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Developing Countries Urgently Need a Fix for WTO's Ban on Capital Controls

In the wake of the global economic crisis, even the International Monetary Fund (IMF) has noted the utility of capital management techniques (CMTs) for helping insulate developing countries from crisis-causing capital floods and flights.[1] But many developing nations may find their ability to use these tools hampered by their financial services commitments under the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS). Indeed, many developing countries face more constraints in this area than developed countries, which are generally thought to have the deepest GATS financial services commitments. The IMF, Bank of International Settlements and Financial Stability Board have noted that "Some countries have subscribed to international instruments that limit their ability to use capital controls."[2] Based on past IMF writing, it is clear that this could only refer to trade and investment pacts.

What GATS provision restricts capital controls?

Article XI of the GATS states that countries "shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions…" Countries list their "specific commitments" pursuant to GATS Article XVI on market access, which has a footnote that reads in part, "If a Member undertakes a market-access commitment in relation to the supply of a service through [Mode 1] 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."[3]

What does this mean?

The strictness of these disciplines turn on several interpretative and technical questions. First, how widely would a panel construe the notion of "restriction" in Article XI? Second, are the only "restrictions" to be avoided that that do not "allow… movement of capital" at all, or could a broader range of restrictions be prohibited? In other words, what is the range of "restrictions" that can be imposed "consistently with specific commitments"? Finally, when is "capital… an essential part of the service itself"?

As for the term "restriction," WTO panels and legal scholars all agree that it should be construed broadly.[4] Its meaning, according to such sources, could include measures to prohibit capital flows, to requiring permits for capital transactions, to measures that tax or increase the cost of such transactions. Accordingly, a wide range of capital controls could constitute "restrictions."

As for the requirement that "restrictions" not be imposed "inconsistently with specific commitments," there is a range of possible interpretations. One interpretation of the phrase "that Member is committed to allow such movement of capital" is that the only GATS-prohibited "restriction" would be an outright refusal to allow Mode 1 capital movements in a committed

sector. This is a fairly extreme CMT that most countries do not utilize (although it is unfortunate that even that policy space would have to be given up).

However, the rest of the GATS provides context that suggests that a broader range of CMTs could be inconsistent with GATS specific commitments in Mode 1.[5] For instance, GATS Article XII is a provision that countries can invoke as a defense in balance of payments (BOP) emergencies to get out of having to comply with Article XI. It states that (subject to over a dozen procedural and substantive hurdles, such as the requirement that CMTs be temporary rather than preventative) "… 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." If the only prohibited form a "restriction" could take were an absolute refusal to allow capital to flow, GATS Article XII would have been couched more narrowly than "restrictions on trade in services… including on payments or transfers for transactions…" Instead, it would have said "… a Member may refuse to allow movement of capital that is an essential part of a service in which the Member has undertaken a market access commitment." In other words, if "restrictions" other than outright prohibitions are not inconsistent with GATS obligations, a country wouldn't need a defense provision in Article XII that allowed recourse to all "restrictions on trade in services" in BOP emergencies.

Finally, when is cross-border movement of capital an "essential part of the service itself"? This is most clearly the case for financial services. In core financial service sectors, there is no service transaction unless it is accompanied by a capital flow. For instance, it would be difficult to supply lending services if there were no loan (i.e. capital).[6] For the purposes of this analysis, we assume that five service sectors outlined in the GATS Annex on Financial Services constitute "core financial services," where capital is an essential part of the service itself.[7]

Which countries are affected?

Most developed countries utilized the Understanding on Commitments in Financial Services, an alternative protocol which envisioned very limited Mode 1 liberalization. Consequently, these countries face few constraints on their ability to utilize CMTs. But Latin American, Asian and African countries were subjected to immense pressure in the Uruguay Round from developed countries and multinational companies. Moreover, these countries were often led by neoliberal governments that have long since passed from the scene.

Detailed Public Citizen analysis has found that 26 countries have virtually unlimited Mode 1 market-access commitments in core financial services sectors, while an additional 22 countries have some level of Mode 1 market-access commitments in some core financial services sectors (ranging from low to moderate levels of commitment). These nations are displayed in Table 1. This universe of 48 nations could serve as a useful bloc of countries pushing for a ministerial declaration or other step clarifying that nothing in the GATS should be construed to prohibit capital controls in covered sectors.

