Capital Controls in International Law: Clarity Through a Central Regulatory System

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Financial crises have long been international concerns. Capital controls once were a standard policy tool that nations would employ to manage their internal economies in the face of international flows of capital.[1] For much of the recent past, developed Western countries have viewed capital control as a major impediment to global development. Conversely, some developing countries have argued that they are a critical tool for managing economies without which they would be helpless in the face of the international financial cycle. Recent crises have caused a resurgence in the debate over capital control use.[2]

The IMF has historically toed the liberalized capital market line. In 2012, however, it changed course and endorsed the limited use of capital controls as a prudential policy instrument.[3] While the IMF frequently requires the use of capital controls as a condition to extending aid to faltering countries, it had stood with the U.S. Treasury Department and the World Bank in preaching the evils of capital controls as a

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1. *See* Simon Johnson et al., *Malaysian Economic Controls: Macroeconomics and Institutions, in* CAPITAL CONTROLS AND CAPITAL FLOWS IN EMERGING ECONOMIES: POLICIES, PRACTICES AND CONSEQUENCES 529 (Sebastian Edwards, ed., 2007), *available at* http://www.nber.org/chapters/c0159.pdf.

2. For a discussion of capital control use in the Asian financial crisis, see generally Duncan E. Williams, *Policy Perspectives on the Use of Capital Controls in Emerging Market Nations: Lessons from the Asian Financial Crisis and a Look at the International Legal Regime*, 70 FORDHAM L. REV. 561 (2001). For a discussion of capital controls in light of the 2008 financial crisis, see generally Andrew Yianni & Carlos de Vera, *The Return of Capital Controls?*, 73 LAW & CONTEMP. PROBS. 357 (2010).

3. *See* Int'l Monetary Fund, *The Liberalization and Management of Capital Flows – An Institutional View*, IMF Policy Paper (Nov. 14, 2012), *available at* http://www.imf.org/external/pp/longres.aspx?id=4720.

tool of general policy.[4] Many Asian nations experienced a lost generation – a decade's worth of young workers lost to chronic unemployment – as a result of the 1998 Asian financial crisis.[5] Malaysia instituted capital controls during the crisis and weathered the downturn much better than its neighbors.[6] The lost generation experienced by nations that declined to utilize capital controls, contrasted with the success of some that, caused many in Asia and Latin America to discard negative Western views about capital controls.[7] Though capital controls are not without drawbacks, many countries could have fared better during the 2008 financial crisis had they used capital controls as a policy tool. Large foreign debts played a role in the crash of the Icelandic and Cypriot economies, though both countries were actively courting inflows of hot money with slack banking regulation.[8] Both countries have been under emergency capital controls to prevent capital outflow since the crisis.[9] Most European countries, like Spain, have no control over inflows and outflows due to their membership in the Eurozone, though controls arguably could have helped.[10]

The guiding principle in international agreements has been that capital market liberalization is the path to prosperity.[11] However, the use of capital controls is not governed under a single international legal regime. Rather,

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4. *See Capital Controls: Ebb Tide*, THE ECONOMIST, Oct. 8, 2012, *available at* http://www.economist.com/blogs/freeexchange/2012/10/capital-controls (discussing the place of capital controls in the Washington Consensus).

5. *See* Williams, *supra* note 2.

6. *Id.*

7. Nancy Birdsall & Francis Fukuyama, *The Post-Washington Consensus*, FOREIGN AFF., Mar./Apr. 2011 ("The financial crises of the late 1990s in East Asia and Latin America discredited many of the ideas associated with the so-called Washington consensus, particularly that of unalloyed reliance on foreign capital.").

8. *See* Yianni and de Vera *supra* note 2, at 368.

9. *See* Central Bank of Cyprus, The Enforcement of Restrictive Measures on Transactions in case of Emergency Law of 2013 (Aug. 29, 2014), *available at* http://www.centralbank.gov.cy/media//pdf/ENG_31_Aug_2014_decree.pdf; see also Annamaria Viterbo, *Iceland's Capital Controls and the Constraints Imposed by the EEA Agreement*, 6 CAP. MKT. L. J. 214 (2011).

10. *The Choice: A Limited Version of Federalism is a Less Miserable Solution than the Break-Up of the Euro*, THE ECONOMIST, Oct. 16, 2014, *available at* http://www.economist.com/node/21555916.

11. *See* Joseph Stiglitz, *Capital Market Liberalization and Exchange Rate Regimes: Risk without Reward*, 579 ANNALS OF AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 219, 220 (2002).

their use is governed by both monetary law and trade law.[12] Capital controls are found in the IMF in the Articles of Agreement, Bilateral Investment Treaties (BITs), Free Trade Agreements (FTAs), and GATS (General Agreement on Trade in Services).[13] Capital controls are primarily a tool of monetary policy but can implicate trade law in that restrictions on the flow of money can impede international trade. The result is a web of treaties and agreements that govern the use of capital controls, often with objectives other than economic stability.

This article will consider the arguments for and against capital controls as a prudential policy tool. It will then look at capital controls within the international legal order. This article will argue that capital controls deserve an independent legal framework. It will then propose that the IMF play a role in the international regulation of capital controls and discuss some potential roadblocks to such a system. Given the difficulty of achieving a new international regulatory system, this article will propose less ambitious changes to the current situation through changes to the U.S. Model BIT that reflect growing support for capital controls as a prudential measure.

I. THE CURRENT STATUS OF CAPITAL CONTROLS

There is no enumerated list of actions that constitute a capital control. The term is defined fairly broadly. "Capital controls are regulatory measures to smooth the amount and composition of capital flows."[14] These measures often target short-term inflows and outflows that are speculative in nature and cause asset bubbles, unstable currencies, and investor alarm.[15] The world financial system is interconnected. "International capital flows are surging into many emerging markets, driven by the *push* of sluggish economic prospects for ailing developed economies, combined with relatively loose monetary policy and low interest rates, and *pulled* by the much

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12. *See* Federico Lup Pasini, *The International Regulatory Regime on Capital Flows* (Asian Dev. Bank Inst., Working Paper No. 338, 2011), *available at* http://www.adbi.org/files/2011.12.30.wp338.intl.regulatory.capital.flows.trade.services.pdf.

13. *Id.*

14. *See* Kevin P. Gallagher, *Capital Controls and Trade Agreements*, 1 (G-24, Policy Brief No. 55), *available at* http://www.ase.tufts.edu/gdae/Pubs/rp/GallagherCapContr24PB55.pdf.

15. *Id.*

stronger growth prospects in some 'emerging market' economies."[16] As demand for a particular currency increases, its value relative to other currencies increases. This relative value increase creates currency speculation, as investors try to profit from the increase in value, and decreased competitiveness of exports, as the cost of the country's products rise relative to those of other countries. Asset bubbles may form as outside investors purchase internal assets as a way to capitalize on the currency and economic boon.[17] Unchecked, these actions put many assets out of reach of the majority of the local population and potentially lead to a crash and rapid capital flight.

Capital controls "have in general taken two broad forms: (1) 'administrative' or direct controls and (2) 'market-based' or indirect controls."[18] "Direct controls involve prohibitions on specific types of transactions, quotas, rule-based or discretionary approval and minimum-stay requirements. Indirect controls rely primarily on explicit or implicit taxation to discourage capital flows."[19] An example of administrative controls occurred in the summer of 2013 when India reduced allowable remittances (the amount of money Resident Indians can send abroad) to $75,000 per year from $200,000 per year.[20] India also reduced the amount of overseas direct investment in which Indian companies could engage, from 400% to 100% of a firm's net worth.[21] One commonly studied example of a market-based or indirect control is the unremunerated reserve requirement (URR) instituted by Chile in 1991 in an attempt to manage short-term inflows.[22] Capital importers were required

16. *See* Gerald Epstein, *Using Capital Management Techniques to Manage Disruptive Capital Flows*, 1 (G-24 Policy Brief No. 74, April 5, 2012) (emphasis in original) *available at* http://g24.org/publications/policy-briefs/.

