INTRODUCTION TO THE ILW PANEL ON "NEW INITIATIVES IN INVESTMENT LAW: USING TRADE AGREEMENTS TO 'CONTROL' CAPITAL MOVEMENT RESTRICTIONS"

Cynthia Lichtenstein

The Panel speakers on this topic were Deborah Siegel, Esq., Senior Counsel, Legal Department, International Monetary Fund (whose paper follows), Professor Jagdish Bhagwati, University Professor, Columbia University (giving the viewpoint of an economist), and Mr. James Wallace, standing in for Randall Quarels, Assistant Secretary for International Affairs, United States Department of the Treasury. The Treasury Department was at the forefront of the negotiation of the "transfers" provisions of the recently concluded United States-Chile and United States-Singapore Free Trade Agreements, which were discussed by the Panel. Cynthia Lichtenstein, the organizer and moderator of the Panel, introduced the topic as follows:

The subject matter of this Panel is the "free transfers" provision that the United States government has recently been inserting into the bilateral free trade agreements that it has been negotiating with a number of countries. Such a provision appears in the investment chapter contained in the most recent free trade agreements, namely with Singapore and Chile, and the Fact Sheet on United States-Singapore free transfers (which may be found at www.ustr.gov) states that "retaining the principle of free transfers sends a strong signal to the markets that the U.S. and Singapore support the free flow of capital and recognize its importance in economic development." That Fact Sheet also provides that "The free transfers provision of the Singapore FTA meets an important Trade Promotion Authority . . . objective—'freeing the transfer of funds relating to investments.'"

The background to these transfer provisions is important to consider. We all know that there is an important linkage between both trade in goods and services and payments for those goods and services, and that payments are made in currency. Thus the GATT and WTO efforts at liberalization of trade are paralleled by the IMF Agreement provisions outlawing restrictions on payments for current transactions. Equally, when an investor wants to take out of the host country dividends or interest on a foreign direct investment, the investor needs to be allowed to convert the host country currency dividends or interest into a currency that the investor needs.

Now, it is possible to extend these concepts further: if what one is trying to create, as the European Community is in the process of doing, is an integrated financial market, it is necessary to provide for free convertibility for short term investments, or what we call "portfolio investments." However, for a legal system to provide that currency will be freely transferable not only for current payments (as is the obligation of most parties to the International Monetary Fund Agreement), but also for all capital investments whether short term or long term, is a bit more problematic for the host government. Macroeconomic management may require the ability to staunch, extreme, and sudden capital outflows.

This problem does not arise in the case of foreign direct investment, which by definition involves control of a host country enterprise. The foreign investor cannot in any event instantaneously withdraw his investment since the investor will want to get the control premium on resale of the investment as well as any appreciation. However, in the case of short term investments in debt or equity, so-called "hot money flows," the investor wants assurance that it can take its money and run at the first sign of economic difficulty of the host country. There is considerable academic writing today on this phenomenon of herd behavior in the case of short-term capital inflows. It is this desire on the part of portfolio investors to have convertibility at the very moment that a better return is sighted elsewhere that may be considered to necessitate the inclusion in any transfer provisions in a treaty of a safeguards clause.

It may be noted that the grandparent of all investment agreements with a free transfer clause, the aborted Multinational Investment Agreement which was being drafted under the auspices of the OECD (the "MAI"), in its last draft of the definition of "investment" (which was highly inclusive as is the definition in the most recent United States bilateral Free Trade Agreements, covering not only direct investment but also all forms of intangible property), contained a footnote to the definition that said: "The Negotiating Group agrees that this broad definition of investment calls for further work on appropriate safeguard provisions."

However, the United States-Chile and United States-Singapore free trade agreements' transfer provisions do not include any safeguard clauses. What I wanted to tell you, as an introduction to the Panel, is the history of the European Community's handling of capital controls in the process of their creation of their financial single market, as I think that history is rather enlightening. In the process of creating a "single market" as the European Community's economic integration process is called, a detailed history of the liberalization of inter-member state capital movements is given in Bermann, Goebel, Davey, and Fox, European Union Law, 2nd Ed., in their Chapter thirty two on Free Movement of Capital and the Integrated Financial Market. I cannot give here all of that detail, but very briefly, by 1988, after the Commission's 1985 White Paper on Completing the Internal Market urged greater liberalization of capital movements, the Community enacted Directive 88/361 to implement then Article 67 of the Treaty of Rome. Briefly, that Directive required abolition of all restrictions on movements of capital taking place between persons resident in the member states. However, its Article 3 provided that "where short-term capital movements of exceptional magnitude impose severe strains on foreign exchange markets and lead to serious disturbances in the conduct of a member state's monetary and exchange rate policies," the Commission, after certain consultations, might authorize the member state to take protective measures, "the conditions and details of which the Commission shall determine." In short, a safeguard clause was provided, but the measures taken by the states in an emergency would be overseen by the Commission. Paragraph two of Article 3 permitted the member state itself to take the protective measures "on grounds of urgency should those measures be necessary." In this case, the Commission was to decide whether the member state might continue to apply the measures, or whether it should amend or abolish them, and in any event, the period of application of the protective measures was limited to six months.

Now with the introduction of the Euro for twelve of the fifteen member states, and a unified control of monetary policy for those twelve states, the Treaty was amended by the Maastrict Agreement to impose an absolute prohibition of all restrictions on the movement of capital, not only between member states, but also between member states and third countries. However, the Council was given authority in Article 57 to adopt measures on the movement of capital to or from third countries "involving direct investment . . . the provision of financial services or the admission of securities to capital markets." Equally, Article 59 gives the Council the power to take "safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary."

What then of restrictions on capital movements imposed by member states not forming part of Euroland? Article 56 of the Treaty would seem to forbid them without any safeguard provision whatsoever. However, it may be noted that the earlier Directive permitting the use of safeguards has not been repealed and conceivably could be applied by the three outsiders. It will be extremely interesting to see what the situation is for the newly acceding ten member states who surely will not at first become part of the European Monetary Union. Will they be required to completely liberalize capital movements in accordance with Article 56? Presumably, however, Directive 88/361 remains on the books, and in any event, Article 59 of the Treaty continues to allow the Council, after consulting the European Central Bank, to take safeguard measures with respect to any difficulties that the new member states might experience with respect to their currencies from inflows or outflows from third countries. Thus, the European Union has not opted for the kind of free transfers provisions that the United States has negotiated with Singapore and Chile.