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Abstract

Capital controls and exchange restrictions are used to restrict international capital flows during economic crises. This paper looks at the legal implications of these restrictions and explores the current international regulatory framework applicable to international capital movements and current payments. It shows how international capital flows suffer from the lack of a comprehensive and coherent regulatory framework that would harmonize the patchwork of multilateral, regional, and bilateral treaties that currently regulate this issue. These treaties include the Articles of Agreement of the International Monetary Fund (IMF Articles), the General Agreement on Trade in Services (GATS), free-trade agreements, the European Union treaty, bilateral investment treaties, and the Organization for Economic Co-operation and Development (OECD) Code of Liberalization of Capital Movements (OECD Code of Capital Movement). Each of these instruments regulate differently capital movements with little coordination with other areas of law. This situation sometimes leads to regulatory overlaps and conflict between different sources of law. Given the strong links between capital movements and trade in services, this paper pays particular attention to the rules of the GATS on capital flows and discusses the policy space available in the GATS for restricting capital flows in times of crisis.

**JEL Classification:** O16; O53; R11
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1. INTRODUCTION

International flows of capital have increased over the years, driven by the reduction in regulatory barriers. In parallel to the benefits of capital flows\(^1\), the need has emerged to curb the negative effects that are sometimes associated with an open capital account. The imposition of various forms of restrictions on the free flow of capital is a common measure adopted to stabilize an economy in time of crisis.\(^2\) For instance, during the 1997 crisis that hit Southeast Asia, the governments of Thailand and Malaysia adopted currency and capital controls to restrict the inflow and outflow of capital and reduce the negative effects associated with them. Similar measures have also been adopted in Latin America and other parts of the world. The necessity for these types of interventions, their modalities, and also the various roles of capital movements in the economy have been subject to extensive analysis and debate in the economic literature for over 50 years.

There is, however, a relatively small amount of literature that examines the legal implications of capital controls and the international regulatory regime applicable to capital flows. Given their multidimensional aspects (which touch upon trade, investment, and financial and monetary policy), capital flows are subject to the provisions of various legal instruments that differ widely in their scope of application, measures targeted, and remedies available. In some cases these instruments end up conflicting with each other, thereby creating uncertainty as to the legality of the measure at stake. As a consequence of the regulatory fragmentation and the lack of a clear discipline, a timid discussion on the necessity of the creation of a uniform and coherent international legal regime for capital movements has only recently begun to emerge, promoted by the International Monetary Fund (IMF).

This paper addresses some of the main legal issues associated with capital controls and provides a brief overview of the various legal regimes regulating capital flows. Given the strong relationship between movement of capital and trade in services, the role of the GATS in regulating capital movements and current payments will be analyzed in particular. The research is not limited to regulations affecting the movement of capital as such, intended only as international capital account transactions and related payments. Rather, the investigation takes a broader perspective and focuses on the rules affecting the flow of capital, which also comprises payments and transfers for current international transactions. The reason for this is that, while capital movements are only touched by measures that affect capital account transactions, capital flows are also affected by exchange measures that have an impact on the free flow of currency as a means of payment for both current account and capital account transactions. Furthermore, most of the legal instruments examined provide a regulatory structure that takes into account both kinds of movements.

The paper has three main parts. The first part provides a general overview of the main regulatory issues associated with capital flows and the role of the IMF in disciplining capital movements and current payments and transfers. The second part of the paper explores the economic relationship between capital movement and trade in services, and analyzes the applicable legal provisions in the GATS, as well as the policy space offered by the GATS for

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\(^1\) This paper will differentiate between “capital movements” and “capital flows”. While the term “capital movements” will describe capital account transaction, the term “capital flow” will be used to describe both the movement of capitals and international payments for current account transactions considered together.

\(^2\) The extensive literature on capital flows and capital controls identifies numerous examples. For a recent survey of country experiences in Asia see Kaway and Lamberte (2010). For a general overview see Johnson and Tamirisa (1998), Schulze (2000), and Edwards (2000).
restricting capital flows. The third part looks at the regulation of capital movements in preferential trade agreements, international investment treaties, as well as in the OECD Code of Liberalization of Capital Movements.

2. REGULATING CAPITAL FLOWS

In international law, the flow of capital and foreign currency is essentially regulated by five sets of instruments, each setting out slightly different rules, crafted on the underlying economic or legal perspectives specific to each treaty. The Articles of Agreement of the International Monetary Fund have the fundamental aim of ensuring financial and monetary stability and prescribe stringent rules on payment and transfers for international current account transactions, while leaving room for discretion on capital account transactions. Multilateral and preferential agreements on services, such as the GATS and various free-trade agreements (FTAs), regulate current account payment and transfers as well as capital account movements to the extent that they are incidental to the freedom of trade in services. International investment agreements or bilateral investment treaties (BITs) look at capital flows as one of the collateral conditions necessary for ensuring freedom of investment. Capital movements are also indirectly affected by international financial regulations, on capital adequacy. Lastly, capital flows are regulated by regional treaties, such as the European Union treaty, which require freedom of movement of capital as one of the “four freedoms” of the single market, or by wider regional agreements such as the OECD Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations, which adopt the most comprehensive rules on international capital flows.