17. *See* Isabella Massa, *Capital Controls in a Global Economy: In Search of a Coordinated Truce*, OVERSEAS DEVEL. INST. (2011), *available at* http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6722.pdf.

18. Akira Ariyoshi et al., *Capital Controls: Country Experiences with Their Use and Liberalization*, 6 (Int'l Monetary Fund Occasional Paper No. 190, 2000), *available at* http://www.imf.org/external/pubs/ft/op/op190/.

19. Williams, *supra* note 2, at 573.

20. Press Release, Reserve Bank of India, RBI Announces Measures To Rationalise Foreign Exchange Outflows by Resident Indians (Aug. 14, 2013) *available at* http://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29309.

21. *Id.*

22. *See* Ross. P. Buckley, *Why Some Developing Countries Are Better Placed Than the International Monetary Fund To Develop Policy Responses to*

to deposit a specified fraction of the imported capital with the Chilean Central bank in an account that bore no interest.[23] This acted as a tax on the capital inflow and allowed Chile to provide for different foreign and domestic interest rates.[24] It also allowed Chile to more effectively control domestic inflation and its current account deficit without giving up exchange rate policy.[25] A country may use capital controls for many different reasons. It may, like India in the summer of 2013, limit their resident's investments abroad in order to prevent cash from leaving the country and to protect the value of the local currency.[26] Or a country may, like Chile in 1991, seek to limit foreigners' investments in its own economy to protect against the damage and instability that accompany the sudden halt or reversal of capital inflows.[27]

A. THE CASE FOR CAPITAL MARKET LIBERALIZATION

Opponents of capital controls cite a number of benefits to the free flow of capital and detriments to the artificial restriction of that flow. While many opponents recognize that there can be benefits to the use of capital controls, they see the cost of their imposition to outweigh the benefit of their use. Similarly, they see the inverse to be true as well. That is, they see the advantages of freely flowing capital to outweigh any potential accompanying disadvantages.[28]

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the Challenges of Global Capital, 15 TUL. J. INT'L & COMP. L. 121, 139 (2006) (describing the unremunerated reserve requirement instituted by Chile, the motivations behind its institution, and its effectiveness).

23. *Id.*

24. *See* Francisco A. Gallego & F. Leonardo Hernandez, *Microeconomic Effects of Capital Controls: The Chilean Experience During the 1990s*, 8 INT'L J. FIN. & ECON. 225, 226 (2003).

25. *Id.*

26. *Capital Controls in India: Fight the Flight,* ECONOMIST (Aug. 16, 2013, 3:07 PM), http://www.economist.com/blogs/freeexchange/2013/08/capital-controls-india (discussing the capital controls put in place and the reaction to those controls).

27. Ross B. Leckow, *The Role of the International Monetary Fund in the Liberalization of Capital Movements*, 17 WIS. INT'L L.J. 515, 516 (1999); Williams, *supra* note 2, at 573; *see* Buckley, *supra* note 22.

28. *Tide Barriers: Capital Controls Would Work Better if There Were Some International Norms*, ECONOMIST, Oct. 6, 2012, http://www.economist.com/node/21564193 ("The case for the free movement of capital is similar to that for free trade, an area where economists' long-held convictions remain firm. Voluntary exchange across borders should make everyone better off. Borrowers receive better access to credit at lower cost;

One cost of capital controls can be an atmosphere of uncertainty among investors and a coinciding erosion of confidence.[29] When Malaysia instituted controls on capital outflows during the 1997 Asian Financial Crisis, rating agencies quickly downgraded its sovereign risk and credit ratings.[30] The cost for Malaysia to borrow rose much more than for other affected countries.[31]

Capital controls can also have spillover effects. One study found that as Brazil instituted capital controls between 2005 and 2011, investors reduced the share of their portfolio in Brazil and shifted to other countries, especially those with greater capital market liberalization.[32] This results in market distortion causing unequal distribution of those funds and has great potential to cause the very problems that capital controls attempt to address in other countries.[33] These problems create a risk that countries will impose capital controls in a domino effect and greatly reduce total investment which would have an adverse effect on the global economy.

Capital controls can be used as part of an effort to sustain an undervalued currency.[34] This keeps up demand for exports from that country. China has used capital controls to keep its exports competitive and prevent currency speculation.[35] It is difficult to determine the intent of a policy to control capital

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lenders can earn higher returns on a diverse array of investments. Yet large, temporary inflows of money have been known to pave the way for big economic trouble.”).

29. Masahiro Kawai & Shinji Takagi, *Rethinking Capital Controls: The Malaysian Experience* 14 (PRI Discussion Paper Series, Paper No. 03A-05), *available at* http://www.mof.go.jp/pri/research/discussion_paper/ron056.pdf (discussing Malaysia’s use of capital outflow controls in the late 1990’s).

30. *Id.*

31. *Id.*

32. Kristin Forbes et al., *Bubble Thy Neighbor: Direct and Spillover Effects of Capital Controls*, 4 (12th Jacques Polak Annual Research Conference, Nov. 10 – 11, 2011), https://www.imf.org/external/np/res/seminars/2011/arc/pdf/forbes.pdf.

33. *Id.* at 27

34. Olivier Blanchard & Jonathan D. Ostry, *The Multilateral Approach to Capital Controls*, VOX (Dec. 11, 2012), http://www.voxeu.org/article/multilateral-approach-capital-controls.

35. Tom Orlik, *China Signals Speedier Moves to Loosen Capital Controls: Bank Official Says Recent Volatility Shouldn’t Hinder Reform*, WALL ST. J. (Sept. 5, 2013, 10:29 AM), http://online.wsj.com/news/articles/SB10001424127887323623304579056741795219748.

flows.[36] This supports a general policy of open capital flows to prevent trade wars that might stem from the perception that a country is using capital controls to maintain an undervalued currency or for some other illegitimate purpose. Countries can also use capital controls to attempt to influence world interest rates in a way that would benefit that country.[37] A large creditor country may restrict outflows in an attempt to raise world interest rates, and large debtor countries may attempt to lower world interest rates. [38] This generates a global market distortion that can produce an unfair advantage and cause animosity among nations. It can create severe economic consequences through trade wars and artificially stunted or overheated markets depending on whether rates are increased or decreased. Market liberalization helps prevent such consequences.

Another important benefit of open capital markets is the availability of capital for economic development. "Advocates for capital market liberalization argue that, by liberalizing the flows of international capital, developing countries would benefit by getting access to cheaper credit and investment from developed markets, promoting growth and stability."[39] The availability of foreign credit can reduce the price, making it available to more people for economic development.[40]

Finally, as with any type of financial control or regulation, people will always find a way around capital controls. In the West, the hawala system is often associated with funding terrorism.[41] However, its traditional role is transmitting money between individuals and families in different countries.[42] Hawala is just one of many informal funds transfer systems that can effectively evade capital control mechanisms.

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36. Blanchard, *supra* note 34.

37. *Id.*

38. JONATHAN D. OSTRY ET AL., MULTILATERAL ASPECTS OF MANAGING THE CAPITAL ACCOUNT 7, (Sept. 2012), *available at* https://www.imf.org/external/pubs/ft/sdn/2012/sdn1210.pdf.

39. Kevin P. Gallagher, *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements*, 2 (United Nations Conference on Trade and Development, G-24 Discussion Paper Series No. 58, May 2010).

