATS coverage on capital account transactions.

Another issues is linked with the policy space for capital flow restrictions in the GATS. The recent experience in Latina America and South East Asia suggests that Countries are often required to impose restrictions on capital flows, even though their GATS commitments would bound the liberalization of their capital accounts. Given the regulatory uncertainties on restrictions on short-term flows or exchange controls, the balance of payment provision and the prudential carve-out, which have never been tested in practice, could not offer the necessary leeway and would require a heavy burden of proof on the necessity of their use. One option would be to use Article XVIII schedule possible deviations not linked to market access or national treatment. Such deviation could be in the form of prudential regulations on short term or volatile capital flows or in the possibility to adopt temporary restrictions on outflow.

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