If we consider capital flows as comprising both capital account transactions (and related payments and transfers) as well as payments and transfers for current account transactions, the regulations affecting their movement can be divided between (i) regulations targeting capital account transactions and their payments and transfers, (ii) regulations targeting payments and transfers for current account transactions, and (iii) general prudential regulations for international financial institutions. From a regulatory point of view, the most important distinction is between measures that affect capital account transactions, which are generally tolerated, and measures that restrict current account transactions, which are generally prohibited. While both measures affect capital flows, their legal regimes are invariably different across all the legal instruments regulating capital flows. In this respect, the IMF articles are the primary regulatory reference on both capital account and current account transactions, as other international instruments usually refer to their regulatory regime.
Box 1: Defining Capital Movements

In international law there is no comprehensive definition of “capital movements.” Indeed, neither the IMF articles nor the GATS or even international investment law provide a clear cut description of capital movements. The Organization for Economic Co-operation and Development Code of Liberalization of Capital Movements, which is the only legal instrument specifically regulating capital account transactions and related payments, does not define capital movements either. Rather, it provides a description of all the capital account transactions that members must liberalize in order to achieve full capital account liberalization.

In international law the only reference on the meaning of capital movement is given indirectly by Article XXX(d) of the IMF Agreement that instead provides a definition of “payments for current transaction”. These are payments which are not for the purpose of transferring capital, and includes, without limitation:

1. All payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities;
2. Payments due as interest on loans and as net income from other investments;
3. Payments of moderate amount for amortization of loans or for depreciation of direct investments; and
4. Moderate remittances for family living expenses.

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

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

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\(^a\) Articles of the Agreement of the International Monetary Fund, Article XXX(d).
\(^b\) IMF. 2010. The Fund’s Role Regarding Cross-Border Capital Flows. Washington, DC.

Source: Author

2.1 The Movement of Capitals in the International Monetary Fund Articles

Capital can flow among countries as an asset in a capital account transaction. In order to enable capital transactions, it is necessary that the country open its capital account, which in broad terms requires the easing of restrictions on international purchases, and sales of real and financial assets recorded in the capital account of the balance of payments. The assets that can be traded in the capital account are usually differentiated between portfolio and foreign direct investment (FDI). In this respect, FDI encompasses the acquisition of real estate and production
facilities and substantial equity investment in domestic companies, while portfolio investment involves the purchase of financial assets, such as stocks, bonds, foreign currency, derivatives, and bank loans (Neely 1999). The opening of the capital account is not an all-or-nothing issue; it can be gradual and, depending on the kind of assets traded, it requires different measures.\(^3\) Usually FDIs are the first assets to be liberalized, as they are usually less volatile and do not pose much of a macroeconomic problem. Portfolio transactions are considered more volatile and pose a number of problems from a macroeconomic perspective. When a country liberalizes both FDI and portfolio flows, it has adopted “capital account convertibility,” which can be defined as the freedom to convert at the market rate domestic financial assets into foreign financial asset and vice versa, and broadly it entails the possibility for foreigners and nationals to convert currency for operations affecting the capital account (such as FDIs and portfolio operations), as well as for current payments (Reserve Bank of India 1997).

As mentioned, the distinction between capital account transactions (movement of capitals) and related payments and current account transactions is at the core of the analysis. In this respect, both the IMF articles as well as other international treaties that refer to the IMF rules simply differentiate between capital account transactions and current account transactions.

In the preamble to Article IV of the IMF articles, it is clarified for the first time that movement of capital is also an element of the international monetary system, and that stability of movement requires the IMF to oversee members’ policies that affect such stability. Given this, it would be logical to look at the IMF as the primary regulator of the international movement of capital. Despite the overall competence of the IMF with regard to the international monetary system, it does not control the movement of capital; each member still largely regulates movement independently.

The main provision on capital movements in the IMF Articles is contained in Article VI, Section 3, which stipulates that members may exercise controls that

> “..are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2 (IMF).

Thus, as far the IMF’s jurisdiction is concerned, this provision structures a regulatory dichotomy between current account measures, which are generally strictly regulated by the IMF, and capital account measures, which are generally regulated by the member states.

According to the rules of the IMF, members generally retain the exclusive right to regulate both inward and outward capital movements and decide whether such regulation is necessary. Despite their comprehensive autonomy in regulating capital movements, IMF members are bound by a few provisions of the IMF treaty that ensure the IMF has some influence over capital controls. In this respect, the IMF has the power to intervene and to provide guidance to members on the adoption of measures that affect the capital account in three distinct areas.

First, a member cannot use IMF resources to meet a large or sustained outflow of capital\(^4\) The reason to this is that the IMF’s resources are primarily directed at correcting current account

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\(^3\) For example, it is possible to attract FDI without excessive opening of the capital account, such as through transfer of funds provisions (Williamson and Drabek 1999)

\(^4\) Article VI, Section 1 provides as follows:
deficits, which falls within its mandate. Such financing will allow the elimination of current account restrictions. The jurisprudence of the IMF has never clarified the precise meaning of “large or sustained outflow,” either from a conceptual or temporal point of view. Nevertheless, the practice of the IMF has been to determine the concept of large or sustained outflow with regard to the overall mandate of the IMF in providing financial assistance, and, therefore, looking at the underlying reasons that led to the outflow. In this respect, if such outflow of capital was due to problems in fiscal or exchange policy, which are in the mandate of the IMF, it would primarily look at whether the use of IMF resources would resolve the underlying fiscal or monetary difficulties (IMF 2010).