40. *Id.*

41. Mohammed El-Qorchi, *Hawala: How Does This Informal Funds Transfer System Work, and Should It Be Regulated?*, FIN. & DEV., Vol. 39, No. 4 , 2 (Dec. 2002).

42. *Id.*

B. THE CASE FOR CAPITAL CONTROLS

Capital market liberalization can actually be detrimental to developing economies. One of the main constraints for some developing countries is a lack of demand for investment.[43] Without a sufficiently strong economy, there is little demand for investment in the economy. Increased foreign capital inflows cause the currency value to appreciate and reduce the competitiveness of goods, which further decreases demand for investment.[44] In countries that haven't reached a certain development threshold, capital market liberalization can actually have a negative effect.[45] Moreover, many developing countries lack the stringent prudential regulation that is necessary to safely maintain a liberalized capital market.[46]

As waves of capital enter an economy, the currency can become unstable, asset prices can rapidly appreciate (placing them out of reach of many locals), and the government can encounter difficulty in conducting monetary policy.[47] **"**International capital flows tend to be pro-cyclical, creating excess inflows during booms and causing capital flights in moments of instability, further aggravating crises."[48] The Argentine economy of the 1990s is evidence of how large capital inflows produce growth and then draw more inflows. This is unsustainable, as it is disconnected from economic essentials.[49] "Asset markets with more credit inflows tend to be more sensitive to the global cycle. The global financial cycle is not aligned with countries' specific macroeconomic conditions . . . one important determinant of the global financial cycle is monetary policy in the center country, which affects leverage of global banks, credit flows and credit growth in the international financial system."[50] This can lead to bubbles and

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43. Gallagher, *supra* note 39, at 2–3.
44. *Id.*
45. *Id.*
46. *See* Buckley, *supra* note 22 at 127.
47. Gallagher, *supra* note 14, at 1.
48. Gallagher, *supra* note 39, at 3.
49. Buckley, *supra* note 22, at 128.
50. Helene Rey, Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence 1 (Aug. 23, 2013) (unpublished manuscript), *available at* https://www.kansascityfed.org/publicat/sympos/2013/2013Rey.pdf. For a look at Brazil's criticism of the Federal Reserve's Quantitative Easing policies in this respect, see John Paul Rathbone & Jonathan Wheatley, *Brazil's Finance Chief Attacks US over QE3*, FIN. TIMES, Sept. 20, 2012,

excess credit; omens of crises.[51] Liberalized capital accounts constrain national monetary policy "regardless of the exchange rate regime."[52] Just as mob mentality brought the money in, mob mentality takes the money out, similar to a bank run. In many cases, however, this is accompanied by what economists call "original sin," which involves a country borrowing in foreign currency.[53] As the exchange rate drops, the purchasing power of domestic output against foreign debt is reduced and makes servicing debt in a foreign currency increasingly difficult.[54] Foreign lenders become less willing to lend, reinforcing the troubles of servicing debt in a downward spiral.[55]

A recent study has shown that support for the benefits of liberal capital markets are elusive.[56] The study's author noted that, while not definitively absent, "we cannot take them for granted."[57] This raises the obvious question: are the elusive benefits of open capital markets worth the high risk?

C. Capital Controls in the International Legal Order

Cross border movement of currency can take the form of an international payment or a capital movement.[58] Though both involve the cross-border movement of money, one involves payment for goods and the other involves investment.[59] They are appropriately subject to different legal regimes.[60]

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http://www.ft.com/intl/cms/s/0/69c0b800-032c-11e2-a484-00144feabdc0.html#axzz2j9lKOUgx.

51. Rey, *supra* note 50, at 313.

52. *Id.*

53. *See* Barry Eichengreen et al., *Currency Mismatches, Debt Intolerance and Original Sin: Why They Are Not the Same and Why It Matters* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 10036, 2003); Paul Krugman, *Original Sin and the Euro Crisis*, N.Y. TIMES (Nov. 10, 2011, 2:23 AM), http://krugman.blogs.nytimes/2011/11/10/original-sin-and-the-euro-crisis/?_r=0.

54. Eichengreen, *supra* note 53, at 136.

55. *Id.* at 123.

56. Rey, *supra* note 50, at 313.

57. *Id.*

58. Federico Lupo Pasini, *Movement of Capital and Trade in Services: Distinguishing Myth from Reality Regarding the GATS and the Liberalization of the Capital Account*, 15 J. INT'L ECON. L. 581, 586 (2012).

59. *Id.*

60. *Id.* at 587.

> Both Article XI:1 of the GATS and Article VIII of the Articles of Agreement of the International Monetary Fund (IMF Articles) require the complete liberalization of international current payments, which can be restricted only in a few circumstances. In Contrast, states are in principle free to regulate capital movements, which are subject only to the requirements of the Footnote to Article XVI of the GATS.[61]

Currency is used as a method of payment in transactions, but also acts as an asset.[62] Currency is bought, sold, and speculated upon. "Whatever its final use, foreign currency has fundamental importance for managing the balance of payments and, more generally, in maintaining economic stability."[63] While there is little to clarify what legal regime a particular currency control falls under, it helps to look at the purpose of the transaction that is controlled.[64]

> If a currency control affects underlying unilateral transactions in foreign exchange, such as the opening of an offshore deposit by residents or the trading of foreign exchange, then the measure would be a capital control and subject to the discipline of the GATS on capital movements. If the measure targets a subordinate transaction, such as the payment for a consulting service, then the measure would be an exchange restriction. In that case, it would be subject to the discipline on international payments and in principle would be prohibited.[65]

Both trade law and monetary law govern capital controls.[66] In

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61. *Id.* (footnote omitted); *see also* General Agreement on Trade in Services, Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, Annex 1B, art. XI:1, 1869 U.N.T.S. 183 [hereinafter GATS]; Articles of Agreement of the International Monetary Fund, July 22, 1944, 60 Stat. 1401, art. VII, 2 U.N.T.S. 39, *as amended* through April 28, 2008 [hereinafter Articles of Agreement].

62. Pasini, *supra* note 58, at 587.

63. *Id.*

64. *Id.* at 587 – 88.

65. *Id.* at 588-89.

66. *See* Deborah E. Siegel, *Using Free Trade Agreements to Control Capital Account Restrictions: Summary of Remarks on the Relationship to the Mandate of the IMF*, 10 ILSA J. INT'L & COMP. L. 297, 298 (2004) (discussing the overlap of Free Trade Agreements and Bilateral Investment Treaties with

addition to providing financing, the IMF "also has important regulatory powers."[67]

1. FTAs and BITs

Free Trade Agreements (FTAs) and Bilateral Investment Treaties (BITs) increasingly pull the issue of capital controls into the realm of trade law.[68] They promote free capital flows "as a by-product of some other principal goal,"[69] such as the protection of investments.[70] By preferring free capital movement as a mean to some other end, these agreements often limit the nation's ability to use capital controls without fully considering the issue.[71]

BITs and FTAs seek to impose clear rules governing the transfer of capital to prevent the "arbitrary administration of exchange transactions."[72] FTAs necessarily cover a much wider range of activities.[73] While trade is fully considered in an FTA, capital controls are only considered to the extent they relate to trade, and, probably, free investment.[74] An FTA does not consider the broader implications of capital control's use or non-use.[75] Compared to an FTA, a BIT considers capital controls differently by encouraging cross-border investment and seeking to protect those investments from arbitrary state actions as a part of that encouragement.[76] A patchwork of agreements promoting capital market liberalization as a mean to encourage and promote investment has arisen, but there is no comprehensive legal edifice that defines when capital movements should be restricted or when restrictions should be

the law and work of the IMF, particularly in the context of managing economic and financial crises).

67. *Id.*

68. *See id.*; s*ee generally* Leckow, *supra* note 27, at 515–16 (discussing forms, stages, and reasons of capital controls).

