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MEMO

FR: Todd Tucker and Lori Wallach, Public Citizen
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RE: Korea FTA Financial Services and Investment Rules Do Not Safeguard Policy Space for Use of Capital Controls and Other Capital Management Mechanisms

Policymakers and economists are increasingly concerned about the possibility for international trade and investment agreements to limit countries' policy space for implementing capital controls and other capital management techniques. For instance:

- Rep. Barney Frank (D-Mass.), one of the leading architects of the Dodd-Frank financial re-regulation package, recently noted that, "One of the lessons we should have learned again from the recent crisis is that cross-border capital flows, the rapid mobility of capital, especially short term capital, can be particularly dangerous..." Frank went on to note a concern that trade agreements not restrict countries' freedom to use these tools.[1]
- A January 2011 letter from over 250 leading economists to the Obama administration similarly noted that "many U.S. free trade agreements and bilateral investment treaties contain provisions that strictly limit the ability of our trading partners to deploy capital controls… Under these agreements, private foreign investors have the power to effectively sue governments in international tribunals over alleged violations of these provisions…. We recommend that future U.S. FTAs [Free Trade Agreements] and BITs [Bilateral Investment Treaties] permit governments to deploy capital controls without being subject to investor claims, as part of a broader menu of policy options to prevent and mitigate financial crises."[2]
- The matter has become so controversial that the political party likely to sweep the April 2012 national assembly elections in Korea has committed to block implementation of the U.S.-Korea FTA. In a February 2012 letter to President Obama, these parties wrote that, "The majority of the Korean people are concerned that a range of provisions in the FTA, designed to maximize corporate interests, would jeopardize democratic polices that promote economic justice, eliminate poverty, regulate financial services, and develop healthy communities." They called for elimination of so-called investor-state mechanism, and for an overhaul of the provisions of the deal restricting capital controls.[3]

Some have suggested that there are provisions of the U.S.-Korea FTA that protect Korea's ability to deploy capital controls, in particular a set of policies announced in June 2010 in response to the financial crisis. But this memo shows conclusively that a carve-out to the FTA "Transfers" provisions (that generally forbid most uses of capital controls that Korea obtained before the FTA was signed in 2007) does not provide an exception that would safeguard Korea's post-crisis June 2010 new capital control measures. The main problem: Korea's carve-out only applies to one provision of a previously existing law. The new capital controls were implemented under entirely different provisions of Korean law, and therefore fall outside the carve-out. **The Korean FTA example highlights why it is critical to change the underlying FTA rules that limit countries' rights to manage capital flows, rather than trying to rely on carve outs to exclude specific domestic measures.**

This memo begins with a review of how the Investment and Financial Services chapters of the Korea FTA generally forbid use of capital management mechanisms with respect to limiting both inflows and outflows. The scope of these rules, which apply generally to all capital flows related to services and investment, implicates both countries' policies on current and capital transactions (when applied to financial services). Given that the United States is promoting the same approach in the Trans-Pacific Partnership (TPP) trade talks, the problems with the past U.S. FTA are of special note.

The Korea FTA also includes an array of exceptions, several of which have been raised by those arguing the FTA does not undermine the use of capital controls. These general exceptions clauses do not operate to safeguard some of the most important measures, as reviewed in Section III of this memo. (We include one of the exceptions in Section II because it relates to Annex 11-G, a carve-out Korea obtained to safeguard its Foreign Exchange Transactions Act (FETA), which includes some restrictions on capital transfers.)

A key issue which will be addressed in Section II of this memo is whether the special Annex 11-G carve-out pertaining to Article 6 of Korea's FETA provides an effective safeguard, especially with respect to the new 2010 capital control measures that Korea implemented – and that the IMF has praised. This is of special concern in the context of the TPP negotiations, as countries that are raising concerns about maintaining policy space for capital controls may well be told by U.S. negotiators that Korea's carve out remedied this problem, and thus changes to the underlying Transfers rules are not necessary. This is not the case. There are two issues to consider:

- The scope of the Annex 11-G carve-out relative to the terms of Korea's Foreign Exchange Transactions Act *as it existed when the FTA was signed in 2007*; and

- Whether the Annex 11-G carve-out covers Korea's new financial stability policies that were enacted in 2010 and that include capital control features. We also address whether other Korean carve outs, such as those listed in Korea's Annex III exception to Market Access obligations, could provide a safeguard for these new policies.

We conclude that a careful reading of the Korea FTA confirms the worries expressed by Korean legislators and others about the implications for capital controls under the FTA, which the Obama administration has recently announced may go into effect on March 15, 2012.

I. The U.S.-Korea FTA's Investment and Financial Services Rules Limit Countries' Use of Capital Controls and Other Capital Management Mechanisms: Not a Model for the TPP

The U.S.-Korea FTA's Financial Services chapter reflects the pro-deregulation mentality that helped foster the worst financial crisis since the Great Depression. More than other FTAs, it has been justified for its role in pushing financial liberalization and deregulation. Bush administration fact sheets note: "The Financial Services Chapter of the United States-South Korea Free Trade Agreement … is a groundbreaking achievement, providing more extensive provisions related to financial services than ever before included in a U.S. FTA."[4] Citigroup, the co-chair of the U.S.-Korea FTA Business Coalition, stated that "it is the best financial services chapter negotiated in a free trade agreement to date."[5] In a similar vein, Ambassador Han Duk-Soo of South Korea has emphasized the binding nature of the financial services and other commitments, saying, "The Asian financial crisis of 1997 and 1998 was a good lesson for us. What the Korea-U.S. free trade agreements [sic] the Korean people is a comprehensive, legally binding reform package…"[6]

The model established in this chapter and in the Korea FTA's Investment Chapter should not be replicated in the TPP. Many TPP countries have implemented new financial regulations that could conflict with the past U.S. FTA model, as could provisions enacted by Congress and the Korean parliament (which could conflict with the Korea FTA provisions). The U.S. FTA's Financial Services chapters read in the investor-state enforcement mechanism established in the Investment Chapter – thus empowering private investor attacks on domestic financial regulation and capital controls. Consider just the Korea FTA: there are at least 74 financial corporations cross-established in the United States and Korea that would be newly empowered to use the private investor-state enforcement rights in the FTA to attack U.S. and Korean financial policies, even if the U.S. and Korean government might refrain from using FTA government-government enforcement to challenge each other's domestic laws that conflict with the FTA. Extending the ability of financial firms in TPP countries to do the same is not prudent.

The interrelationship between the financial services and investment chapters

U.S. FTAs' financial services chapters conflate liberalization of the financial sector and deregulation, simply banning many forms of regulation even when rules are applied equally to domestic and foreign firms. The Korea FTA's free transfer provisions commit the signatory countries to refrain from controlling destabilizing capital flights and floods. These terms go beyond those covering this issue in the World Trade Organization's (WTO) General Agreement on Trade in Services (GATS), as U.S. FTAs do not even include the extremely limited and short term balance of payments crisis exception found in the GATS.

Principal Transfers Obligations

First, we'll discuss the free transfers provisions found in U.S. FTAs by reviewing these provisions in the Korea FTA. As a Bush administration Treasury official told Congress, "The right of free transfers is considered by the business community as one of the most important protections conferred in these treaties." He noted that recent FTAs "provide U.S. investors with substantially strengthened transfer rights over those available under the IMF Articles of Agreement and the General Agreement on Trade in Services (GATS). These agreements, like most multilateral agreements, represent a floor for investor protection. Our position is to seek greater protection for U.S. investors than the IMF Articles

of Agreement and the GATS afford. In addition, unlike those other agreements, the FTAs provide for effective investor-state arbitration provisions to enforce free transfer rights."[7]

However, some proponents of the Korea FTA have argued the opposite point: that FTA financial services provisions are actually not so strict. Witness the Obama administration's response to the following congressional inquiry. Senator Ron Wyden (D-Ore.) submitted the following written questions after a March 3, 2010 hearing of the full U.S. Senate Finance Committee, at which the U.S. Trade Representative (USTR) Ron Kirk testified:

> "Some have suggested that the WTO General Agreement on Trade in Services contains rules that can limit the types of financial service regulations we can apply here in the United States. Furthermore, it has been argued that the current WTO rules prohibit regulatory bans and policies that restrict unfettered capital flow, which could make it more difficult to limit the size of financial firms and the types of services and products they provide. What is the USTR's view about these arguments? Is the USTR considering proposing any changes to WTO rules to ensure that the U.S. is not limited in any way to impose reforms to manner in which financial services are regulated, including stricter prudential standards?"

USTR responded that:

> "The WTO and all of our free trade agreements provide flexibility for governments to regulate and to develop new regulations. These agreements also expressly allow the Parties to take prudential measures to ensure the stability of the financial system and to protect depositors; and explicitly preserve the ability of a central bank or monetary authority to adopt measures pursuant to monetary and related credit policies or exchange rate policies. Because U.S. regulatory discretion is already protected by WTO rules, we do not see a need to propose any changes."

Notably, USTR did not counter the principal allegation: that trade deals might limit policies that restrict unfettered capital flows.