Another issue is whether the IMF can request that a member either imposes capital controls or eliminates capital controls as a condition for the use IMF resources. The nexus between capital controls and IMF conditionality is provided by Article V, Section 3, which provides that the IMF shall adopt policies regarding the use of its resources that will (i) help members to solve their balance-of-payment difficulties in a manner consistent with the provisions of the IMF articles, and (ii) establish adequate safeguards for the temporary use of IMF general resources. According to this provision, the IMF is entitled to require the member to adopt capital controls as a condition to access resources. This is also confirmed in the above-mentioned Article VI, Section 1(a) that allows the IMF to require a member to adopt capital controls in order to prevent a large or sustained capital outflow as a preliminary condition before being allowed to apply for the resources of the IMF (provided that such controls result in effective limiting of the outflow). If the member does not adopt capital controls as requested by the IMF, it will be not allowed to access IMF resources. Conversely, the lack of jurisdiction of the IMF in capital account transactions is generally intended to prevent it from requesting a member to remove capital controls as a condition of access to IMF resources. However, one exception to this practice does not allow members using IMF resources to apply capital controls in a manner that will give rise to external payment arrears (IMF 2010c).

Lastly, Article IV, Section 1 of the IMF articles provides the general obligations on members to “avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members” (IMF). Despite its wide coverage, Article IV has been considered to be advisory in nature and not directly enforceable. According to the jurisprudence, the breach of a member of one of the provisions of Section 1 will be considered only as a breach of the general obligation to collaborate, and will not give rise to any specific action. If a member violates one of the provisions, the IMF will be allowed to recommend that the member take or refrain from taking additional actions, as it deems appropriate. Nevertheless, the intention is that Section 1(iii) also covers movement of capital. In particular, the intention is that the unclear “manipulating exchange rate or the international monetary system” includes excessive intervention in the

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

5 The IMF has included in its economic programs during economic crises controls on capital outflows where large outflows have threatened to overwhelm emergency financing (including under IMF arrangements) and deplete international reserves. Examples include Argentina in 2002 and Iceland in 2008 (IMF 2010c).
exchange rate markets or the imposition of capital controls. For this reason, capital controls deemed to be used as a way of preventing balance of payment adjustments or gaining an unfair competitive advantage over other members would be likely to trigger the soft intervention of the IMF.\(^6\)

2.2 International Current Payments and Transfers in the International Monetary Fund Articles

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

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

In this respect, the limited competence of the IMF with regard to capital account transactions stands in contrast with the parallel full competence on current account transactions. Indeed, Article VIII, Section 2(a) imposes that members refrain from imposing restrictions on the making of payments and transfers for current international transactions. As we saw before (Box 1), the definition of “payments and transfers for current international transaction” provided by Article XXX(d) is broader than the definition used by economists or balance of payment statisticians. This means that the jurisdiction of the IMF (and all other treaties that make reference to the IMF rules) on current account transactions also encompasses certain capital movements.

Article VIII:2 of the IMF articles forbids exchange restrictions on current account payments. This provision imposes two obligations on IMF members. First, a member must not limit or impede any of its residents from obtaining the foreign currency necessary for making payments to nonresidents in settlement of the underlying current transactions. Second, members must permit nonresidents that have acquired balances of the country’s currency by engaging in international current transactions with members to transfer that currency or convert it to a freely usable currency and transfer it abroad, as long as this does not represent a capital movement. Article VIII, Section 2(b) provides that exchange contracts involving the currency of any other member and which are contrary to the exchange control regulations of that member that are maintained or imposed consistently with the IMF articles shall be unenforceable in the territories of that member. The previous consensus was that capital restrictions in the form of exchange controls that affect current account payments would be considered as falling within the ambit of application of this provision, and therefore be unenforceable. Nevertheless, the German national court called to interpret this provision has held that the lack of competence of the IMF on capital transactions renders this provision applicable only to contracts involving exchange control restrictions on current transactions (Helizalde 2004).

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\(^6\) For an overview of the jurisprudence on Article IV, see IMF (2006).
Article VIII, Section 3 prohibits members from engaging in discriminatory currency arrangements or multicurrency practices that occur when different groups of foreign exchange transactions are conducted at different exchange rates, resulting in a spread of more than 2% between buying and selling rates for spot exchange transactions.\footnote{IMF Decision No. 6790-(81/43) of 20 March 1981 defines multicurrency practices as action by a member or its fiscal agencies that of itself gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions between the member's currency and any other member's currency would be considered a multiple currency practice and would require the prior approval of the Fund (IMF Executive Board Decision No. 6790-(81/43) of March 20, 1981)} According to the jurisprudence of Article VIII, the prohibition applies only to multicurrency practices that relate only to current account transactions, and the IMF has clarified that multicurrency arrangements that apply to capital transactions can be adopted by members whenever they may be reasonably needed.