69. Leckow, *supra* note 27, at 523.

70. *See id.* (discussing the patchwork nature of current agreements that implicate the use of capital controls and proposing an amendment to the Articles of the IMF that would constitute a comprehensive legal framework for capital account liberalization).

71. *Id.*

72. Siegel, *supra* note 66, at 297.

73. *Id.* at 298.

74. *See id.*

75. *See id.*

76. *See id.*

removed.[77]

The FTAs and BITs of the United States have two key provisions that limit the use of capital controls.[78] The first is the free transfer clauses that are present in all U.S. BITs "requir[ing] host nations to permit free transfers without delay of all types of covered investments."[79] The use of free transfer clauses has accelerated the advance towards capital market liberalization.[80] These clauses prohibit any capital controls that might impede an investor's ability to remove their investments and any returns and have no provision for emergency use of capital controls.[81] The free transfer of funds plays an important role in investments.[82] BITs implicate the ability to control capital outflows and inflows.[83] The second is an investor-state dispute mechanism that allows individual investors to bring claims against the other nation.[84] This is a unique development as countries normally enjoy immunity from claims by individuals.[85] The United States BITs actually elevate the rights of the U.S. investors above those of domestic investors by allowing the U.S. investors to bring claims against a foreign nation and receive money damages.[86]

The absence of a balance of payments safeguard in many BITs and FTAs is an area of specific concern.[87] There may be some historical reasons for this, but many multilateral agreements recognize that "exchange restrictions may be needed during extraordinary economic turbulence."[88]

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77. Leckow, *supra* note 27, at 523.

78. *See* Gallagher, *supra* note 39, at 11.

79. Gallagher, *supra* note 39, at 11; s*ee, e.g.*, United States Model Bilateral Investment Treaty, Art. 7 (2012), http://www.state.gov/documents/organization/188371.pdf.

80. Yianni & de Vera, *supra* note 2, at 364.

81. *See id.*

82. *See id.*; *see also* Michael Waibel, *Bit by Bit: The Silent Liberalization of the Capital Account*, *in* INTERNATIONAL INVESTMENT LAW FOR THE 21ST CENTURY: ESSAYS IN HONOUR OF CRISTOPH SCHREUER, 497, 498 (Christina Binder et al. eds. 2009) ("Free transfer clauses are critical to the overall degree of investment protection.")

83. Gallagher, *supra* note 39, at 11.

84. *Id.*

85. *See id.*

86. *Id.* at 10.

87. Siegel, *supra* note 66, at 301; *see also* Waibel, *supra* note 82, at 516 (discussing that the absence of a balance of payments safeguards in BITs leads to potential overprotection of investors at the expense of international financial stability).

88. Waibel, *supra* note 82, at 516.

2. GATS

The General Agreement on Trade in Services (GATS) is a WTO treaty that pulls the service sector into the purview of the WTO.[89] "Although the movement of capital is largely confined to the domain of international financial or monetary policy, it is regulated by WTO law due to its role in the process of financial services liberalization, which generally requires liberalized capital flows."[90] Trade in services is the ability of a service provider to provide services abroad or a domestic consumer to consume services from abroad.[91] For the most part, besides the financial services industry, services themselves do not involve capital movements.[92]

GATS provides for some obligatory liberalization of the capital account in order to promote free trade in financial services, as the free movement of capital is necessary for financial services.[93] In areas that a member country has committed to open market access, that member is obligated to allow the free movement of capital in relation to that service.[94] "The GATS is concerned only with promoting free trade in services, and in principle does not promote the liberalization of capital movements."[95] In places where trade in services and the movement of capital overlap, such as a bank loan, restrictions on capital movements may act as a barrier.[96] To prevent this, GATS coverage "was extended to comprise the liberalization of those capital movements connected to trade in services."[97]

Some argue that members who commit to open market access with financial services extremely limit their ability to protect their economies from crises.[98] GATS, no doubt, does

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89. *See* Gallagher, *supra* note 39, at 5.
90. Pasini *supra* note 58, at 581.
91. *Id.* at 593.
92. *Id.*
93. *Id.* at 582.
94. GATS, *supra* note 61, Footnote 8 to Article XVI:1; *see* INTERNATIONAL MONETARY FUND, LIBERALIZING CAPITAL FLOWS AND MANAGING OUTFLOWS, 22 (2012); *see also* Gallagher, *supra* note 39, at 1 ("The WTO allows for nations to deploy capital controls on both inflows and outflows as long as nations have not committed to the liberalization of certain financial services. If a nation has made commitments in financial services, restrictions on inflows are not permitted.").
95. Pasini, *supra* note 58, at 594.
96. *Id.*
97. *Id.*; *see also* GATS, *supra* note 61, Footnote to Article XVI: 1
98. *See* Pasini, *supra* note 58, at 583 (citing Todd Tucker, *The WTO*

limit the ability to stray from liberalization commitments. However, GATS does provide for derogating from liberalization commitments for countries facing exceptional circumstances and includes a prudential carve-out allowing members to take prudential measures.[99] "In the GATS, the link between capital flow and economic stability is particularly strong, and it develops on three fronts."[100] Article XI contains conditions when capital movement connected to trade in services can be restricted, including balance of payments problems, at the request of the IMF, and prudential regulations or emergency measures.[101] Further, "GATS does not cover all possible capital movements . . . a Member would be allowed to block the outflow of capital by preventing resident financial institutions, irrespective of their origin, from performing operations that would transfer capital out of the country. Similarly, a Member would be allowed to block certain capital inflows by preventing financial institutions from selling financial instruments or opening deposits for non-residents."[102]

Countries also restrict capital movements for other reasons. GATS does not provide for deviation when they occur for monetary or fiscal policy reasons.[103] While current discussions tend to focus on GATS' position on capital controls when it comes to financial crises, there are discussions about its position on capital controls as it relates to monetary and fiscal policies.[104] Some contend that there should be more flexibility. However, trade law is generally not concerned with monetary and fiscal policies. Any flexibility in these areas would require the international trade regime to recognize the importance of monetary and fiscal policies to the overall well-being of world trade. Those in the trade world may be more willing to accept such flexibility if an independent body can

Conflict with Financial Transactional Tax and Capital Management Techniques and How to Fix It, CITIZEN, http://www.citizen.org/documents/MemoonCapitalControls.pdf (visited Jan 10, 2012)).

99. *See* LIBERALIZING CAPITAL FLOWS AND MANAGING OUTFLOWS, *supra* note 94.

100. Pasini, *supra* note 58 at 604.

101. Pasini, *supra* note 58 at 604; Gallagher, *supra* note 39 at 8.

102. Pasini, *supra* note 58 at 602.

103. Pasini, *supra* note 58 at 616–17.

104. *Id.*; *See also* D. Filiz Unsal, Capital Flows and Financial Stability: Monetary Policy and Macroprudential Responses 16-17 (Aug. 2011) (IMF Working Paper No. WP/11/189, 2011).

verify that any measures taken are based on legitimate policy goals rather than an attempt to gain a trade advantage.

II. CENTRALIZING DISJOINTED INTERNATIONAL LAW ON CAPITAL CONTROLS

With no central regulation or agreement governing capital controls, the issue has spread through numerous agreements. The agreements addressing capital controls often have some other focus. This has created a fairly complicated web for countries to navigate and impedes the formation of free trade agreements and investment treaties among countries with conflicting views on the use of capital controls. Creating an international system of regulation for capital controls would serve to coordinate among nations and eliminate many problems that currently plague the issue. An increase in certainty should actually have a net increase effect on capital flows. Regardless, increasing support from economists for their use as part of prudential regulation should be reflected in the reduction of measures that prevent their use.