The starting point for any analysis of restrictions on financial service policy under the Korea FTA is Chapter 13 "Financial Services." The very first article of this chapter (Article 13.1.1) states that the chapter applies to any government policy "relating to: (a) financial institutions of the other Party; (b) investors of the other Party, and investments of such investors, in financial institutions in the Party's territory; and (c) cross-border trade in financial services."

The very next article makes clear that certain obligations of other chapters are incorporated into Chapter 13. Article 13.1.2 reads:

> "2. Chapters Eleven (Investment) and Twelve (Cross-Border Trade in Services) apply to measures described in paragraph 1 only to the extent that these Chapters or Articles of these Chapters are incorporated into this Chapter.
> (a) Articles 11.6 (Expropriation and Compensation), 11.7 (Transfers), 11.10 (Investment and Environment), 11.11 (Denial of Benefits), 11.13 (Special Formalities and Information Requirements), and 12.11 (Denial of Benefits) are hereby incorporated into and made part of this Chapter.

(b) Section B (Investor-State Dispute Settlement) of Chapter Eleven (Investment) is hereby incorporated into and made part of this Chapter solely for claims that a Party has breached Article 11.6, 11.7, 11.11, or 11.13 as incorporated into this Chapter.
(c) Article 12.10 (Payments and Transfers) is incorporated into and made part of this Chapter to the extent that cross-border trade in financial services is subject to obligations under Article 13.5."

Korea FTA Article 11.7 is referenced above in subparagraphs a and b. It contains the meat of the free transfers obligations relevant to financial services. This article reads in part:

"ARTICLE 11.7: TRANSFERS [Footnote: For greater certainty, Annex 11-G applies to this Article.]
1. **Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory**. Such transfers include:
(a) contributions to capital, including the initial contribution;
(b) profits, dividends, capital gains, and proceeds from the sale of all or any part of the covered investment or from the partial or complete liquidation of the covered investment;
(c) interest, royalty payments, management fees, and technical assistance and other fees;
(d) payments made under a contract, including a loan agreement;
(e) payments made pursuant to Article 11.5.4 and 11.5.5 and Article 11.6 [editorial note: these provisions relate to payment in a period of war or civil strife]; and
(f) payments arising out of a dispute.
2. Each Party shall permit transfers relating to a covered investment to be made in a freely usable currency at the market rate of exchange prevailing at the time of transfer.
3. Each Party shall permit returns in kind relating to a covered investment to be made as authorized or specified in a written agreement between the Party and a covered investment or an investor of the other Party." [emphasis added]

(Article 12.10 parallels Article 11.7 fairly closely, but relates only to cross-border financial services provision, i.e. Korean firms offering financial services to U.S. consumers in U.S. territory, or vice versa. We will not separately examine these provisions in this memo.)

As the emphasized portion states, the FTA strongly presumes that transfers be allowed to be made "freely and without delay into and out of" an FTA country. As a related memo explains, the notion of freedom and lack of delay in this context is very sweeping. (See: http://www.citizen.org/documents/MemoonCapitalControls.pdf)

As that memo shows, the affected policies could encompass inflow restrictions such as:

- Restrictions on currency mismatches
- End use limitations
- Unremunerated reserve requirements
- Taxes on inflows
- Minimum stay requirements
- Limits on domestic firms and residents from borrowing in foreign currencies
- Mandatory approvals for capital transactions
- Prohibitions on inflows

It could also encompass outflow restrictions such as:

- Limits on ability of foreigners to borrow domestically
- Exchange controls
- Taxes / restrictions on outflows
- Mandatory approvals for capital transactions
- Prohibitions on outflows

The Planck Commentaries – a widely consulted source on WTO rules, including similar free transfer provisions – states that:

> "the term 'restriction' should be construed broadly… as a basic rule, any measure that could impede international transfers and payments in connection with GATS services is prohibited. Restrictions can be direct or indirect. Direct restrictions affect the transactions themselves, for instance prohibiting certain transactions, setting quotas, providing for approval procedures, etc. Indirect restrictions, conversely, do not restrict international transfers and payments as such, but discourage them without directly limiting them by means of restrictive regulation, such as excessive taxation, measures requiring undue paperwork or those creating extensive delays, etc."[8]

The European Commission (dominated by countries that have advocated financial transaction taxes, or FTTs) sees its policy options limited by transfers provisions in the WTO that are similar to those in the Korea FTA. As the European Commission recently noted in a staff working paper on FTTs:

> "the compatibility of such a levy with Article XI of the General Agreement on Trade in Services (GATS), which provides that WTO Members cannot apply any restrictions on international transfer and payments for current transactions relating to their specific commitments, would have to be further assessed. As the EU has taken specific commitments relating to financial transactions, including lending, deposits, securities and derivatives trading and these commitments relate to transactions with third countries, a currency transactions tax could constitute a breach of the EU's GATS obligations."[9]

This may complicate Korea's current plans to institute a "macroprudential stability levy… on foreign exchange liabilities."

In summary, a wide range of policies – including some that may be permissible under the IMF Article of Agreement – could be hindered by trade pact rules on financial services.

Market Access provisions

The other primary non-discriminatory financial service obligation established by the FTA is the market access provision. Contained in Article 13.4, it lays out a set of five non-discriminatory policies that cannot be adopted or maintained. It reads:

> "ARTICLE 13.4: MARKET ACCESS FOR FINANCIAL INSTITUTIONS
> A Party shall not adopt or maintain, with respect to financial institutions of the other Party or investors of the other Party seeking to establish such institutions, either on the basis of a regional subdivision or on the basis of its entire territory, measures that:
> (a) impose limitations on:

(i) the number of financial institutions whether in the form of numerical quotas, monopolies, exclusive service suppliers, or the requirements of an economic needs test;
(ii) the total value of financial service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;
(iii) the total number of financial service operations or on the total quantity of financial services output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;[Footnote: Clause (iii) does not cover measures of a Party which limit inputs for the supply of financial services.] or
(iv) the total number of natural persons that may be employed in a particular financial service sector or that a financial institution may employ and who are necessary for, and directly related to, the supply of a specific financial service in the form of numerical quotas or the requirement of an economic needs test; or

(b) restrict or require specific types of legal entity or joint venture through which a financial institution may supply a service."

FTA Article 13.4(a)(ii-iii) would restrict the U.S. or Korea's ability to ban a financial service. The GATS has similar rules that the WTO Appellate Body has interpreted as prohibiting regulatory bans, since such bans set a quota or ceiling of zero on "the total value of financial service transactions or assets… or on the total quantity of financial services output." FTA Articles 13.4(a)(ii-iii) also restrict other ceilings on service sectors.

II. Neither the General nor Specific Annex 11-G Exceptions Provide Policy Space for Capital Controls

1. <u>The Annex 11-G carve out does not cover all of Korea's Foreign Exchange Transactions Act, even as it existed in 2007 when the FTA was signed.</u>

To analyze how much of FETA the 11-G carve-out covers requires review of the texts' language:

Annex 11-G "TRANSFERS"
1. Nothing in this Chapter, Chapter Twelve (Cross-Border Trade in Services), or Chapter Thirteen (Financial Services) shall be construed to prevent Korea from applying measures pursuant to Article 6 of the Foreign Exchange Transactions Act, provided that such measures:[Footnote: Korea shall endeavor to provide that such measures will be price-based.]
(a) are in effect for a period not to exceed one year; however, if extremely exceptional circumstances arise such that Korea seeks to extend such measures, Korea will coordinate in advance with the United States concerning the implementation of any proposed extension;
(b) are not confiscatory;
(c) do not constitute a dual or multiple exchange rate practice;
(d) do not otherwise interfere with investors' ability to earn a market rate of return in the territory of Korea on any restricted assets;[Footnote: For greater certainty, the term "restricted assets" in subparagraph (d) refers only to assets invested in the territory of Korea by an investor of the United States that are restricted from being transferred out of the territory of Korea.]
(e) avoid unnecessary damage to the commercial, economic, or financial interests of the United States;
(f) are temporary and phased out progressively as the situation calling for imposition of such measures improves;
(g) are applied in a manner consistent with Articles 11.3, 12.2, and 13.2 (National Treatment) and Articles 11.4, 12.3, and 13.3 (Most-Favored-Nation Treatment) subject to the Schedules of Korea to Annex I, Annex II, and Annex III; and
(h) are promptly published by the Ministry of Finance and Economy or the Bank of Korea.
2. Paragraph 1 does not apply to measures that restrict:
(a) payments or transfers for current transactions, unless:

(i) the imposition of such measures complies with the procedures stipulated in the Articles of Agreement of the International Monetary Fund;[Footnote: Current transactions shall have the meaning set forth in Article 30(d) of the Articles of Agreement of the International Monetary Fund and, for greater certainty, shall include interest pursuant to a loan or bond on any restricted amortization payments coming due during the period that controls on capital transactions are applied.] and
(ii) Korea coordinates any such measures in advance with the United States; or
(b) payments or transfers associated with foreign direct investment."