Despite the overall competence of the IMF on current account measures, members are allowed to impose restrictions on current payments and transfers when (i) they have been temporarily approved by the executive board for balance of payments reasons, or (ii) their maintenance is authorized under the transitional provisions under Article XIV of the IMF articles. The balance of payment clause acts as a safety valve in case of serious economic crisis and, with the exception of United States (US) FTAs and BITs, it is replicated in almost all of the international legal instruments that regulate capital flows.

3. MOVEMENT OF CAPITAL AND TRADE IN SERVICES

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

Trade in services always involves international payments and transfers associated with underlying international current account transactions. However, services trade does not always give rise to capital movements. Broadly speaking, a service transaction involves the international supply of a service by a domestic service provider to a consumer abroad, or the access of domestic consumers to a service provided by a foreign supplier. Such transactions are to be recorded in the current account and give rise to payments of service fees, charges, and commissions. On the other hand, capital account transactions do not necessarily involve the provision of a service but they simply imply the creation, transfer of ownership, or liquidation of capital assets and the payment and transfer associated with such transaction (Key 2003). Among various kinds of capital assets that could form a capital transaction, financial assets are those closely associated with a provision of a service. In this respect, both the use of foreign capital by domestic consumers and the use of domestic capital by nonresidents imply the access to a banking service, which also results in payment of a service fee (Lehmann, Tamirisa, and Wieczorek 2003).
Box 2: Dissecting Capital Movements from Services Trade

Kono and Schuknecht (1999) provide a clear example of the difference between a supply of a service that entails capital flow and a pure service transaction without capital movement. In the example there are six situations that can apply:

1) A lending transaction in local currency between a domestic financial service provider and a domestic customer. In this case there is neither trade in services nor capital movement.

2) A lending transaction in foreign currency between a domestic financial service provider and a domestic customer. In this case there is movement of capital but no trade in services.

3) A lending transaction in local currency between a domestic financial service provider and a foreign customer consuming abroad. In this case there is no movement of capital but there is trade in services.

4) A cross-border lending transaction in foreign currency between a financial service provider in country A and a customer in country B. In this case there is trade in services (mode 1) and capital movement.

5) A lending transaction in domestic currency between a foreign financial service provider in country B (mode 3) and a domestic customer. In this case there is trade in services but no capital movement, as the lending transaction uses domestic currency.

6) A lending transaction in foreign currency between a foreign financial services provider in country B (mode 3) and a domestic customer. In this case there is movement of capital and trade in services.

From these examples it is clear that there is pure trade in services in situations 3 and 5, pure capital movement in situation 2, and trade in service and capital movement in situations 4 and 6.


The direction and the kind of capital moved depend highly on the typology of the service and its mode of supply. In this respect, the establishment of the commercial presence (mode 3) of a foreign service supplier requires the movement of capital necessary to acquire an existing firm or to purchase land and any other assets necessary to set up the operation of the company. Indeed, if a country commits to allowing foreign service suppliers to acquire 100% equity in a domestic bank, or to establish a de novo subsidiary, it essentially allows an inflow of capital to perform the operation. If a country wishes to block any inflow of capital, it must also block any FDI in the services sector. Even after that phase, there is a high possibility that the day-to-day operations of the subsidiary would involve a movement of capital. This will happen if the activities of the subsidiary imply transactions in foreign financial assets with host-country residents. Similarly, the creation of branches and their day-to-day activities almost invariably involve capital movements necessary to perform the initial investment and to conduct portfolio transactions with the head office (Key 2003). It is important to note that, for what concerns the GATS, the movement of capital related to the establishment of a commercial presence is only inward (Kono and Schuknecht 1999). This means that, unlike BITs or FTAs, the GATS does not control or regulate the outward movement of capital resulting from the operations of the foreign-invested company, such as repatriation of profits or transfer of funds. Furthermore, once a foreign service supplier is incorporated in the host country it is generally considered a domestic company and therefore subject to the domestic laws on capital movement. Therefore, despite the fact that the operations of the company involve international movement of capital, a member can impose restrictions on the outflow of capital involving (also) a foreign service supplier.
without violating any GATS rule, as long as it does not negatively discriminate between foreign and domestic companies.

Another mode of supply that gives rise to substantial capital movement is mode 1. The cross-border supply of a service, when it entails movement of capital, can give rise to both inward and outward capital flows. The cross-border movement of capital is typical of financial services. One example could be a domestic bank making loans to or accepting deposits from nonresident customers. Similarly, in the securities sector most international portfolio transactions are associated with securities trading or asset management services provided by a host bank to a nonresident investor. Capital movements could be theoretically covered by mode 2, when a consumer moves to another country to enjoy a service, bringing their own money to pay for the service. Nonetheless the footnote to Article XVI limits the coverage of capital movements only to mode-1 and mode-3.