A. IMF Regulation of Capital Controls

The ideal method of managing capital control use is to grant the IMF regulatory responsibility. This might appear similar to the Fund's previous role as overseer of the fixed exchange rate system. Regulating capital controls would help prevent international crises just as the Fund's assistance with exchange rates and emergency loans were meant to do. As the IMF has a history of regulation and supervision,[105] it would not be bizarre to see the IMF take on a regulatory and supervisory role regarding capital control use. In fact, capital control regulation appears to fit almost perfectly within the IMF mandate.[106]

Article I of the Articles of Agreement sets out the purposes

105. Articles of Agreement, *supra* note 61, art. 4, §§ 3-4 (providing for IMF surveillance of exchange rates and potential imposition of a par value).

106. *Id*. §1 (describing IMF member's general obligations regarding exchange agreements). . Article 6, Section 1 allows the Fund to request capital controls on outflows to be used to prevent the Fund's resources from being used to sustain outflows and Section 3 allows members to use the controls as necessary to regulate international capital movements as long as the controls do not restrict current transactions or delay payments. *Id.*art. 6.

of the IMF.[107] The IMF is charged with promoting international monetary cooperation, collaboration on international monetary problems, and establishing a multilateral system of payments.[108] Regulation of capital controls fits with all of these purposes. Creating an international regulator on the use of capital controls would solve a major problem by centralizing the issue. Rather than having the issue subtly referenced in a number of different treaties that have varying goals, the issue would be governed by an individual body. The current tangle would be replaced with an orderly system that could be navigated much more easily. Countries would no longer need to sort through various treaties to discover what action they could take with respect to capital controls. This would also have preemptive effect. The issue would no longer need to be negotiated over and over again. A treaty on investment could deal with investment without capital controls being part of the negotiation process.

An articulated and transparent schedule similar to the tariff schedules used by the WTO may be the best way of implementing an IMF regulatory structure. The WTO has rules of general applicability that all members must follow. Each nation also makes specific commitments that they must follow individually. The IMF could institute a similar program for the use of capital controls. Capital controls resemble tariffs in that they are both barriers. A similar system of commitments and restrictions would fit the capital control issue well. Just as the WTO exhibits a preference for tariffs over quotas, any international agreement should prefer indirect controls to direct controls. Indirect controls, analogous to tariffs, have less of a distorting effect on the market, are more predictable, and are more transparent than direct controls, analogous to quotas. Such a system should exhibit a preference for liberalized capital markets preferring capital controls to generally be temporary and progressively decreased, except, perhaps, for countries seriously lacking the internal architecture necessary for a liberalized capital market. This would address one of the major issues concerning capital control use post World War Two, when many nations employed capital controls until the 1970s and later. A dispute resolution body similar to that employed by the WTO would be required to handle disputes that arise regarding adherence to the commitments.

107. *Id.* art. 1.
108. *Id.* art. 1.

Similarly, a safeguard provision would need to be created to allow members to depart from their commitments in times of special need. The safeguard provision could be administered either by unilateral invocation or the invoking country could be required to go through the IMF to have it approved. Requiring nations to apply to the IMF in order to invoke the safeguard provision, or maintain it, would have the potential to indirectly address a major criticism of current discussions on capital controls. The criticism is that the actions by large economies that are contributing to the large inflows and outflows are not addressed.[109] Submission to the IMF to employ safeguards would create an opportunity for greater coordination. If the actions of a particular country or countries are creating a situation in which another country feels it needs to invoke capital controls or invoke the safeguard provision, the IMF would be well positioned to work with the various nations to secure the best resolution. The countries that affect the invoking country should retain their sovereignty over domestic policies. That is, the IMF would not be in a position to mandate policy changes for third parties. Rather, the IMF would be in a position to assist in coordinating among multiple countries to create a mutually beneficial outcome or, if that is not possible, to take into account the effect of fiscal or economic policies of important related countries when assessing a request to employ capital controls in excess of commitments through the

109. For a discussion of Brazil's perspective on the Federal Reserve's Quantitative Easing policy, see Rathbone & Wheatley, *supra* note 50. For recent news regarding international capital flows and center country financial policy, see Sujata Rao et al., *Analysis: Emerging Markets as Vulnerable to Contagion as Ever*, REUTERS, Jan. 27, 2014, http://www.reuters.com/article/2014/01/27/us-emerging-contagion-analysis-idUSBREA0Q1G420140127 (emerging markets have been inflated in recent years by huge amounts of cheap cash created by the U.S. Federal Reserve, much [o]f which found its way into developing economies in the hunt for better returns."); Chris Vellacott, *Next Wave of Super-Rich Heading for London as New Crises Bite*, REUTERS, Feb. 7, 2014, http://www.reuters.com/article/2014/02/07/us-london-property-idUSBREA160HH20140207 (detailing an influx of London property purchases by wealthy foreign buyers from countries whose economies are "seen as vulnerable to the U.S. Federal Reserve scaling back monetary stimulus."); David Gaffen & Francesco Canepa, *Emerging Markets Selloff Picks Up, Drags Down Europe, U.S.*, REUTERS, Jan. 24, 2014, http://www.reuters.com/article/2014/01/24/us-markets-global-idUSBRE96S00E20140124 ("The broad nature of the selloff combines country-specific problems with the reality that reduced U.S. Federal Reserve bond buying reduces the liquidity that has in the past booster higher-yielding emerging markets assets.").

safeguard provision.

Such a system would create an environment of greater stability and certainty in the international capital market. International coordination would reduce potential domino affects. An open system with IMF oversight would greatly reduce incidences of capital control use to affect under valuated currencies and any attempts to manipulate international interest rates thus reducing the risk of international animosity and trade wars. A generally liberal capital market that leaves countries the policy space necessary to manage their internal economies and monetary systems would keep capital flows open for economic development and reduce the scale of crises, international and domestic, creating a net economic gain.

Of course, implementing such a system through amendment of the Articles of Agreement poses a significant challenge.[110] The United States, a vocal opponent of capital controls, holds over fifteen percent of the voting power creating an effective veto.[111] Significant international pressure and/or a change in philosophy of the United States would be required to effect change through amending the Articles of Agreement.

B. Linking the IMF to Disputes Involving Capital Controls

One major concern facing the capital control issue stems from structural differences between the IMF and WTO. Members of the WTO agree to limits on trade restrictions and the WTO enforces those limits through a Dispute Settlement Body that allows harmed countries to set retaliatory trade restrictions on the offending country's imports. The WTO's Dispute Settlement Body has resulted in increased legalism in the application of trade agreements.[112] "However, the cases that have concerned the Fund/WTO relationship show that the panel process, which is designed to resolve disputes between

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110. Article 28 of the Articles of Agreement requires "three-fifths of the members, having eighty-five percent of the total voting power" to accept "any proposal to introduce modifications in this Agreement" in order for the proposal to be passed. Articles of Agreement, *supra* note 61, art. 28.

111. *Id.*; *See also* Int'l Monetary Fund [IMF], *IMF Members' Quotas and Voting Power, and IMF Board of Governors*, (Sept. 24, 2014), *available at* http://www.imf.org/external/np/sec/memdir/members.aspx.

112. *See* Deborah E. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 AM. J. INT'L L. 561, 562 (2002).

WTO members, is not well suited to addressing questions of international architecture."[113]

Trade and monetary policy are undeniably linked. Though the IMF and WTO are separate entities, the WTO outlines cooperation with the IMF in its founding document.[114] Most BITs and FTAs have not adopted the idea that economic policy extends beyond trade. Rather, they prefer firm commitments and bright line rules. Trade law is considerably more amenable to firm commitments and bright line rules than is monetary policy.