Translation of FETA's Article 6

"Article 6 (Suspension, etc. of Foreign Exchange Transactions)

(1)The Minister of Strategy and Finance may, pursuant to Presidential Decree, take measures as provided for in any of the following subparagraphs, if such measures are deemed inevitable on account of the outbreak of natural calamities, war, conflicts of arms, grave and sudden changes in domestic and foreign economic conditions, or other situations equivalent thereto:
1. Temporary suspension of payment, receipt, or the whole or a part of transactions to which this Act applies;
2. Imposition of obligations to safekeep, deposit or sell means of payment or precious metals in or to the Bank of Korea, government agencies, the foreign exchange equalization fund, or financial institutions.

(2) In cases where it is deemed to fall under any of the following subpara- graphs, the Minister of Strategy and Finance may, pursuant to Presidential Decree, take measures to place any person intending to perform capital transactions under an obligation to obtain permission, or any person performing capital transactions under an obligation to deposit part of means of payment acquired in such transactions in the Bank of Korea, the foreign exchange equalization fund or financial institutions:
1.In cases where international payments and international finance are confronted or are liable to be confronted with serious difficulty;
2.In cases where the movement of capital between the Republic of Korea and a foreign country creates or is liable to create serious obstacles in carrying out currency policies, exchange rate policies and other macroeconomic policies.
(3) Measures provided for in paragraphs (1) and (2) may be taken for not more than six months unless there exist special grounds to the contrary, and if grounds of such measures cease to exist, such measures shall be cancelled without delay.
(4) Measures provided for in paragraphs (1) through (3), shall not apply to foreign investment as provided for in Article 2 (1) 4 of the Foreign Investment Promotion Act."

Several things are worth noting about FETA Article 6 relative to the FTA's Annex 11-G.

First, the universe of potentially permissible policies under paragraph 1 of Annex 11-G is limited to measures pursuant to Article 6 of FETA – not any new capital control policy outside of Article 6 of the FETA that Korea might adopt in the future. The FETA text is therefore the outer bounds of FTA-permissible capital controls forever more: any shortcomings, limitations or inadequacies currently in the FETA are thus locked in. It's simply too bad if Korea's government failed to foresee or anticipate future capital controls needs outside of FETA. (Major changes to the content of Article 6 of the FETA itself would probably also conflict with the FTA.)

Second, paragraph 1 of FETA gives the Korean government the power to temporarily suspend payment for current (as opposed to capital) transactions when the government deems such a policy "inevitable on account of … grave and sudden changes in domestic and foreign economic conditions" or equivalent situations. In contrast, Annex 11-G, paragraph 2 restricts current transaction restrictions to compliance with IMF rules *and* U.S. coordination. Given U.S. executive branches' longstanding antipathy to current transactions limits, the FTA is likely to claw back a range of policy options currently available to Korea under the FETA. The GATS' restriction on current account regulations was the reason that the European Commission gave why it might not be able to

enact a financial transaction tax (see Addendum II). So the FTA may effectively foreclose this option for Korea.

Third, FETA subparagraph 4 and FTA Annex 11-G(2)(b) suggest that current transaction limitations associated with foreign direct investment are not protected by either. From the text, it is not clear whether this means FDI of Korean or U.S. banks in third countries, or FDI of U.S. or Korean banks in the other's territory. If the latter, this effectively forecloses the space for capital controls applying to any financial service provider operating through a commercial presence (or Mode 3, in the WTO nomenclature) – which is to say any U.S. financial service provider operating in Korea.

Fourth, in contrast to Annex 11-G, the current text of the FETA does not place many restrictions on Korea's ability to design capital controls as it sees fit. (And without an FTA, of course, Korea could make its FETA even more flexible without risking a trade pact attack.) FETA Article 6(2) states that Korea can limit capital transactions on precautionary grounds, such as when international finance might face "serious difficulty" or Korea's macroeconomic policies face "serious obstacles." FETA Article 6(3) allows such restrictions to last six months or as long as they need to last if "there exist special grounds" for doing so.

The FTA Annex 11-G(1)(a), in contrast, creates a strong presumption that the policy not be in effect for longer than a year, requires coordination with the United States if "extremely exceptional circumstances arise" that might lead Korea to extend the measure longer, and does not state that purely precautionary grounds are a legitimate reason to impose capital controls. Even for application of under one year, Annex 11-G(1)(f) states that the measure must be "temporary and phased out" as soon as practicable. **The time requirement in FTA Annex 11-G(1) effectively forecloses the possibility of Korea using long-term capital controls that are preventative in nature, as opposed to those that are imposed after a crisis has already struck.**

Fifth, under Annex 11-G(1)(e), even these very short-term permissible measures under FETA must "avoid unnecessary damage to the commercial, economic, or financial interests of the United States." The concept of "necessity" in trade law is well defined in jurisprudence and highly restrictive. In the *Brazil – Tyres* case, considered to be among the rulings on the concept of "necessity" most deferential to public interest regulations, the WTO Appellate Body wrote:

> "To be characterized as necessary, a measure does not have to be indispensable. However, its contribution to the achievement of the objective must be material, not merely marginal or insignificant, especially if the measure at issue is as trade restrictive as an import ban. Thus, the contribution of the measure has to be weighed against its trade restrictiveness, taking into account the importance of the interests or the values underlying the objective pursued by it."[10]

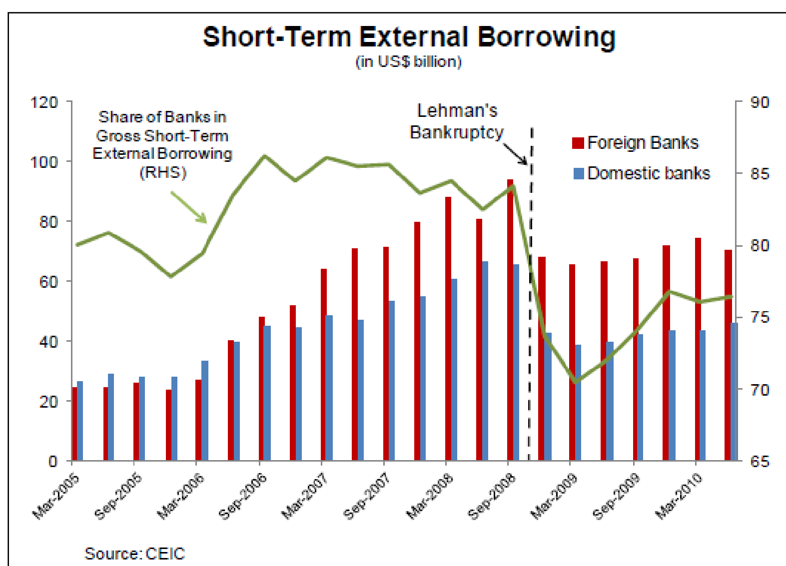
Of course, there's no reason to believe that FTA tribunals would be even as deferential as the WTO Appellate Body in this case. There is no principle of binding precedent (*stare decisis*) in international trade law. And, some GATT and WTO interpretations of necessity are less flexible – requiring the defending party to prove that no less-trade restrictive measure was available. An FTA tribunal could apply a more restrictive formulation of "necessity," such as the notion that an applied policy be the least trade-restrictive option, or not at all trade restrictive.

But even under the "best case" of the *Brazil – Tyres* interpretation, an FTA tribunal – tasked with looking at all areas of public interest regulation through a trade lens – would ask whether a certain

amount of damage to Wall Street banks was "necessary" when weighed against the contribution of capital controls to accomplishing FETA objectives. In other words, limitation of harm to Wall Street banks would be considered a co-equal (or nearly equal) factor against the overriding public interest in maintaining economic stability (that capital controls serve). This "best case" scenario shows the extent to which FTA free transfers provisions have shifted the trade policy debate in an anti-public interest direction. Indeed, such deference to the corporate interest is at odds with the domestic U.S. jurisprudence. As a top U.S. legal scholar noted in a World Bank publication, "From a U.S. perspective, this [necessity] test immediately appears to be overbroad… The main thrust of the U.S. approach is to ferret out discrimination, and not to independently impose requirements for the most open or efficient markets."[11]

Sixth, Annex 11-G(1)(g) also requires that FETA capital controls be imposed in a non-discriminatory manner, which in trade law includes unintended discriminatory effects. This may impose no additional obligation given the FTA's national treatment requirements, but it is worth noting that the non-discrimination requirement in FTAs goes beyond intentional discrimination, to encompass measures that may have an inadvertent disproportionate *impact* on foreign financial service providers. It is entirely possible that the administration of formally non-discriminatory capital controls could impact Wall Street banks disproportionately – meaning recourse to this policy tool could be more difficult. Indeed, it might be appropriate for foreign-owned banks in Korea to pay more of the costs of financial reform relative to domestic banks, since their operations disproportionately generated the vulnerabilities in the banking system, as shown in Figure 1 below (taken from a recent IMF report):

Figure 1



Seventh, there is apparently an exhortation in the form of a footnote to Annex 11-G's opening paragraph that states that Korea "shall endeavor to provide that [FETA] measures will be price-based" – as opposed to quantity based. This would seem to suggest that fees and taxes on derivatives trading under FETA are preferable to measures that, say, restrict the quantity of foreign exchange available for certain derivatives trading.