3.1 Regulating Capital Flows in the GATS

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

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

From the provisions of Articles XI and XII, it is possible to argue that, even in the GATS (and similar to the IMF), the dichotomy between capital account transactions and current account transactions exists, with current account transactions being heavily controlled and subject to the regulations of the IMF, and capital account transactions being substantially liberalized and subject only to balance of payments or prudential restrictions, as stipulated in the GATS.

Article XI of the GATS stipulates the following:

“1. Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments. (emphasis added)

2. Nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund” (emphasis added) (WTO)

3.1.1 Capital Movements

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

The most important provision, and the only one that directly regulates movement of capital, is a footnote to the market access provision of GATS Article XVI:1, which stipulates that

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

A footnote to this provision provides:

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

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

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

One issue to be clarified is whether the GATS imposes a general prohibition on any restrictions on the movement of capital associated with the services scheduled, or whether the prohibition is limited only to the situations mentioned in the footnote to Article XVI, which restrict the ambit of application to restrictions on capital inflow for sectors scheduled in mode 1 and 3, and for restrictions on capital outflow for sectors scheduled in mode 1. Take for example the case of a domestic consumer located in country A who travels to country B to open a bank account in a local bank, bringing with them a sum of money to deposit in the new account. This is a classical example of mode 2, where a consumer moves to another territory to enjoy a service supplied in that territory. Restrictions on market access for mode 2 would basically consist of preventing domestic consumers from enjoying the services provided in another country. The imposition of capital controls on the outflow of currency would therefore affect the supply of financial services

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8 GATS, Footnote to Article XVI:1
through mode 2. Nonetheless, the footnote to Article XVI does not mention this situation, which fall outside the coverage of the GATS.

**Table 1:Coverage of Capital Movements in the GATS by Modes of Supply and Directions**

<table>
<thead>
<tr>
<th>Flow</th>
<th>Mode 1</th>
<th>Mode 2</th>
<th>Mode 3</th>
<th>Mode 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflow</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Outflow</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
</tbody>
</table>

Source: Author

Based on these provisions, the movement of capital allowed in the GATS is fully covered only in mode 1 and partially covered in mode 2 (only outflow) and mode 3 (only inflow). The GATS does not cover the outflow of capital related to the investment, which is heavily regulated in BITs and in some FTAs. For the sectors and modes covered by the general prohibition on capital controls, there are still three exceptions that can apply.

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

### 3.1.2 Current Payments and Exchange Restrictions

According to the letter of Article XI, current account transactions and capital account transactions are treated differently. The first paragraph of Article XI stipulates that, for all those services sectors that are committed to by a member, it is not possible to apply any restriction on international transfers and payments for the underlying current transaction. This provision, however, has two limitations. The first is set out in paragraph 2 of the same article, which carves out from the prohibition those exchange measures that are in conformity with the IMF article. The second limitation is provided in Article XII of the GATS that allows restrictions on current international transactions (and related payments) for balance of payment purposes. Despite the limited possibility for members to adopt current account restrictions provided by the GATS, it is important to remember that WTO members that are also members of the IMF are bound by the general prohibition of Article VIII of the IMF articles that imposes an obligation on the members not to adopt any current account restriction. This means that, even if a member wishes to impose a restriction on a sector not committed to in its services schedule, it would nevertheless be bound by its IMF obligations. In this respect, the reference to the IMF articles allows a limited possibility to impose restrictions on current payments and transfers for balance of payment

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9 The General Agreement on Tariffs and Trade (GATT) Article XV:9 provides for a similar exception.
reasons, provided that they have been temporarily approved of by the executive board, or their maintenance is authorized by Article XIV of the IMF articles (IMF 2010b).

Paragraph 2 of Article XI contains a general provision that ensures the prevalence of IMF rights over GATS obligations. Among the rights of IMF members under the articles of the agreement is the use of exchange actions. Deborah Siegel, once IMF general counsel, considers such obligation to include “the requirement to refrain from imposing exchange restrictions on payments and transfers for current international transactions, multiple currency practices, and discriminatory currency arrangements unless approved by the Fund or maintained under Article XIV” (Siegel 2002). One important note is that exchange restrictions that impose a direct limitation on the availability of foreign currency or on their use and transfer and could cover both current and capital account transactions (as well as the underlying payment). While exchange restrictions affecting current account transactions are generally prohibited under the IMF articles and therefore are also not allowed by the GATS, the same does not apply to exchange restrictions on capital account transactions. Indeed, restrictions on international payments and transfers apply only to the underlying services transactions that have been liberalized by the members in their schedules of commitments.

3.2 Policy Space for Capital Controls

Capital and exchange controls represent a deviation from the freedom of capital movement based on financial or macroeconomic considerations. Indeed, from the experience of various countries in recent years, it seems that the reason for the adoption of capital controls was almost entirely protection of the stability of the financial system. Provided that this is the main reason, then the question to ask is, does the GATS offer any latitude for members to deviate from their commitments and block movements of capital? Before explaining the issue, it is important once again to stress one important point: while capital account transactions enjoy a high degree of flexibility, this is not the same for controls on current account payments and transfers, which are generally prohibited and whose legitimacy at the WTO can only derive from approval by the IMF or by the balance of payments provision of Article XII.