Capital controls fall within the natural purview of the IMF. "The purposes of the IMF include promoting international monetary cooperation and assisting in the establishment of a multilateral system of payments [with] respect [to] current international transactions (IMF Articles of Agreement, Article I, paragraphs (i) and (iv))."[115] There is an overlap of the IMF's jurisdiction and that of trade law.[116] "The definition in the IMF Articles of 'Current International Transactions' is not limited to the prevalent concept of payments and transfers for trade in goods and services, but extends to transactions covered in the investment agreements that would be considered 'capital' in other contexts."[117] The IMF is much better situated to determine the legitimacy of capital control use in a particular instance than an arbitral body created for trade disputes due to the prevalence of free transfer clauses without exceptions. Often, arbitral bodies will not address the legitimacy of capital control use at all.[118] Unlike a dispute resolution body concerned with whether a bright line legal rule has been crossed, the IMF is staffed with economists and finance experts and would have discretion in deciding whether or not to allow capital control use.

Because of this broad discretionary power, the question should not be whether capital controls have been deployed, but

113. *Id.*

114. *See* Marrakesh Agreement Establishing the World Trade Organization art. 3, ¶ 5, Apr. 15, 1994, 1867 U.N.T.S. 154 [hereinafter *Marrakesh Agreement*] ("With a view to achieving greater coherence in global economic policy-making, the WTO shall cooperate, as appropriate, with the International Monetary Fund and with the International Bank for Reconstruction and Development and its affiliated agencies.").

115. Siegel, *supra* note 66, at 298.

116. *Id* at 299.

117. *See id.*

118. *Id.* at 300.

whether they have been deployed legitimately. Such a discipline specific and nuanced question is best answered by economists, not judges. Of course, there is a place for law in all of this. The IMF should be brought into trade and investment related disputes that implicate capital control use. This can be achieved by creating a panel within the IMF that would hear requests for the use of capital controls. When a country is considering the use of capital controls it would submit a proposal to the panel. The panel would be required to approve, modify, or disapprove the proposal. The panel may also issue suggestions. If capital controls have been deployed and a dispute has arisen over their use, the panel would also have the authority to approve the use post hoc.

In order to function effectively, an IMF panel would have to be incorporated into international trade law instruments due to the potential for capital controls to raise trade issues. The WTO Dispute Settlement Body will call in experts and, from time to time, consider in some limited fashion outside agreements amongst the parties. However, to ensure a place in relevant WTO disputes, the IMF panel should be incorporated into the WTO. Incorporating the panel into the WTO would provide for increased coordination between the trade policy world and the financial policy world. Such coordination should theoretically result in a set of rules on how to approach a case in which capital control use has created a barrier to trade that harms another country.

Incorporation of the IMF panel could be accomplished informally through Article 3, Paragraph 5 of the *Marrakesh Agreement* .[119] Article 3, Paragraph 5 uses the imperative "*shall* cooperate, as appropriate, with the International Monetary Fund" regarding the goal of a coherent global economic policy.[120] The use of the imperative indicates required cooperation with the IMF. The creation of an IMF panel on the issue of capital controls would create an excellent opportunity for such cooperation. Though the *Marrakesh Agreement* does not specify whether the cooperation is to be on policy issues or regarding individual cases, it is clear that such an IMF panel would be an ideal candidate for the cooperation contemplated.[121]

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119. Marrakesh Agreement, *supra* note 114.
120. *Id.* (emphasis added).
121. *Id.*

Further, incorporating an IMF panel into the WTO in such a manner would avoid the difficulties of altering the legal structure of the WTO. Neither amendments, nor the political process amendments would be needed. This offers the clear benefit of simplicity. The WTO would stay essentially as it is, but would cooperate with the IMF on capital controls. WTO Panel and Appellate Body judges often take into account external agreements in accord with the Vienna Convention on the Law of Treaties. The judges may take into account an IMF panel decision on capital control use insofar as doing so is in accordance with the Vienna Convention on the Law of Treaties. The WTO could make any internal changes or additions to complement an IMF panel as it sees fit.

An internal process to link the IMF panel and the WTO would be ideal. Each organization could construct the procedures and departments necessary to ensure cooperation. Such a structure would include a place for IMF panel decisions in the WTO Dispute Settlement Body. If the IMF panel sanctioned particular methods, then their use could not be held against a country in a WTO dispute settlement. While countries would normally be held to the trade obligations, during the time and within the parameters sanctioned by the IMF, a country would be allowed to deviate with respect to capital controls. Such a system would provide a role for the IMF in the world of trade law and be a proactive safeguard to prevent trade crises before they arise rather than only stepping in after the fact.

The word cooperation, however, is subject to a broad spectrum of definitions. Since the WTO is not bound to anything beyond "cooperating" with the IMF the chosen definition matters significantly. Cooperation could be interpreted as nothing more than communicating with the IMF on current issues. No formal complementary structure with an IMF panel would be certain. An IMF panel decision would not necessarily be taken under advisement in a WTO dispute settlement proceeding. The WTO would be in a position to take or leave any input from the IMF as they saw fit. Accordingly, it may be better to create a formal negotiation process in which the various countries would come together and amend the WTO and IMF as necessary to link the two for purposes of capital control disputes.

The WTO was created by the 1994 *Marrakesh Agreement*,

which sets out the structure and governing rules.[122] Negotiations since 1994 have focused on tariff reduction or expanding the WTO's coverage beyond goods and into services and intellectual property. One result has been the proliferation of Free Trade Agreements (FTAs) and other agreements outside of the WTO.[123] Accordingly, linking to the WTO alone would not be sufficient. For any measurable effect, the IMF would need to have a place in disputes involving capital controls that arise in multilateral and bilateral agreements outside of the WTO framework.

Another possibility is to route all conflicts regarding the use of capital controls through the IMF by way of a large multilateral agreement. A dispute body similar to the one used by the WTO could be created within the IMF to handle such issues. This dispute resolution body would be able to create precedent and a body of monetary law. One issue, however, with capital controls is that they are not normally discussed in treaties, unless it is a prohibition. Even when it is a prohibition, it generally takes the form a free transfer clause in which capital controls are not explicitly mentioned.[124] The IMF dispute body would not change the current situation much if it were to hear treaty disputes that dealt with capital controls. Rather, there would have to be a general understanding that capital controls may be employed in certain circumstances. The IMF dispute body would be in a position to decide whether the use of capital controls is legitimate in a given situation. A country that received authorization from the IMF before using capital controls would be allowed to proceed within the parameters specified by the IMF. All claims against the country as a result of the use of capital controls would be quashed as long as the country adheres to all of the IMF's parameters. If a country were to experience an emergency in which it felt it had to immediately impose capital controls, it would be required to submit the measures to the IMF in a timely fashion and make any adjustments to the controls as the IMF found appropriate. This dispute resolution body would operate much like the administrative role of the IMF

122. Marrakesh Agreement, *supra* note 114.

123. *See* Nuno Limao, *Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the United States*, 96 AM. ECON. REV. 896, 896 (2006).

124. *See* United States Model BIT *supra* note 79.

mentioned earlier.[125]

A less ambitious alternative would be to create such a dispute resolution body within the IMF, but not mandate its use through any multilateral agreement. As countries negotiate agreements that implicate capital control they could include provisions referring disputes under that agreement that involve capital control use to be determined by the IMF dispute resolution body. This would be positive because it would provide countries with an extra tool to include in their agreements. It would allow for more middle ground and may result in the conclusion of more investment and trade treaties, further opening the world economy.

The use of capital controls does have the potential to disrupt trade, but their orderly and prudential use should result in a net gain in trade. Such controls would serve to prevent major crises that significantly lower trade and take years to abate. The use of capital controls represents a small, but certain loss of liberalization in exchange for prevention or mitigation of a much larger potential economic loss in the future.