How binding is "shall endeavor" language? As the WTO Appellate Body has noted, "many binding legal texts employ the word 'should' and, depending on the context, the word may imply either an

exhortation or express an obligation."[12] Indeed, the recent *Nations Energy v. Panama* case under the U.S.-Panama Bilateral Investment Treaty (BIT) looked at a "should strive" clause of that treaty. A dissenting tribunalist argued: "A mere change of words – from 'should accord' to 'should strive to accord' – does not change at all the meaning and character of the legal norm at stake… [the latter language] is not simply a pious exhortation directed at State virtue. It is a legal norm. The interpretive rules of the Vienna Convention on treaties, and particularly the articles that deal with the concept of effectiveness in treaty interpretation (Article 26) are also relevant here… the fact that a more or less incisive or expressive language is used does not change the unequivocal coercive nature of the norm…"[13] The tribunalist went on to rule that Panama was affirmatively bound by obligations worded in the "should strive" format.[14] This may inject a higher degree of uncertainty into the debate on the importance of seemingly exhortative provisions in trade and investment agreements.

Finally, it is important to consider how the exception in FTA Article 11.7 (the most controlling provision with respect to system-wide capital controls as opposed to those for specific institutions in pre-bankruptcy proceedings) relates to Annex 11-G. The relevant subparagraph of Article 11.7 is:

> "4. Notwithstanding paragraphs 1 through 3, a Party may prevent a transfer through the equitable, non-discriminatory, and good faith application of its laws relating to:
> (a) bankruptcy, insolvency, or the protection of the rights of creditors;
> (b) issuing, trading, or dealing in securities, futures, options, or derivatives;
> (c) criminal or penal offenses;
> (d) financial reporting or record keeping of transfers when necessary to assist law enforcement or financial regulatory authorities; or
> (e) ensuring compliance with orders or judgments in judicial or administrative proceedings."

There are two interpretations of Article 11.7.4, described in Addendum I to this memo. Regardless of which interpretation one prefers, it is worth recalling that Article 11.7 has a footnote that requires: "For greater certainty, Annex 11-G applies to this Article." This is attached to the article header, not to paragraphs 1-3. In other words, the preposition "notwithstanding" from Article 11.7.4 does not protect Korea from having to meet the very specific instructions on capital controls in Annex 11-G, which carves out aspects of Korea's policies pursuant to the FETA.

2. **The Annex 11-G carve out does not cover Korea's 2010 financial stability policies**

In the lead-up to the recent global economic crisis, banks in Korea (especially foreign owned ones) had turned away from reliance on consumer deposits as a funding source, and instead borrowed overseas and in foreign currencies to finance their loans made to construction projects and the other finance needs of Korean clients. These capital inflows from overseas suddenly dried up in late 2008 after the collapse of Lehman Brothers, and Korean banks were unable to roll over their debts. With assistance from the U.S. Federal Reserve, the Korean government stepped in to provide foreign exchange liquidity to the nation's banks, so that they could pay their foreign creditors.

As the crisis settled, Korean policymakers rolled out a set of new policies intended to address two problems. On the one hand, Korean regulators wished to address the possibilities of asset market bubbles and exchange rate appreciation (which could hamper exports) that excessive capital inflows can cause. On the other, they wanted to avoid "sudden stops" in inflows that can affect Korean banks' ability to service clients.

In June 2010, Korean financial regulators decreed a new set of so-called "macro-prudential" policies aimed at responding to ongoing turmoil in domestic and international financial markets. The IMF examined these policies in a February 2011 report (along with measures taken or announced in November 2009, late 2010, and January 2011). The Fund praised Korea's actions, saying that they had "succeeded in preventing banks' external debt from returning to pre-crisis levels."[15]

How do these measures relate to the FTA? In a separate paper from February 2011, even the IMF (along with the Bank of International Settlements and Financial Stability Board) noted that "Some countries have subscribed to international instruments that limit their ability to use capital controls."[16] Given the IMF's longstanding frustration with trade pacts' incursion into finance, this likely refers to FTAs and the GATS.

As a starting point, any FTA carve-out, such as that contained in Annex 11-G, applies to the measures listed under the terms set within it. (It is possible to list a measure and "such amendments as may be made to it in the future" or "any policies relating to… and a general description, such as 'minority affairs" or "nuclear non-proliferation." However, that is not the nature of Annex 11-G, which is specific in its scope (Article 6 of FETA) and does not include coverage of amendments to that Act.) **Thus, the core question is whether all of the 2010 measures fall within the scope of FETA Article 6 as it existed when the FTA was signed, and if the new policies are directly under FETA Article 6, do they meet the Annex 11-G requirements.**

According to the Korean government factsheet on the June 2010 policies, the first plank in the decree was to set new "ceilings on domestic banks' FX derivatives contracts [to] no more than 50% of their capital in the previous month. In case of foreign bank branches, the ceilings will be set at 250% of their capital in the previous month, given that their current level is around 300%."[17] The second plank in the policy requires (among other things) long-term foreign currency borrowing to equal long-term foreign currency lending. The third plank in the policy relates to Korea's general prohibition on the use of bank loans denominated in foreign currency for domestic operations. In the past, an exception was granted for acquisition of domestic facilities. The June 2010 policy scales back this exception so that only small and medium-sized manufacturers will be able to take advantage of it.

Table 1 lays out the three planks, and the underlying legal authority on which they are based. (Unfortunately, no specific articles of the related superior acts are referenced in the regulations, but can be inferred by examination of the underlying texts, which can be accessed here: http://www.fsc.go.kr/eng/lr/list02.jsp?menu=0202&bbsid=BBS0086)

Table 1

Measures	Legal basis (amendment)	Content of the reform	Related superior Acts (hierarchy)
1. Introducing New Ceiling on FX Derivatives Positions	- Foreign Exchange Transaction Regulation (Notification of Ministry of Finance and Strategy, No. 2010-14)	- introduction of a new category for FX derivatives position (Article 2-9) - 50% for domestic banks and 250% for foreign branch office (Article 2-9-2) - grace periods and other interim measures (Addendum)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21-> Foreign Exchange Transaction Regulation (Ministerial Decree) Article 2-9, 2-9-2, Addendum
	- Regulations on Financial Investment Business(Notification of the Financial Services Commission, No 2010-112)	- introduction of a new category for FX derivatives position for Financial Investment Businesses (Article 3-47) - Overall Position: 50/100, Derivative position: 50% (Article 3-48) - 2 years grace period (Article 3-49)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21.6-> Regulations on Financial Investment Business
	- Operational Enforcement Rule of the Foreign Exchange Transaction Business (the Bank of Korea, 2010.7.9)	- introduction of FX derivative position and of means of calculating it (Article 2-1) - introduction of standards for management of FX derivative position, ie. the moving average (Article 2-3) - articulation of excessive FX derivative position for FX hedge up to 2 years (Article 2-4) - introduction of exemptions from the limitation of the FX derivative position (Article 2-5(2)) - ways of managing the limitation during the grace period, and grace period for the application of the moving average (Addendum paragraph 2, 3)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21 -> Foreign Exchange Transaction Regulation (Ministerial Decree) Article 2-9, 2-9-2, Addendum -> Operational Enforcement Rule Article 2-1, 2-3, 2-4, 2-5, Addendum)
2. Improving FX soundness of financial institutions	- Regulation on the Supervision of Banking Business (Notification of the Financial Services Commission, No. 2010-111).	- tightening of Monitoring: Banks should manage the ratio of foreign currency liquidity on daily basis and must report it to the Financial Supervisory Service on monthly basis (Article 72-2,3) -the ratio of “foreign currency *borrowing* longer than 1 year” / “foreign currency *lending* longer than 1 year” has tightened from 80% to 90% (2009) and again to 100% this time in 2010 (Article 65)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21 -> Regulation on the Supervision of Banking Business Article 72-2,3 and 65
	- Operational Rule of the Supervision of Banking Service (Notification of the Financial Supervisory Service, 2010.7.30)	- the management standards for foreign currency risk now applies to the foreign branch banks as well (Article 41 table 15-3) - the limitation of the ratio “derivative FX transaction”/ “spot FX transaction” become 100% from 125% (Article 41 table 15-2)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21 -> Regulation on the Supervision of Banking Business Article 65 -> Operational Rule of the Supervision of Banking Service (Article 42 table 15-2,3)
	- Enforcement rule of the Financial Investment Services Regulation (Notification of the Financial Supervisory Service, 2010.7.30)	- change terminologies in conformity with the introduction of FX derivative position(Article 2-16-1)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21 -> Regulation on the Supervision of Banking Business Article 65 -> Enforcement rule of the Financial Investment Services Regulation (Article 2-16-1)
3. Reinforcing the Regulations on the Use of Foreign Currency Bank Loans	- Operational Enforcement Rule of the Foreign Exchange Transaction Business (the Bank of Korea, 2010.6.22)	- Tightening the use of foreign currency bank loans: Foreign currency bank loans should be for overseas use only. Exception has changed from “purchasing domestic facilities” to “purchasing domestic facilities by SMEs (manufacturers)” as long as the total foreign currency bank loans of them stay at the current level(Article 2-9-1, 2) - it will be applied only to new loans(Addendum paragraph 2)	Foreign Exchange Transaction Act (ACT) Article 11 -> the Enforcement Decree of FETA (Presidential Decree) Article 21 -> Foreign Exchange Transaction Regulation (Ministerial Decree) Article 2-9, 2-9-2, Addendum -> Operational Enforcement Rule Article 2-9-1,2; Addendum paragraph 2)

What are the likely implications (if any) of the FTA for the policies in Table 1?