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

Table 2: Brief Summary of The Coverage and Treatment of Capital Flow in the GATS

<table>
<thead>
<tr>
<th></th>
<th>Capital Movement (and Capital Payments and Transfers)</th>
<th>Current Payments and Transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage</td>
<td>Only mode 1, and 3, and only services scheduled in those modes</td>
<td>All services scheduled</td>
</tr>
<tr>
<td>Balance of Payments</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Prudential Carve-Out</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Request by the IMF</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

IMF = International Monetary Fund
Source: Author

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3.2.1 The Balance of Payment Derogation

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

"1. In the event of serious balance of payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, inter alia, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

2. The restrictions referred to in paragraph 1:
(a) Shall not discriminate among Members;
(b) Shall be consistent with the Articles of Agreement of the International Monetary Fund;
(c) Shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;
(d) Shall not exceed those necessary to deal with the circumstances described in paragraph 1;
(e) Shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves" (GATS, Article XII:1-2).

This provision allows members to deviate from their commitments in both capital movement and current account transactions in the event of both current serious balance of payments or external financial difficulties and in the case of a threat of a crisis. Particular consideration is then given to developing countries, which are considered more prone to monetary instability associated with opening of the capital account. To invoke Article XII, members must demonstrate that the measure (i) does not discriminate against members, (ii) is consistent with IMF articles (which restrict the policy space only on capital account restrictions allowed by the IMF) and current account restrictions approved by the IMF,¹⁰ (iii) does not cause unnecessary damage to other members, (iv) shall not be unnecessary in respect to the conditions set out above, and (v) shall be only temporary.

One of the major issues is whether the balance of payment provision can be applied only to restrict capital outflow. This issue was a matter of debate between the IMF and OECD in the 1990s. During discussions for the OECD Multilateral Agreement on Investment, the IMF expressed the view that only capital controls on outflows could cause serious balance of payment difficulties or depletion of monetary reserves; the OECD argued that inflows could also cause macroeconomic disturbances (Auboin 2010). The different view is of outmost importance from a practical perspective. Indeed, if the IMF view was accepted, the balance of payment derogation would be essentially limited to measures targeting capital outflow, which are covered only by mode 1 commitments. Clearly, derogations affecting payments and transfers for services transactions would remain fully covered as they entail an outflow of currency. Nevertheless, this issue is still to be tested by the jurisprudence, as Article XII has never been invoked in practice.

¹⁰One example is the current and capital account restrictions approved by the IMF on Iceland during the financial crisis of 2008. In order to be approved, Iceland had to comply with the recommendations of the IMF.
3.2.2 The Prudential Carve-Out

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

Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement (WTO, Annex A. GATS, Annex on Financial Services, Article 2).

In this respect, any domestic measure that might be inconsistent with Articles XVI or VI of the GATS, as in the case of financial safety measures, can nevertheless be justified on prudential grounds once it is proven that it has been adopted to accomplish prudential objectives. Briefly, this clause operates as an escape clause that derogates from the general obligation to the GATS, based on the prevalence of macroeconomic stability against the positive effects of trade liberalization.

Based on the prudential carve-out, members could impose restrictions on capital flows in order to maintain or restore the stability of the financial system. The definition of prudential reasons, which is the subject of an infinite academic debate, would define the perimeter of legitimacy of the measure. As yet there has not been any dispute that clarifies the actual ambit of the provisions or which kind of measures are considered to be of a prudential nature. A possible interpretation of this provision would limit the possible measures to those that are strictly linked to the stability of the banking system, leaving aside other macroeconomic or balance of payment considerations, which would be covered by Article XII. Based on this interpretation, the regulatory space offered by Article 2 is somehow different from that of Article XII. Indeed, while capital controls adopted for balance of payment reasons are essentially covered by the balance of payment derogation, the prudential carve-out is limited to issues of financial stability, and for this reason it is more suited to the adoption of controls on short-term capital flows or on risky financial products.

4. A PREFERENTIAL AGENDA FOR CAPITAL FLOWS

The internal resistance of countries to relinquish control of their capital account policies constituted an insurmountable difficulty for the process of international financial and monetary rule making on capital flows. The IMF, which in the mid-1990s pushed for more stringent regulations on capital movement, failed to convince countries to give up their sovereignty on capital account policies. Similarly, in Geneva during the Uruguay round negotiations on services and financial services, capital flows were left out of the WTO agenda. Nonetheless, countries progressively engaged in preferential arrangements in which capital controls were part of the regulatory undertaking. Indeed, at the preferential level, capital flows are regulated by three sets of agreements, each tackling capital movement from a specific angle.
Given the complexity of the task and the differences in policy space with regard to restriction of capital flows among the various agreements, a comprehensive analysis of capital flow regulations in preferential trade and investment agreements would take a chapter itself. Nonetheless, it is important to briefly introduce some considerations that offer the basis for future research.