Requiring their use to be approved by the IMF would serve a few important functions. It would primarily ensure impartiality. As the IMF has no financial stake in the outcome, other nations could accept that capital control provisions were not for some nefarious purpose. The IMF role would be that of an outside auditor. Countries could not use capital controls as they saw fit, but would be required to comply with the principles set forth by the IMF. The rest of the world would be more willing to accept capital controls if an independent body of experts found them to be appropriate measures.

The IMF would also serve to limit the scope and duration of capital controls. Hypothetically, a country would be required to comply with IMF direction as to scope and duration in order to receive the benefits of IMF approval of a safeguard provision. By keeping capital controls limited, the IMF would serve to limit trade disruption and investment and serve to increase acceptance of their use. Going through the IMF would also decrease uncertainty. The rest of the world would know, with some degree of assurance, that the controls will be used within the parameters set forth and only to the extent stated. With the

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125. For an overview of this topic see the previous section titled "IMF Regulation of Capital Controls" discussing a possible IMF administrative role regarding capital controls and safeguard provisions.

world more confident in a definite plan, the impact on trade and investment would be limited to the direct impact of the controls themselves rather than investor or trade uncertainty. This should serve to help combat the pro-cyclical nature of international capital flows.

While linking the WTO and IMF may have some very positive results, it may be very difficult to effectuate. The two organizations have their traditional territory. While cooperation is built into both of their founding documents, most institutions are hesitant to cede any power or influence to another.[126] Capital control use has yet to reach consensus despite the growing support in the wake of the financial crises of the past two decades.[127] A lack of consensus will create difficulty.[128] There is neither the international pressure for the two organizations to come up with a joint solution, nor sufficient backing from either the pro- or anti-capital control camps to guarantee a change to the status quo, in which capital controls are allowed without constraint under generally applicable international law but restricted in a hodgepodge of disparate treaties.[129] The IMF and the GATT were created as a result of significant international turmoil and agreement that measures needed to be taken before such turmoil was repeated.[130] Significant structural changes will not be easy to accomplish.

Those who oppose capital controls may avoid any agreement that appears to give legitimacy to their use. As such a structure would do just that, those who oppose capital controls must be persuaded that international cooperation on the topic will create a better result than the current situation.

126. For the WTO's requirement to cooperate with the IMF, *see* Marrakesh Agreement, *supra* note 114. For the IMF mandate to cooperate with other international organizations, *see* Articles of Agreement, *supra* note 61.

127. *Capital Controls: Ebb Tide*, FREE EXCHANGE – ECONOMIST (Oct. 8, 2012, 12:35 PM), http://www.economist.com/blogs/freeexchange/2012/10/capital-controls (discussing the debate over capital controls in the wake of the Asian and 2008 Financial Crises).

128. *See generally*, *id.*

129. *See generally id.*

130. *See generally*, Siegel, *supra* note 66.

C. ADJUSTING THE U.S. MODEL BIT TO ACCOMMODATE CAPITAL CONTROL USE

Given the low likelihood that massive transformation of the current international architecture might occur, other avenues of opening up capital control use should be explored. Adjusting the U.S. Model BIT could maintain the obligation to open capital markets but provide for the possibility of policy space through diplomacy. While such a solution lacks some of the benefits, in both size and number, that a centralized system would possess,[131] it has the potential to prevent or minimize the impact of crises in foreign countries.

Trade law has asserted increased control over the issue of capital controls through the proliferation of BITs and FTAs. Capital controls tend to be severely restricted through these agreements and are only considered through the lens of free trade or free investment without considering financial stability.[132] The U.S. free transfer clauses ban the use of capital controls without their explicit reference.[133] Article 7 of the U.S. Model BIT covers capital controls on both inflows and outflows, requiring both parties to allow for the free transfer of capital across their borders.[134] The U.S. BIT allows for no emergency exception to the free transfer clause.[135] Even an emergency exception may not allow sufficient policy room for the deployment of capital controls or inflows. The BIT also elevates investor status by providing a private right of action for any transgressions.[136] This provides foreign investors with more rights than domestic investors, in that they are guaranteed the ability to transfer funds on demand *and* they are provided with external arbitration for their claims rather than being required to pursue claims through domestic courts.[137] Providing investors with a right of action eliminates the possibility that

131. *See, e.g.*, Buckley, *supra* note 22.

132. *See* United States Model BIT, *supra* note 79, art. 7.

133. *See* United States Model BIT, *supra* note 79, art. 7 (stating what elements are implied with a transfer clause without including capital controls).

134. *Id.*

135. *See Id.* (lacking any emergency exception within the free transfer article).

136. United States Model BIT *supra* note 79, art 1. (providing investors a right of action by defining "claimant" as "an investor of a Party that is a party to an investment dispute with the other Party.")., Art 1.

137. *See generally*, Limao, *supra* note 123.

one country may decline to pursue a remedy if they view the use of capital controls by the other country as a necessary measure, or perhaps even if they view it as being in the best interests of both countries. Contagion can easily cross national borders. By committing the use of capital controls to a firm legal framework with a private right of action, BITs and FTAs can effectively eliminate any policy space a country may have for their use.

The legitimacy of capital control use is a complicated economic issue. The rigid legal framework created by trade and investment agreements does not acknowledge the complex nature of monetary policy. Free transfer clauses prohibit the use of capital controls in pursuit of free trade or free investment.[138] Free trade and investment have obvious benefits, but tying the hands of sovereign nations regarding monetary policy in pursuit of free trade and investment, often to the benefit of investors seeking to pull out of an overheated economy they may well have helped to produce, creates massive risks. Blind pursuit of increased global trade and investment may lead to significant unintended consequences.

Free transfer clauses seek to allay a fear similar to the fear of expropriation. Investors fear that they will lose control of, access to, or any claim over the funds that they invest in a foreign jurisdiction. Just as a state may expropriate an industry, a state may limit access to funds or an investor's ability to withdraw from a market. Free transfer clauses ensure that investors can expropriate their profits.[139] Article 6 of the U.S. Model BIT covers expropriation,[140] while Article 7 contains the free transfer clause.[141]

Article 7 states, in relevant part:

> 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;
> (b) profits, dividends, capital gains, and proceeds from the sale of all or any part of the covered investment

138. *See* United States Model BIT, *supra* note 79, art. 7.
139. *See, e.g.*, United States Model BIT, *supra* note 79, art. 6.
140. United States Model BIT *supra* note 79, art. 6.
141. United States Model BIT, *supra* note 79, art. 7.

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 5 [Minimum Standard of Treatment](4) and (5) and Article 6 [Expropriation and Compensation]; and

(f) payments arising out of a dispute.[142]

This language guarantees that capital will freely flow between the two countries without regard to economic stability. Of course, individual investors will take economic conditions into account but this does not change the fact that markets are prone to bubbles and crashes or that international capital flows are pro-cyclical.[143] This clause removes a government's ability to control cash inflows or outflows from the other state party.[144] They do remain free to restrict inflows and outflows from other countries, so long as there is no similar agreement.[145]

It is in the best interests of all involved to create some policy space for individual countries to manage their own financial systems and economies. Certain speculators will undoubtedly profit off of a superheated economy. Higher interest rates that result from attempts to cool the economy allow investors to dump cash into foreign banks to reap higher returns. The higher interest rates have the perverse effect of actually attracting more foreign capital.[146] More foreign cash entering the country can result in the domestic currency gaining value relative to foreign currencies as the demand for the domestic currency (in finite supply) increases. This attracts investors in the currency itself to profit off of increases in value. The purchase of currency itself for this purpose further inflates the currency's value. Massive inflows of cash can create an economic boom unsupported by economic fundamentals. Those who profit tend to be short-term investors who buy in

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142. *Id.*

143. *See* Helene Rey, Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence 285–333 (Aug. 23, 2013) (unpublished manuscript) *available at* i.