TABLE 1: NATIONS WITH CMT LIMITS UNDER GATS

Most Committed	Some Commitments
Armenia	Angola
Ecuador	Bahrain
Estonia	Benin
Gambia	Cambodia
Georgia	Cote d'Ivoire
Ghana	Dominican Republic
Haiti	Egypt
Indonesia	Gabon
Jordan	Guyana
Kenya	Hong Kong
Lithuania	Israel
Malawi	Korea RP
Malaysia	Kuwait
Mauritius	Macau
Moldova	Malta
Mozambique	Mexico
Panama	Mongolia
Papua New Guinea	Morocco
Qatar	Philippines
Romania	Singapore
Sierra Leone	Slovenia
Solomon Islands	Thailand
Tonga	
Tunisia	
Ukraine	
Uruguay	

For a more detailed exposition of these points, including analysis of why various GATS defense provisions are not applicable to forward-looking, preventative capital controls,[8] *read our longer 2010 memo at: http://www.citizen.org/documents/MemoonCapitalControls.pdf*

ENDNOTES

[1] IMF, "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework," February 14, 2011. Available at: http://www.imf.org/external/np/pp/eng/2011/021411a.pdf.

[2] IMF, BIS and FSB, "Macroprudential policy tools and frameworks: Update to G20 Finance Ministers and Central Bank Governors," February 2011, at 13. Available at: http://www.imf.org/external/np/g20/pdf/021411.pdf

[3] The GATS text is available at: http://wto.org/english/docs_e/legal_e/26-gats_01_e.htm

[4] "WTO - Trade in Services," Edited by Rüdiger Wolfrum, Peter-Tobias Stoll and Clemens Feinäugle, Max Planck Commentaries on World Trade Law, Volume 6, (Koninklijke Brill N.V., Leiden, 2008), at 251-252; Deborah Siegel, "Legal Aspects Of The IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements," *American Journal of International Law*, July 2002, at 586-587; Panel Report, *European Communities - Measures*

Affecting Asbestos and Asbestos-Containing Products, WT/DS135/R and Add.1, adopted 5 April 2001, as modified by the Appellate Body Report, WT/DS135/AB/R, para. 8.235.

[5] The Vienna Convention on the Law of Treaties Article 31.1 establishes the general rule of treaty interpretation that "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." The text of the treaty as a whole is the primary context. Available at: http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf

[6] Or as one IMF scholar has written, "this rule would serve, for example, to liberalize both the interest and principal portion of loan repayments made by a consumer to a foreign bank." See Sean Hagan, "Transfer of Funds," UNCTAD/ITE/IIT/20, 2000, at 25.

[7] These are "v) Acceptance of deposits and other repayable funds from the public; (vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; (vii) Financial leasing; (viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts; [and] (ix) Guarantees and commitments…" What are these services, and why is capital an essential part of them?

According to the IMF, the term "capital transactions" refers to "changes in financial claims on, and liabilities to, the rest of the world…" The IMF then states that "A claim is a financial instrument that gives rise to an economic asset that has a counterpart liability," while "Economic assets are resources over which ownership rights are enforced and from which future economic benefits may flow to the owner…" (See IMF, "Balance of Payments and International Investment Position Manual," December 2008, at 253. Available at: http://www.imf.org/external/pubs/ft/bopman/bopman.pdf. Accessed Feb. 26, 2010.)

We would assume, then, that claims that give rise to assets with counterpart liabilities would meet the minimum requirements for being a capital transaction. While it is possible that capital could be an essential part of services involving transactions other than capital transactions, we will assume at a minimum that capital is an essential part of services involving capital transactions.

All five of the financial service sectors we note above appear to involve capital as an essential and non-segregable (or difficult to segregate) ingredient in the service provision. Arguably, many other financial services – like stock issuance services – are for-fee services, where the capital flow can be distinguished from the service itself.