4.1 Free-Trade Agreements

FTAs often cover capital flows, either as a stand-alone chapter, as in the case of European Union (EU) agreements, or in the framework of services and investment chapters. One common treatment is in the services dimension of EU and US FTAs that offer a GATS-like approach. In these FTAs countries are required to liberalize the capital movements associated with services commitments. In addition to this (and similar to the GATS), countries are required to liberalize the payments and transfers associated with the transactions based on the requirements of IMF Article VIII. Apart from these similarities, among various FTAs there are differences in the level of opening to capital flows and on the potential use of safeguards. Indeed, while EU, Canadian, and Japanese FTAs provide balance of payment safeguards or regulatory carve-outs on host-country capital account legislations, US FTAs (with the notable exception of the North American Free Trade Agreement (NAFTA) are more prone towards full liberalization of capital movements and usually do not provide for balance of payment exceptions or other safeguards against possible negative effects of capital flows.11

4.2 International Investment Agreements

International investment agreements, whether in the form of BITs or as stand-alone chapters in FTAs, provide for strong discipline for capital movements, albeit with a narrower focus than services agreements. While trade agreements promote the inflow of capital as an element of the services package, leaving the free outflow only to financial services in mode 1, most bilateral investment treaties leave aside the market access and/or pre-establishment aspect (although there are notable exceptions) and regulate the movement of capital from an investor perspective at the post-establishment phase. Hence, the regulatory framework offered by international investment agreements usually covers only outflow of capital.

In international investment agreements, capital movements can be regulated in two ways: first, capital can be considered as a form of investment itself, thereby enjoying the protections offered by the treaties; second, capital can be considered as one of the essential elements of an investment.

The definition of investment is one of the elements that determine the coverage of the treaty. In this respect, a common definition of investment is that it comprises not only physical assets located in the host country but also other intangible assets of particular value to the investors, such as mortgages, liens, pledges, and portfolio investment in the form of shares, stocks, debts,

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11 One notable feature is contained in the US–Chile FTA, and has been replicated in US FTAs with Colombia, Peru, and Singapore. In these agreements there is a cooling-off provision, which allows countries to violate the terms of the treaty on capital movements (albeit only those in the investment chapter) for a period of 1 year after the measure has been deployed, without the threat of being sued by the US. The cooling-off provision is somewhat limited in practice, as it does not apply to restrictions on current transfers and on payment for equity investments, bonds, or loans. In addition, after 1 year the violating party would have to respond in an international tribunal. The aim of this provision was to provide countries with some policy space during times of economic crisis by allowing them to violate the terms of the treaty without the pressure of an incumbent dispute.
or interests in the property of local companies.provided that the treaty also covers financial assets, the question is how portfolio investment is regulated. In this respect, international investment agreements provide a number of clauses that aim at ensuring that investors are protected against the powers of the host state. Among the most important clauses that have an effect are (i) the most-favored nation clause; (ii) the nondiscrimination clause; (iii) the fair and equitable treatment clause; (iv) the expropriation clause; (v) the so-called “free transfer of fund” provision; and (v) in some cases, the balance of payment clause. Such clauses have the goal of ensuring that foreign investors are not treated arbitrarily or in a discriminatory way by the host government and, depending on the specific provisions in the treaty, the clauses could limit the possibility of the host government adopting capital or exchange controls. For example, the decision of the host state to adopt currency exchange restrictions could be considered a form of indirect expropriation as it could substantially diminish the value of the investment (Kolo and Walde 2008)

When an international investment agreement does not cover portfolio investment, financial assets do not enjoy the protection of the treaty. Nevertheless, capital flows are still partially regulated as a collateral element of the investment. The “free transfer of fund” provision is a common feature of international investment agreements and it ensures the right of investors to repatriate their assets at all times, guarding against possible restrictions imposed by the host state. Such transfer provisions, if not matched by other safeguard measures, could substantially limit the monetary sovereignty of the countries, especially their right to control their balance of payments (on both current and capital account).

Free transfer of fund provisions differ widely among agreements. One common treatment is that they almost all apply only to the outflow of capital and only rarely cover the freedom of investors to bring in their capital (Dolzer and Schreuer 2008). A broad classification of transfer of fund provisions has been provided by Sean Hagan. It divides such clauses into three categories. The first category consists of the outward transfer of amounts derived from or associated with protected investments. The second category entails outward transfer of amounts arising from the host country’s performance of other investor protection obligations under an agreement. The third category covers inward transfer of amounts to be invested by a foreign investor, which covers those transfers that are made for purposes of making a new investment, as well as those that are made to develop or maintain an existing investment (Hagan 2000).

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

13 Free transfer of fund would usually cover (i) payments received as compensation for a host country’s expropriation of the investment, (ii) payments received as compensation for losses suffered by an investor as a result of an armed conflict or civil disturbance, (iii) payments arising from the settlement of disputes, and (iv) payments of contractual debts owed by the government of a host country to the foreign investor.
It is important to note that a corollary of free transfer of fund provisions is the obligation on the government to allow the repatriation of funds at a market-determined exchange rate. Indeed, governments usually allow the repatriation of profits at a market rate that is above the market price rate. This tendency does not fall under the IMF’s general prohibition of multicurrency practices, as Article VIII, Section 3 of the IMF articles only prescribes nondiscrimination between current transfers or capital transfers. For this reason, many BITs provide for a guarantee that the exchange rate is at the market price (Weibel 2009).