Ceilings on derivatives contracts

The June 2010 ceiling on derivative contracts cites *Article 11-2* of the Foreign Exchange Transaction Act (FETA) as a statutory authority.[18] Therefore, this first plank of the June 2010 policies would not be covered by FTA Annex 11-G, which provides Korea with a defense for certain policies taken pursuant to *Article 6* of the FETA. (The June 2010 ceiling may also be based on Korea's Financial Investment Services and Capital Market Act (FISCMA) as a statutory authority. FISCMA was not even in place when the FTA was finalized. Its first version was put into place on August 3, 2007, and it has been amended as recently as June 8, 2010.[19] In other words, to the extent that FISCMA conflicts with the FTA, it would not be grandfathered in through ANY FTA carve-out, as it did not exist when the pact was signed.)

It is worth considering another carve-out. Korea's FTA Annex III Appendix III-A(5) has a carve-out (explored in Addendum I below) which relates to the foreign exchange exposure of both foreign exchange banks and onshore banks. But, like Annex 11-G, that Annex III carve-out is very specific, limiting the net open position of foreign exchange banks to 50 percent of their total equity in the previous two months. The overbought position of onshore banks, by contrast, may not exceed 110 percent of the position registered on January 14, 2004. By standard treaty interpretation, the carve-out is so specific that any policy that deviates (however slightly) from its confines would likely be deemed not covered by it.

And there are several key differences between the FTA carve-out and the first plank of the June 2010 reform. First, the Appendix III-A(5) carve-out refers only to the overall foreign exchange exposure, not to foreign exchange *derivatives* exposure (as do the June 2010 reforms). Second, the Appendix III-A(5) carve-out does not reference the 250 percent ceiling for foreign bank branches. Thus, if Appendix III-A is interpreted as laying the outer bounds of carved out policy, then Korea's June 2010 policy passes that outer bound by subjecting non-carved out institutions to market access violative ceilings.

Foreign currency liquidity requirements

The second plank of the June 2010 reforms also cites Article 11 of the FETA as an authority. **Therefore, this second plank of the June 2010 policies would also not be covered by FTA Annex 11-G, which provides Korea with a defense for certain policies taken pursuant to *Article 6* of the FETA.** The analysis with respect to the first plank of the June 2010 reforms also holds: FTA Annex III, Appendix III-A(5) wouldn't apply to requirements that banks match foreign currency borrowing to lending. Such a link could be seen as a market access-prohibited ceiling.

Foreign currency denominated loans

The prohibition on foreign currency-denominated lending for domestic projects in the third plank of the June 2010 policies may also have implications under FTA Article 13.4 (Market Access). It appears to establish a ceiling of zero for that particular segment of the lending market.

The measure also appears to have no protection under either FTA Annex 11-G or Annex III. Like the previous two planks, it is not a measure pursuant to FETA Article 6, but instead FETA Article 11.

Annex III appears to offer little protection either. As Addendum I below shows, FTA Annex III, Appendix III-A(3) states that Koreans cannot use won to pay for services rendered them by financial service suppliers located overseas, and FTA Appendix III-A(10) states that non-residents cannot buy won except "for actual use in Korea." These two carve-outs relate to Foreign Exchange Transaction Regulations as notified in 2006. In contrast, the third plank of Korea's June 2010 policies post-date the carved-out 2006 regulations. Moreover, neither carve-out appears to address the specific situation addressed by the third plank of the June 2010 reforms: use of non-won loans in the domestic market.

Some sources have suggested that this measure may have been taken pursuant in part to the Banking Act. Several Banking Act-related provisions appear as carve-outs in Korea's FTA Annex III, but none that appear relevant for this policy. Appendix III-A (which, recall, is carve-outs from market access obligations) states in part that:

> "(8) A bank, securities company or other financial institution constituted in Korea may only engage in activities permitted by the relevant laws. (Articles 27 and 28 of the Banking Act (Law No. 7428, March 31, 2005); and Article 51 of the Securities and Exchange Act (Law No. 7762, December 29, 2005) and Articles 36-2 and 36-3 of the Enforcement Decree of Securities and Exchange Act (Presidential Decree No. 19806, December 29, 2006)); (9) A financial institution is prohibited from acquiring real estate for non-business purpose. (Article 38 of the Banking Act (Law No. 7428, March 31, 2005); Article 105 of the Insurance Business Act (Law No. 7971, August 29, 2006);... (11) Korea may restrict deposit interest rates, loan interest rates, other interest rates, maturity of deposit and related fees. (Article 30 of the Banking Act (Law No. 7428, March 31, 2005); the Regulation on Financial Institutions' Loans and Deposit Rates (Monetary Policy Committee, December 24, 2003); Article 8 and Article 15 of the Lending Business Act (Law No. 7523, May 31, 2005); and Article 5 and Article 9 of the Enforcement Decree of Lending Business Act (Presidential Decree No. 19019, August 31, 2005))."

But note that only specific articles of the Banking Act as they were in effect as of certain dates are carved out, but amendments to those articles are not. Thus, only Banking Act Article 27 and 28 (March 2005 version) are carved out. Moreover, this vague article[20] does not relate to foreign currency lending.

Annex III-Korea-12 carves out Article 15 and 16-2 of the Banking Act as they existed in March 2005. But these articles only carve out the Korean laws from the national treatment obligation in Article 13.2, not the market access obligation in Article 13.4. Moreover, they are not relevant to the issue of foreign currency lending, and instead place restrictions on foreign banks' shareholding of Korean banks. The same is true of Annex III-Korea-14 and Annex III-Korea-19. Indeed, a tribunal examining an FTA challenge of the June 2010 policies would note that a wide range of Banking Act provisions were carved out in Annex III, but not any that pertain to prohibitions on foreign currency-denominated loans in the domestic market. **This absence in Annex III would likely be interpreted to require that prohibitions on foreign currency loans be brought into compliance with any relevant FTA obligations.**

How likely is a trade pact challenge of a foreign country's prohibition on a particular subslice of the lending market? In fact, none other than the Obama administration has launched a WTO challenge of a Chinese policy that bans foreign firms from accessing the domestic currency denominated payments market.[21] So, fairly likely.

Conclusion

The Korea FTA prohibits most forms of capital controls. The fact that the so-called carve-outs and "exceptions" that touch at least peripherally on capital controls policy space are so numerous, if anything, confirms the wide potential range of application. There is very limited jurisprudence in the area of capital controls in trade agreements, making the outcomes in this area highly uncertain. Policymakers would do well to advocate a precautionary approach, and remove the transfers disciplines entirely from all trade and investment agreements. Moreover, it is clear that the June 2010 policies are likely to run into FTA problems, most likely with the anti-ceiling language in Article 13.4. As our examination above shows, neither Annex 11-G nor Korea's FTA Annex III carve-outs are unlikely to provide protection for these 2010 policies.

III. Review of the Other FTA Exceptions that Have Been Said to Allow for Capital Controls in Certain Instances

There are half of a dozen "exception"-like provisions that could conceivably apply to capital controls. But, upon closer inspection, many provide no defense for capital controls.

Exception Provisions in Chapter 13: Financial Services

The first defense provision we can eliminate is Article 13.9,[22] which allows FTA countries to schedule non-conforming measures in Annex III of the FTA. However, FTA countries cannot get out of *all* obligations through an Annex III listing: for instance, they explicitly cannot schedule measures that would violate Article 11.7 on free transfers. Any policies that are non-compliant with Article 11.7 simply have to be brought into compliance – they cannot be grandfathered in through Annex III. (See the box on the next page for more explication of this Annex.)

The second exception we can eliminate is contained in Article 13.10.1, which reads:

> "1. Notwithstanding any other provision of this Chapter or Chapter Eleven (Investment), Fourteen (Telecommunications), including specifically Article 14.23 (Relation to Other Chapters), or Fifteen (Electronic Commerce), and, in addition, Article 12.1.3 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, a Party shall not be prevented from adopting or maintaining measures for prudential reasons,[Footnote: It is understood that the term "prudential reasons" includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions or cross-border financial service suppliers.] including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. *Where such measures do not conform with the provisions of this Agreement referred to in this paragraph, they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions*."