Most readers will likely comprehend how capital is an essential part of deposit, lending and payment services. For some of the other sectors that we will count as "core financial sectors," matters might be less clear. According to U.S. generally accepted accounting principles (GAAP), in leasing transactions: "The lessee shall record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs such as insurance, maintenance, and taxes to be paid by the lessor, together with any profit thereon." (http://www.fasb.org/pdf/fas13.pdf). In other words, leasing functions much like lending for accounting purposes, and involves a capital flow.

And according to IFRS, "A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument." (http://www.ifrs-ebooks.com/IFRS_texts/IAS_39.pdf) Here too, the service (at least at the moment that the payments are triggered) involves a capital flow.

[8] The basic defense provisions are there:

1) Article XI states that "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…" But the Articles of Agreement do not establish affirmative obligations with respect to CMTs, while the GATS does.

2) As noted above, Article XII establishes a limited derogation from Article XI for balance of payments reasons. But the right is qualified by 15 substantive and procedural hurdles, including that CMTs "shall be temporary and phased out progressively" rather than preventative and that CMTs "shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member." Since CMTs would almost by definition be more trade restrictive than, say, simple buying and selling of currency (i.e. traditional developed country central banking policy), a CMT would likely fail the "necessity test." (This is a three-pronged test that many WTO rulings have utilized: relative importance of the aim of the measure, contribution of the measure to the aim, and the trade restrictiveness of the measure. This is then supplemented by an examination of whether less trade restrictive alternative measures are available to the member.)

3) There is a general "prudential measures defense" (PMD) available under the GATS Annex on Financial Services Article 2(a). But legal scholars believe that the existence of the CMT-specific defenses (like Article XII) mean that CMTs cannot be defended under the PMD, because of the general legal interpretive requirement that specific provisions trump general ones. (See Christine Kaufmann and Rolf Weber, "Reconciling Liberalized Trade in Financial Services and Domestic Regulation," in Kern Alexander and Mads Andenas (eds.), *The World Trade Organization and Trade in Services,* (Amsterdam: Martinus Nijhoff Publishers, 2008), at 424; Mark Kantor, "International investment law protections for Chinese investment into the US," in Karl Sauvant, ed., *Investing in the United States: Is the U.S. Ready for FDI from China?,* (Northampton, Mass.: Edward Elgar, 2010), at 161; Joel Trachtman, "Applicability of the NAFTA 'Prudential Carveout' to Capital Controls," IELP Blog, Jan. 20, 2011. Available at: http://worldtradelaw.typepad.com/ielpblog/2011/01/applicability-of-the-nafta-prudential-carveout-to-capital-controls.html) Moreover, the PMD can only be utilized if they do not help a member avoid their GATS commitments. For the 48 countries that have some level of GATS Mode 1 market-access commitment, a CMT would definitionally constitute an avoidance of GATS obligations.

4) The Annex on Financial Services Article 1(b)(i) also has a provision that states that "activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies" are not included in the definition of "services" for the purposes of GATS financial services commitments. This does not mean that central bank "measures" cannot be challenged for violating GATS commitments; it simply means that what the central bank does is not considered a "service." This is another way of stating that foreign banks are not entitled to challenge central banks for the ability to conduct "monetary or exchange rate policy" per se. But if monetary or exchange rate measures violate the GATS, they can be subject to a challenge.

Say a WTO member attempted to argue that CMTs constituted "exchange rate measures," and that Annex Article 1(b)(i) exempted "exchange rate measures" from having to comply with the GATS. That country would immediately be challenged on the grounds that this would render GATS Article XI without meaning, contrary to the principle of effective treaty interpretation.

Moreover, whether CMTs are a subset of "prudential measures" or "exchange rate policies" – or whether they constitute another genus altogether – is a subject of debate. The U.S. Treasury Department has consistently drawn a line between these two types of policies. (See http://www.treasury.gov/press-center/press-releases/Documents/kd37661.doc; and http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.html) In the financial literature, "prudential measures" are often categorized as the types of policies the government enacts to "help banks not hurt themselves," while "exchange rate policies" refer to the central bank's buying and selling of currency to affect exchange rates. CMTs, which are about imposing costs on private actors to keep them from hurting the system, seem to be a different type of policy altogether, although one that is in some respects less costly for developing countries that may not have the resources for massive exchange market transactions.