Balance of payment and state of necessity clauses are sometimes included in FTAs and in a few BITs to safeguard the stability of the financial system against some economic disequilibria. Such clauses allow derogation from the commitments for a certain period of time provided that the member adopting such measure demonstrates that movements of capital cause, or threaten to cause, serious economic or financial disturbance in the member and that the measure is adopted on a temporary and nondiscriminatory basis. In some agreements, the balance of payment safeguard is crafted to guarantee that the measure would be in conformity with IMF Articles VI and VIII.  

The EU–Republic of Korea FTA provides a set of conditions for the measure to be considered legitimate. The footnote to Article 8.4 provides that safeguard measures provided for in this Article should be applied in such a way that they:

(a) are not confiscatory;
(b) do not constitute a dual or multiple exchange rate practice;
(c) do not otherwise interfere with investors’ ability to earn a market rate of return in the territory of the Party who took safeguard measures on any restricted assets;
(d) avoid unnecessary damage to the commercial, economic or financial interests of the other Party;
(e) are temporary and phased out progressively as the situation calling for imposition of such measures improves; and
(f) are promptly published by the competent authorities responsible for foreign exchange policy (Free Trade Agreement between the European Union and the Republic of Korea, Article 8.4)

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

OECD members are parties to the Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations. Together these codes offer a regulatory platform that bind members to substantially liberalizing both types of international capital flows—from the

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14 Look, for instance, at Article 2104 of the NAFTA (North American Free Trade Agreement).
15 This clause is present in the Republic of Korea, Chile, Colombia, and Peru.
current or the capital account. The capital movements code represents the most comprehensive instrument regulating the movement of capital and it offers a complete regulatory platform for both investors and domestic operators. Unlike other instruments, the capital movements code focuses on the specific transactions to be liberalized, thereby covering capital transactions made both by nonresidents and those made by residents, as well as on the underlying payments and transfers. Furthermore, the code applies to both the inflow and outflow of capital. Despite its regulatory width, the code offers members room for various derogations from the commitments. Indeed, in addition to the exceptions scheduled by OECD members at the time of entry into force, members can derogate at any time from their commitments with regard to short-term financial transactions. In addition, the code presents two exceptions that allow members to suspend their commitments and impose controls on (i) capital outflows for balance of payments reasons, and (ii) inflows for reasons arising from “serious economic and financial disturbances.” The OECD codes in some instances overlap with provisions in other FTAs and/or BITs, giving rise to a regulatory discrepancy, such as in the case of the FTAs negotiated by the US.

5. CONCLUSION

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

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

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

This disparity results in potential overlap of norms and in regulatory uncertainty. Take, for instance the case of the Republic of Korea, which is an OECD and IMF member and has entered into FTAs with the US and with the EU. If the Republic of Korea experiences severe macroeconomic turbulence, the adoption of capital controls would be allowed under the OECD capital movement code, the IMF rules, and by the EU–Republic of Korea FTA, but it would not

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16 The only exception for the US is the NAFTA, which contains a balance of payment clause.
be allowed by the US– Republic of Korea FTA. As it is impossible to select capital controls based on the origin or destination of the capital flow, the country adopting the measure would be in a regulatory dilemma that would ultimately result in the choice between macroeconomic stability versus violation of the FTA with the US.
Table 3: Regulation and Coverage of Capital Flows in Various International Legal Instruments

<table>
<thead>
<tr>
<th>Legal Instrument</th>
<th>Capital Movements</th>
<th>Current Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Coverage</td>
<td>Measures</td>
</tr>
<tr>
<td><strong>GATS</strong></td>
<td>Inflow (mode 1–3) and outflow (mode 1)</td>
<td>Capital controls and exchange restrictions</td>
</tr>
<tr>
<td><strong>OECD</strong></td>
<td>Inflow and outflow</td>
<td>List of various operations on the capital account, covering both FDI and portfolio flows</td>
</tr>
<tr>
<td><strong>IIAs</strong></td>
<td>Mainly outflow</td>
<td>Capital controls and exchange restrictions</td>
</tr>
<tr>
<td><strong>US FTAs</strong></td>
<td>Inflow (mode 1–3) and outflow (mode 1 and 2)</td>
<td>Capital controls and exchange restrictions</td>
</tr>
<tr>
<td><strong>Other FTAs</strong></td>
<td>Inflow (mode 1–3) and outflow (mode 1 and 2)</td>
<td>Capital controls and exchange restrictions</td>
</tr>
<tr>
<td><strong>IMF</strong></td>
<td>Not Covered</td>
<td></td>
</tr>
</tbody>
</table>

Notes: FDI = foreign direct investment; FTAs = free trade agreements; IIAs = international investment agreements

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

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

Another issue is linked to the policy space for capital flow restrictions in the GATS. The recent experience in Latin America and Southeast Asia suggests that countries are often required to impose restrictions on capital flows, even though their GATS commitments would bind the liberalization of their capital accounts. Given the regulatory uncertainties on restrictions on short-term flows or exchange controls, the balance of payment provision and the prudential carve-out, which have never been tested in practice, could not offer the necessary leeway and would require a heavy burden of proof on the necessity for their use.
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