As we note below, there is serious disagreement among scholars as to whether Article 13.10.1 would apply to transfer-limiting capital controls in any instance. But even assuming that it could theoretically apply in certain instances, the second sentence suggests that prudential measures *are only allowed* under the FTA rules *if they don't violate any of the FTA rules*, which are very expansive, or operate to

reduce a member country's commitments or obligations. Yet, a country would only need to employ this defense *if* its financial regulation were challenged before an FTA tribunal as violating FTA rules.

USTR states that U.S. trade agreements "also expressly allow the Parties to take prudential measures to ensure the stability of the financial system and to protect depositors." Yet, a comprehensive literature review spanning two decades of trade law publications conducted by Public Citizen found agreement that the prudential measures defense (PMD) is subject to dispute settlement, and a respondent country could be ruled against. (To see our report detailing these findings with respect to WTO rules, which also has a PMD, see http://www.citizen.org/documents/PrudentialMeasuresReportFINAL.pdf.)[23] Many interpretations are possible. But Public Citizen's review of negotiating documents obtained under the Freedom of Information Act (FOIA) reveals that negotiators intended to guarantee that policies that violate the central FTA / WTO obligations (free transfers, market access) are not able to use the PMD.[24] In sum, while analysts disagree about how the PMD would operate if triggered, they all agree that it does not prohibit challenges of prudential measures, that it is at best confusing, and that a trade tribunal would have the final say.

In fact, a North American Free Trade Agreement (NAFTA) case brought against Mexico, which dealt with language similar to the Korea FTA prudential measure defense clause, confirmed this point.[25] The target of the NAFTA challenge was a series of measures related to Mexico's bailout of its financial sector: Mexico deemed these "prudential" in nature, while a U.S. insurance firm, Fireman's Fund, claimed they constituted an indirect expropriation (among other violations) requiring compensation under NAFTA. Even though NAFTA does not have the self-cancelling language of the Korea FTA provision, Mexico's prudential measure was interpreted as still subject to challenge. The NAFTA case indicates that simply deleting the second sentence of the FTA prudential defense is not sufficient, and that a new second sentence that is either self-judging or shifts the burden of proof onto the complainant / claimant is needed to provide a real safeguard for prudential regulation.

What implications for market access commitments and prudential policies in Annex III?

The meaning of market access commitments and prudential policies within the FTA is given further context by FTA Annex III, which contains carve-outs from Korea's obligations, as permitted by Article 13.9 of the FTA Financial Services Chapter.

Past FTAs contain annexes similar to the Korea FTA's Annex III. As with those FTAs, Korea lists a series of national policies and policy space that it exempts from key FTA obligations like Market Access. The carve-out applies to "existing non-conforming measures" listed in Annex III, their "continuation or prompt renewal," and amendments to them "to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment." In other words, any changes to measures listed in FTA Annex III cannot violate (say) market access rules more than the original listing.

Unlike other FTAs, the Korea FTA includes an Appendix III-A, which is entitled "Certain Measures Not Inconsistent with Article 13.4 or Subject to 13.10.1." This Appendix is further divided into two subsections. The first subsection begins with this text: "The following measures are not inconsistent with Article 13.4 (Market Access for Financial Institutions): …" and proceeds to lay out a set of 11 banking, securities and insurance policies. The second subsection begins with this text: "The following

measures fall within Article 13.10.1 (Exceptions) and that, therefore, Article 13.2 (National Treatment) does not prevent Korea from maintaining them…" and goes on to list two insurance policies.

One of the 11 policies contained at Appendix III-A(5) in the first subsection is: "The overall net open position of foreign exchange banks, measured by the sum of the net short position or the sum of the net long positions, whichever is greater (short-hand method), is limited to 50 percent of the total equity capital at the end of the previous month; the overbought (long won) position of NDFs (Non-Deliverable Forwards) held by onshore banks may not exceed 110 percent of the position as registered on January 14, 2004. (Article 11-2 of the Foreign Exchange Transaction Act (Law No. 8050, October 4, 2006); and Article 2-9 of the Foreign Exchange Transaction Regulation (Notification of the Ministry of Finance and Economy No. 2006-26, August 3, 2006))"

Appendix III-A(3) states: "Residents of Korea are not permitted to settle payment in KRW (Korean won) for cross-border financial services supplied to them by residents of foreign countries. (Articles 5-11 and 7-7 to 7-10 of the Foreign Exchange Transaction Regulation (Notification of the Ministry of Finance and Economy No. 2006-26, August 3, 2006))"

Finally, Appendix III-A(10) states: "Non-resident of Korea may convert foreign currency into KRW (Korean won) only for actual use in Korea. (Articles 7-7 to 7-10 and Articles 7-36 to 7-39 of the Foreign Exchange Transaction Regulations (Notification of the Ministry of Finance and Economy No. 2006-26, August 3, 2006))"

It is difficult to know how to interpret this *sui generis* Appendix III-A. Is it simply a clarification that, say, Article 13.4 does not require removal of any of the types of policies in the list therein? This seems unlikely. Trade negotiators have a standard way of making such clarifications, which typically entail a footnote from the substantive obligation that begins "for greater certainty,…" followed by an inscription such as "nothing in this article requires removal of ceilings on foreign equity positions." The FTA contains no such inscription.

Alternatively, is the implication that the 11 policies listed in the first subsection would be market access violations *if not for* their being listing therein? If so, this by implication provides a much more detailed elucidation of trade negotiators' interpretation of the content of FTA market access commitments than has previously been made public. Indeed, it suggests that a ceiling (expressed as a ratio of foreign exposure to capital) on an individual bank's balance sheet is an FTA-prohibited policy unless explicitly carved out.

Also, why does the Appendix III-A's second subsection make reference to Article 13.10.1 (the PMD), while the first subsection does not? It implies that trade negotiators view the 11 policies in the first subsection as not "prudential" in nature.

Finally, why have an Appendix III-A? Why not just utilize the standard Annex III carve-out method? We may never know the full answers until and if a dispute settlement case emerges.

Moving on to Article 13.10.2, this provision reads:

> "2. Nothing in this Chapter or Chapter Eleven (Investment), Fourteen (Telecommunications), including specifically Article 14.23 (Relation to Other Chapters), or Fifteen (Electronic

> Commerce), and, in addition, Article 12.1.3 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, applies to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit policies or exchange rate policies. *This paragraph shall not affect a Party's obligations under Article 11.8 (Performance Requirements) with respect to measures covered by Chapter Eleven or under Article 11.7 (Transfers) or 12.10 (Payments and Transfers)."*

Whereas the prudential paragraph was arguably self-cancelling, Article 13.10.2 forcefully differentiates between monetary policy that interferes with transfers, and monetary policy that doesn't. (Or, perhaps even more forcefully, it implies that capital controls are not monetary policy. This is an outdated approach, since even the IMF now sees capital controls as an "essential feature of the monetary policy framework," i.e. a subset of monetary policy.[26]) **The transfer-limiting type is not allowed.**

A Bush administration fact sheet on the similar free transfer provisions from the U.S.-Singapore FTA implied that the United States sees capital controls policy as non-prudential and non-monetary in nature: "Free transfers permit the efficient allocation of resources and provide investors with a transparent regime for doing business free of political obstacles. Both countries recognize that a strong reserve position, a flexible exchange rate regime, sound fiscal and monetary policies, and effective prudential measures for the financial sector are the preferred policy tools for both avoiding a balance of payments crisis and for dealing with one."[27]

Obama administration Treasury Secretary Timothy Geithner also drew this dichotomy in a recent letter to economists that had expressed concern about the inclusion of the free transfers provisions in U.S. FTAs. He said "we believe" that the risks associated with capital inflows "are best managed through a mix of fiscal and monetary policy measures, exchange rate adjustment, and carefully designed non-discriminatory prudential measures, such as bank reserve or capital requirements and limitations on exposure to exchange rate risk." In contrast, countries should not have the right to impose restrictions on transfers under FTAs, but rather U.S. investors should have "the right to make investments through capital transfers and to repatriate capital and investment returns."[28]

Despite this commentary, there is substantial evidence that reserve accumulation, so-called "quantitative easing" and other policies may be more costly than capital controls: central banks have to spend resources that may have been put to more productive use elsewhere in the economy. Capital controls, by contrast, only have their enforcement costs. And capital controls such as financial transaction taxes may actually *generate revenue.*[29]

The *lex specialis* principle might have something to tell us about how an FTA tribunal would look at invocation of a prudential or monetary policy defense under an FTA attack on capital controls. For instance, Joel Trachtman and Mark Kantor – two leading international lawyers – examined the existence of similar exceptions in NAFTA, including the first paragraph broadly related to prudential measures, and the second paragraph that makes specific mention of the "free transfers" provision. Invoking the *lex specialis* principle, they argue that the prudential provision cannot provide a defense for monetary policy generally (since that is covered by the Article 13.10.2-type provision), nor capital controls specifically (since they would violate the *more transfers-specific* Article 11.7 paragraph requirements).[30]

There are two more provisions worth noting: Article 13.10.3 and 13.10.4. The first reads:

> "3. Notwithstanding Articles 11.7 (Transfers) and 12.10 (Payments and Transfers), as incorporated into this Chapter, a Party may prevent or limit transfers by a financial institution or cross-border financial service supplier to, or for the benefit of, an affiliate of or person related to such institution or supplier, through the equitable, non-discriminatory, and good faith application of measures relating to maintenance of the safety, soundness, integrity, or financial responsibility of financial institutions or cross-border financial service suppliers. This paragraph does not prejudice any other provision of this Agreement that permits a Party to restrict transfers."