144. *See id.*

145. *See, e.g.*, United States Model BIT, *supra* note 79.

146. *See generally*, *Capital Controls: Ebb Tide*, *supra* note 127.

early and get out before the outflows start.[147]

Despite the profit of some, the majority of investors and the country itself will be left much worse off if the boom is not supported by strong economic fundamentals. Domestic industries face decreased exports and increased competition from imports as the currency value increases relative to foreign currencies. Imports become more competitive as their production cost decreases relative to domestic production. Similarly, increased currency value makes exports less competitive abroad as their relative production cost increases. Many investors, foreign and domestic, will lose their investments. The economy will eventually take a sharp turn, much like overcorrecting in a car. A rapid drop in currency value will cause many to lose money. Foreign debts become increasingly more difficult to pay as the relative currency value drops, requiring more domestic currency to pay a foreign debt. Trade will decrease as the economy falls into recession. Inflation is often a real problem.

Opponents may say that this is just the market correcting itself.[148] However, this is different than domestic investing. Many developing countries lack the infrastructure to safely manage a liberalized capital market.[149] Further, "international capital flows tend to be pro-cyclical."[150] A confluence of factors severely narrows a government's ability to control its economy. Capital flows are often short term and in response to the domestic policies of a center country, seeking out higher returns until the center country ceases its economic stimulus.[151] Rather than requiring state parties to permit all transfers, there should be room for policy decisions that temporarily slow inward or outward flows.

One possible way around this is to remove the investor-state dispute mechanism as relates to capital controls. Article 7 may remain in place as is or with certain alterations. This would give the state parties to the agreement the sole right to bring a claim against the other state. By providing a right of action for individual investors, the U.S. Model BIT virtually

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147. *Id.*

148. *Id.*

149. *See, e.g.*, Buckley, *supra* note 22, at 127. (utilizing Argentina's market as an example of an inadequate infrastructure).

150. *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements, supra* note 39, at 2–3.

151. *See generally*, Buckley, *supra* note 22.

guarantees a suit if capital controls are employed.[152] An investor has every incentive to bring a suit and no incentive to refrain. A state, however, is better situated to exercise discretion. A state may experience significant pressure from affected individuals but may view the situation with less self-interest. If the action amounts to expropriation, the investor-state dispute mechanism will still be in place under Article 6 and the investor may bring his or her own claim.[153] If the action is a temporary device to control the domestic economy then the investor will have to convince his or her government to bring a claim.[154] A state may be more likely to grant another state some leeway for policy maneuvers if it recognizes the economic need.

Some may argue that a state cannot be counted on to represent the interests of individual citizens. This is true under certain situations but is generally fact specific. Here it is clear that the individuals and corporations seeking to invest abroad have significant influence in the U.S. Government. They did, after all, have enough influence to incorporate the Free Transfer Clauses and investor-state dispute resolution mechanism into the BIT in the first place. It is important to remember that under international law a foreign national normally cannot bring a claim against a country outside of the country's domestic courts.[155] International law is the *law of nations*. In fact, there are relatively few situations in which claims can be brought outside of the country's domestic judicial system.[156] Removing the investor-state dispute mechanism does not present a novel situation, nor is a democracy problem involved. This does not relate to rights or representation within one's own government, but rather to rights against a foreign sovereign. Removing the dispute mechanism would be one more element in an investor's risk assessment. It may deter some investment, but sound economic fundamentals always draw investors.

Removing the Free Transfer Clause in Article 7 of the United States Model BIT from the investor-state dispute mechanism would eliminate the player most likely to bring a

152. *See* United States Model BUT, *supra* note 79, art. 26.

153. United States Model BIT, *supra* note 79, art. 6.

154. *See* United States Model, *supra* note 79, art. 6. (declining to provide a right of action when the alleged expropriation is only temporary).

155. *See generally,* THE ECONOMIST, *supra* note 28.

156. *Id*.

claim. The clause may remain to remind each party of the commitment and to provide a claim should one state believe the other is taking advantage of capital controls to gain an edge. This would provide for more diplomatic engagement as well. States are much better equipped than an investor to work a solution with another state. An investor can rarely, if ever, engage in diplomacy with a state. They require clear rules. The legitimacy of capital control use is case specific and a clear legal test does not apply. The need for an inflexible rule disappears by altering the players. Each situation can be assessed based on the economic merits.

D. EXPROPRIATION AS A BACKSTOP

Existing international law on expropriation will serve as a backstop for state action. Expropriation has been addressed extensively through investor-state arbitration.[157] BITs often contain separate provisions on expropriation.[158] Expropriation standards serve as an external restraint on the use of capital controls. Customary international law addresses both direct and indirect expropriation.[159] The U.S. Model BIT defines "direct expropriation" as "where an investment is nationalized or otherwise directly expropriated through formal transfer of title or outright seizure" and 'indirect expropriation" as "an action or series of actions by a Party [that] has an effect equivalent to direct expropriation without formal transfer of title or outright seizure."[160] Expropriation in the context of capital controls would almost certainly fall into the category of indirect expropriation.

The U.S. Model BIT sets out factors to be considered when deciding whether action constitutes indirect expropriation:

> (a) The determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation, requires a case-by-case, fact-based inquiry that considers, among other factors:

157. *See generally,* THE ECONOMIST, *supra* note 28.
158. *See* United States Model BIT, *supra* note 79, art. 6.
159. *See id.*, at 40–41, apps. A, B.
160. *Id.* at 41,app. B, ¶¶ 3–4.

(i) The economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) The Extent to which the government action interferes with distinct, reasonable investment-backed expectations; and

(iii) The character of the government action.

(b) Except in rare circumstances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations.[161]

Paragraph 4(b), cited above, is a source of uncertainty. What constitutes non-compensable regulation is not clearly distinguished from what constitutes indirect expropriation. This is, in part, because there is no clear definition of what constitutes indirect expropriation. Regardless, this is one avenue through which investors will be able to assert themselves in the face of capital controls. Capital controls must be temporary and limited in scope. With international accord on their use, capital controls can be a measure that is predictably temporary and limited in scope. In such a world, they will have a minimized impact on trade and investment. Such accord will help to distinguish capital control use as "non-compensable regulation" when they are employed within agreed upon parameters. A country that diverges too drastically from international norms may find itself liable for indirect expropriation.

161. *Id.* at 41, app. B, ¶ 4.

III. CONCLUSION

The issue of capital control use has slowly reemerged after a series of crises. The IMF's endorsement of limited capital control use as a prudential measure in 2012 provided a level of international legitimacy to control measures that developing countries have long argued are essential to managing domestic economies in an era of drastically increasing global cash flows. There is ongoing debate as to the effectiveness of capital controls. Some argue that capital controls are ineffective and that the path to prosperity lies in capital market liberalization. Others argue that smaller economies are held hostage to the policies of major economies and need tools such as capital controls to prevent unnatural currency appreciation and asset bubbles. As recent financial crises have underscored the risks of contagion associated with the increasing globalization of finance, many economists see capital controls as an essential tool for countries otherwise helpless to control their own economies in the international financial cycle. International law on capital controls is fragmented and found in multitudes of bilateral and multilateral trade and investment agreements. There is no international consensus on the use of capital controls but they are widely employed.

Regardless of a nation's or individual's view on capital control use, the world would benefit from centralized regulation. The IMF is ideally situated for this role. Routing capital control regulation through the IMF would serve to increase transparency, minimize disruptive effects, increase international coordination, and serve to smooth international financial flows. Until centralized regulation of capital controls occurs, the outright bans should be removed from BITs and FTAs to reflect the growing acceptance of their use and to provide governments with the tools necessary to manage destabilizing financial flows.