Article 13.10.3 is unlikely to apply to broad capital controls regulations because the text refers only to "financial institutions or cross-border financial service suppliers." System-wide stability is not mentioned. Contrast this with Article 13.10.1, which refers to prudential motivations related to both system-wide stability and individual institutions. Negotiators clearly could have referred to both policy motivations in the text of Article 13.10.3 if they had intended both types of motivation to be covered by Article 13.10.3. From Article 13.10.1, we know that negotiators were aware of the distinction between the two motivations, so the omission of stability-motivated measures in Article 13.10.3 should not be seen as an inadvertent omission. And unlike Article 13.10.1, the list of indicative policies is Article 13.10.3 is a closed list rather than an open list: the word "including" does not appear in the latter article. (Of course, as we have seen above, due to Article 13.10.1's arguably self-cancelling second sentence, the wider scope for policy motives in theory may provide little protection in practice.) Article 13.10.3 was likely intended to protect policy space for deposit insurance, resolution proceedings, and other policies intended to help individual firms avoid bankruptcy.

Article 13.10.4 also has a bit of the arguably self-cancelling nature of Article 13.10.1. The text of the former reads:

> "4. For greater certainty, nothing in this Chapter shall be construed to prevent a Party from adopting or enforcing measures necessary to secure compliance with laws or regulations that are not inconsistent with this Chapter, including those relating to the prevention of deceptive and fraudulent practices or to deal with the effects of a default on financial services contracts, subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on investment in financial institutions or cross-border trade in financial services."

The requirement that Article 13.10.4 only be invoked to defend policies "that are not inconsistent with this Chapter" severely limits the scope of this defense. The obligation to comply with the market access and other key provisions of Chapter 13 (including those provisions "read in" from Chapter 11, such as free transfers) would still apply.[31]

After this examination of Chapter 13 exceptions, therefore, we can conclude that Article 11.7 is the most controlling provision with respect to system-wide capital controls (as opposed to those for specific institutions in pre-bankruptcy proceedings). Returning to the one subparagraph of Article 11.7 that we have yet to examine:

"4. Notwithstanding paragraphs 1 through 3, a Party may prevent a transfer through the equitable, non-discriminatory, and good faith application of its laws relating to:
(a) bankruptcy, insolvency, or the protection of the rights of creditors;
(b) issuing, trading, or dealing in securities, futures, options, or derivatives;
(c) criminal or penal offenses;
(d) financial reporting or record keeping of transfers when necessary to assist law enforcement or financial regulatory authorities; or
(e) ensuring compliance with orders or judgments in judicial or administrative proceedings."

There are two interpretations of Article 11.7.4. The first is that essentially all of the listed policies are allowed, so long as they do not discriminate. This is a highly unlikely interpretation. Let us focus on subparagraph b: "issuing, trading, or dealing in securities, futures, options, or derivatives." If the FTA's only obligation *vis a vis* transfer rights in securities were non-discrimination, then Article 11.7 would be redundant with the various national treatment articles in Chapters 11, 12 and 13 – in violation of the effectiveness principle. And the notion of "good faith" in governmental conduct is an underlying principle of international law, and would not need to be codified further in an FTA. If a securities dealer were subjected to discriminatory capital controls (i.e. only foreign firms pay a speculation tax), they could pressure their government to launch an FTA dispute settlement case under the national treatment clauses. If a securities dealer had to pay the same speculation tax that nationals had to pay, there would be no FTA violation.

A second interpretation is that transfer restrictions that securities traders confront related to "issuing, trading, or dealing" in securities *per se* can be distinguished from transfer restrictions that securities traders confront to ensure economic stability. Thus, the phrase "relating to" becomes controlling. According to the WTO Appellate Body, for a measure to be considered "related to" a policy goal, it must be "primarily aimed" at the policy, i.e. the means must be "reasonably related to the ends," and the means-end relationship must be "observably a close and real one."[32] Thus, for a law to be "related to… issuing, trading, or dealing in securities, futures, options, or derivatives," it would have to be "primarily aimed" at the issuing or trading per se, i.e. measures to ensure that firms can issue securities, and can trade securities. A capital control, in contrast, is "primarily aimed" at ensuring economic stability, eliminating rent-seeking activities, or avoiding a currency appreciation.

Regardless of which interpretation one prefers, recall the footnoted reference earlier in Article 11.7 ("For greater certainty, Annex 11-G applies to this Article."). It was attached to the article header, not to paragraphs 1-3. In other words, the preposition "notwithstanding" from Article 11.7.4 does not protect Korea or the United States from having to meet the very specific instructions on capital controls in Annex 11-G, which only carves out certain very limited aspects of Korea's policies pursuant to the pre-2007 FETA.

ENDNOTES

1 Letter from Rep. Barney Frank (D-Mass.) to USTR Ron Kirk, Feb. 2, 2012.
2 Letter from over 250 economists to USTR Ron Kirk, Treasury Secretary Tim Geithner, and State Secretary Hillary Clinton, Jan. 31, 2011. Available at: http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.pdf
3 Letter from Korean opposition parties to President Obama, Feb. 8, 2012.
4 See http://www.ustr.gov/sites/default/files/uploads/factsheets/2008/asset_upload_file972_15191.pdf
5 USITC, 2010, at 4-10.
6 Comment on Third Way panel entitled, "Exports from the Heartland to Seoul: How the US-Korea Free Trade Deal Will Help Americans," January 13, 2011. Transcript available at: http://www.thirdway.org/events/36/transcript

7 See John B. Taylor (Under Secretary of Treasury for International Affairs), "Financial Services and Capital Transfer Provisions in Recent Free Trade Agreements," Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Committee on Financial Services, U.S. House of Representatives, April 1, 2003. Available at:
http://www.stanford.edu/~johntayl/taylorspeeches/Financial%20Services%20and%20Capital%20Transfer%20Provisions%20(1%20Apr%2003).doc.
8 "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.

9 European Commission staff working document, "Innovative financing at a global level," SEC(2010) 409 final, April 1, 2010. Available at: http://ec.europa.eu/economy_finance/articles/international/2010-04-06_global_innovative_financing_en.htm
10 Appellate Body Report, Brazil – Measures Affecting Imports Of Retreaded Tyres, WT/DS332/AB/R, Dec. 3, 2007, at para 210.
11 David W. Leebron, "Regulatory Discrimination in Domestic United States Law: A Model for the GATS?," in Aaditya Mattoo and Pierre Sauvé (eds.), *Domestic Regulation and Services Trade Liberalization*, (Oxford: OUP/World Bank, 2003), at 51 and 53.
12 Appellate Body Report, United States – Tax Treatment for Foreign Sales Corporations, WT/DS108/AB/R, Feb. 24, 2000, footnote 124 to para 111. The panel cited the previous year's Appellate Body finding in the *Canada – Aircraft* decision, which stated: "187. We note that Article 13.1 of the DSU provides that 'A Member should respond promptly and fully to any request by a panel for such information as the panel considers necessary and appropriate.' (emphasis added) Although the word 'should' is often used colloquially to imply an exhortation, or to state a preference, it is not always used in those ways. It can also be used 'to express a duty [or] obligation'. The word 'should' has, for instance, previously been interpreted by us as expressing a 'duty' of panels in the context of Article 11 of the DSU. Similarly, we are of the view that the word 'should' in the third sentence of Article 13.1 is, in the context of the whole of Article 13, used in a normative, rather than a merely exhortative, sense. Members are, in other words, under a duty and an obligation to 'respond promptly and fully' to requests made by panels for information under Article 13.1 of the DSU. 188. If Members that were requested by a panel to provide information had no legal duty to 'respond' by providing such information, that panel's undoubted legal 'right to seek' information under the first sentence of Article 13.1 would be rendered meaningless. A Member party to a dispute could, at will, thwart the panel's fact-finding powers and take control itself of the information-gathering process that Articles 12 and 13 of the DSU place in the hands of the panel. A Member could, in other words, prevent a panel from carrying out its task of finding the facts constituting the dispute before it and, inevitably, from going forward with the legal characterization of those facts. Article 12.7 of the DSU provides, in relevant part, that '…the report of a panel shall set out the findings of fact, the applicability of relevant provisions and the basic rationale behind any findings and recommendations that it makes.' If a panel is prevented from ascertaining the real or relevant facts of a dispute, it will not be in a position to determine the applicability of the pertinent treaty provisions to those facts, and, therefore, it will be unable to make any principled findings and recommendations to the DSB."
13 Translation into English of dissenting vote of Dr. José María Chillón Medina in International Center for the Settlement of Investment Disputes, *Nations Energy Inc. et. al. v. Panama,* Award, Nov. 24, 2010, at paragraphs 4-5. Available at: http://ita.law.uvic.ca/documents/NationsResourcesVPanama_Award.pdf
14 Ibid, at paragraphs 66-71.
15 IMF, "Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework," February 14, 2011, at 73. Available at: http://www.imf.org/external/np/pp/eng/2011/021411a.pdf. The IMF explains the measures in the following manner:

- "The first set of comprehensive measures, in November 2009, introduced stronger foreign currency liquidity standards to reduce the maturity mismatch of banks' foreign currency assets and liabilities and to improve the quality of their liquid assets, and imposed a 125 percent cap (relative to underlying export revenues) on forward foreign exchange contracts between banks and exporters. Banks were also directed to reduce their wholesale won (KRW) funding through a 100 percent loan-to-deposit ratio over time. Banks would therefore in the future not be able to fund their lending to households or corporates using wholesale financing and would have to rely primarily on deposits for such loans. Last, tougher capital requirements were imposed on financial bank holding companies to absorb potential losses.
- In June 2010, measures were taken zeroing in on short-term external bank debt. The authorities introduced ceilings on foreign derivatives positions of banks as a ratio to their capital, to reduce the short-term external debt that resulted from banks' provision of forward contracts to corporates. The objective was to reduce the leverage of banks through this channel and to guard against the abrupt withdrawal of capital, especially by foreign bank branches. In addition, the 2009 measures were further strengthened. New measures were introduced to limit foreign currency bank loans to prevent excessive foreign currency leverage in the corporate sector. Financial institutions were also required to further

reduce their foreign exchange asset/liability maturity mismatches. Finally, the ratio of forward contracts to underlying export revenues was further reduced to 100 percent.

- In late 2010, the authorities announced plans to introduce macroprudential stability levy, in the second half of 2011, on (initially banks') non-deposit foreign exchange liabilities. Under current plans, the charges would range between 5 and 20 basis points, with higher charges applying to shorter term non-core liabilities. Once the legislation is implemented, these charges can be adjusted to reflect market conditions.
- In January 2011, the authorities re-introduced a withholding tax on foreign purchases of treasury and monetary stabilization bonds, bringing it back in line with the tax on resident purchases of bonds. Foreign corporations and nonresidents will be subject to the withholding tax, but those who are based in countries which have double taxation treaties with Korea and official investors will be exempt from it."

16 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

17 An English language description of the policy is available here: http://english.mosf.go.kr/pre/view.do?bcd=N0001&seq=2200&bPage=11. The section goes on: "The new restriction will be implemented in a flexible way. First, the ceilings will be adjusted on a quarterly basis depending on the future economic conditions, market situation, and the impact on the business activities, etc. Second, the measures will come into effect with a three-month grace period considering the burden of banks to decrease FX derivatives positions at once. Furthermore, the principle of 'grandfathering' will be considered: For example, in case the existing FX derivatives position is more than the positions of the New Ceilings, the banks can maintain their existing positions of FX derivatives for maximum two years."

18 This article states that "Where it is recognized as necessary for maintaining stability in the foreign exchange market and soundness of foreign exchange agencies, etc., the Minister of Strategy and Finance may impose necessary restrictions on the raising and operation of foreign currency, such as determining the asset-liability ratio of foreign currency of foreign exchange agencies, etc. In such cases, detailed standards for such restrictions shall be prescribed by Presidential Decree."

19 English translations here: http://www.fsc.go.kr/eng/lr/list3.jsp?selection=a37@a.a&bbsid=BBS0085

20 "Article 27 (Scope of Operations)
(1) Financial institutions may be engaged in all operations in the banking business (hereinafter referred to as "banking operations") within the scope of this Act and other related Acts.
(2) The scope of banking operations referred to in paragraph (1) shall be determined by Presidential Decree.
Article 28 (Authorization for Concurrent Business)
(1) Where any financial institution intends to directly run a business which is not a banking business, but prescribed by Presidential Decree, it shall obtain authorization therefor from the Financial Services Commission. In such cases, the provisons of Article 8 (2) and (3) shall apply mutatis mutandis to such authorization.
(2) Where engaged in the business listed in paragraph (1), the financial institution shall separate the relevant business from banking operations and maintain separate books and recorded documents."

21 USTR alleges the following market access violation: "China appears to impose market access restrictions and requirements on service suppliers of other Members seeking to supply electronic payment services in China. It appears that China UnionPay ('CUP'), a Chinese entity, is the only entity that China permits to supply electronic payment services for payment card transactions denominated and paid in renminbi ('RMB') in China. Service suppliers of other Members can only supply these services for payment card transactions paid in foreign currency." But, as USTR knows, there is no such GATS sector as "electronic payment services for payment card transactions denominated and paid in renminbi ('RMB') in China." There is only "All payment and money transmission services." So, USTR doesn't allege that China has a monopoly for "All payment and money transmission services," just those "denominated and paid in RMB in China." See http://www.ustr.gov/webfm_send/2287 and http://www.ustr.gov/about-us/press-office/press-releases/2010/september/united-states-files-two-wto-cases-against-china

22 This provision reads:
"ARTICLE 13.9: NON-CONFORMING MEASURES
1. **Articles 13.2 through 13.5 and Article 13.8 do not apply to**:
(a) any existing non-conforming measure that is maintained by a Party at
(i) the central level of government, as set out by that Party in Section A of its Schedule to Annex III,
(ii) a regional level of government, as set out by that Party in Section A of its Schedule to Annex III, or
(iii) a local level of government;
(b) the continuation or prompt renewal of any non-conforming measure referred to in subparagraph (a); or
(c) an amendment to any non-conforming measure referred to in subparagraph (a) to the extent that the amendment does not decrease the conformity of the measure, as it existed immediately before the amendment, with Article 13.2, 13.3, 13.4, or 13.8.4
2. Articles 13.2 through 13.5 and Article 13.8 do not apply to any measure that a Party adopts or maintains with respect to sectors, subsectors, or activities, as set out by that Party in Section B of its Schedule to Annex III.

3. A non-conforming measure set out in an entry in a Party's Schedule to Annex I or II as not subject to Article 11.3 (National Treatment), 11.4 (Most-Favored-Nation Treatment), 12.2 (National Treatment), or 12.3 (Most-Favored-Nation Treatment), shall be treated as a non-conforming measure not subject to Article 13.2 or 13.3, as the case may be, to the extent that the measure, sector, subsector, or activity set out in the entry is covered by this Chapter."

23 Todd Tucker and Lori Wallach, "No Meaningful Safeguards for Prudential Measures in World Trade Organization's Financial Service Deregulation Agreements," Public Citizen Report, September 2009. Available at: http://www.citizen.org/documents/PrudentialMeasuresReportFINAL.pdf. See also Todd Tucker and Jayati Ghosh, "WTO Conflict with Financial Reregulation," *Economic and Political Weekly,* vol xlvi no 51, Dec. 17, 2011. Available at: http://indiaenvironmentportal.org.in/files/file/WTO.pdf.

24 See our analysis at http://citizen.typepad.com/eyesontrade/2011/04/reflections-on-meaning-of-prudential-language-in-the-wto.html

25 See International Centre for Settlement of Investment Disputes, Additional Facility, Fireman's Fund Insurance Company (Claimant) and The United Mexican States (Respondent), Award Before the Arbitral Tribunal constituted under Chapter Eleven of the North American Free Trade Agreement (NAFTA), ICSID Case No. ARB(AF)/02/01, July 17, 2006, at 59, 73-77, 95, and 103. Available at: http://www.naftaclaims.com/Disputes/Mexico/Fireman/FiremansFund-Mexico-Final_Award.pdf

26 See IMF, "IMF Completes First Review Under Stand-By Arrangement with Iceland, Extends Arrangement, and Approves US$167.5 Million Disbursement," Press Release No. 09/375, October 28, 2009. Available at: http://www.imf.org/external/np/sec/pr/2009/pr09375.htm.

27 See U.S. Treasury Department Fact Sheet, "Agreement on US-Singapore Free Transfers." Available at: *http://www.treasury.gov/press-center/press-releases/Documents/kd37661.doc*

28 Letter from U.S. Treasury Secretary Timothy Geithner to Dr. Ricardo Hausmann and other economists, April 12, 2011.

29 See Gallagher, forthcoming.

30 See conversation at: "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. Similar conclusions were drawn between the GATS Article XI and the prudential defense provision in: 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; and "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 254; and 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.

31 Article 13.10.4 appears to impose a whole new positive obligation, which is to ensure that even measures otherwise consistent with Chapter 13 must still be deemed "*necessary* to secure compliance with laws or regulations" and "not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on investment in financial institutions or cross-border trade in financial services." This wide-ranging provision has gotten little attention from policymakers. It appears to, with respect to financial services measures, create a wide ranging test against which all financial services measures – including those non-violative of capital controls or market access provisions – would have to be examined. This should be a subject for further research.

32 Appellate Body Report, United States - Import Prohibition Of Certain Shrimp And Shrimp Products, WT/DS58/AB/R, Oct. 12, 1998, at paras 135-141.