The IMF and the World Bank

Meeting New Challenges

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The International Monetary Fund (IMF) and the World Bank receive considerable attention in public and scholarly debates over globalization, and rightly so. Endowed with significant financial resources, large expert bureaucracies, and extensive leverage over borrowing governments, these leading International Financial Institutions (IFIs) are a constant reminder that actors other than nation-states play key policy roles in the contemporary world economy. Indeed, the IMF and the World Bank are often seen as strategic drivers of globalization. Since the late 1970s, these twin agencies have promoted a world economic vision that considers intensified integration of increasingly liberalized national markets a universal public good. Their association with the dominant, neoliberal perspective of globalization is so widely recognized that one of the most celebrated accounts of the Fund and Bank is aptly entitled The Globalizers (Woods 2006). No wonder then a sweeping structural reform of these agencies has ranked high on the agenda of all strands of the alternative globalization movement.

Yet beneath this entrenched image, the position of the IMF and the World Bank in the global political economy remains fluid and even somewhat precarious. Their evolution from relatively innocuous agencies in the immediate aftermath of the Second World War into massive organizations with considerable transformative power over some member states late in the century itself illustrates the malleability of their role in the face of sea changes in the international economy. And with more ambitious mandates comes new problems. Over the past two decades, the Fund and Bank have been criticized not only by skeptics on the left, but increasingly by global policy and economic elites as well. The legitimacy of their governance structure, the appropriateness of their lending framework, and in particular the content and consequences of their prescriptions
have been variously challenged across the political spectrum. In their defense the IFIs did acknowledge, albeit selectively, some of their shortcomings and seek to address them through wide-ranging initiatives. But these initiatives have produced fairly modest results thus far. “Change within continuity” remains the dominant pattern.

This pattern is important for two reasons. First, despite their recent emphasis on market regulation and social sustainability, and on transparency, representation, and governance reform, the IFIs are still far removed from the vision of a civilized globalization to which contributors to this volume subscribe. Most of the criticisms levelled against the Fund and Bank continue to hold. Second, the gradualism of the IMF and World Bank also means that they have fallen behind the accelerated pace of change in the power structure of the global economy. This in turn is a growing threat to their capacity and relevance as platforms of global economic governance. But before exploring these points toward the end, I review the organizations, their major critiques, and how they have tried to adapt to evolving currents in the global economy.

A Complex Operation

To describe the IMF and the World Bank as complex organizations would be an understatement. Enjoying near-universal membership of the world’s governments, the Bretton Woods twins are the two largest sources of official financing in the global economy. In each, thousands of economists and policy specialists help design and oversee lending arrangements through close monitoring of member countries, while also undertaking varying tasks of economic surveillance and research at regional and global levels. This comprehensive scope of the Fund and Bank’s functions requires an intricate bureaucratic structure, which over decades has generated organizational incentives and institutional cultures specific to each agency.

Bureaucracy is only one layer of complexity in the IMF and the World Bank. There are additional constraints. For one, as intergovernmental organizations the IFIs are not insulated from member states in their operations. A handful of leading advanced countries exerts direct influence over both agencies due to their extensive voting rights on the IMF’s Executive Board and the World Bank’s Board of Directors. Informally as well, members of this small club, and in particular the United States, try to steer key lending and policy decisions in accordance with their strategic preferences. Yet rich countries are not the only ones the IFIs have to contend with. Active and sustained consent of borrowing governments is also important, both to avoid non-compliance and program failures down the path and to ensure the continuity of lending programs crucial to the institutions’ bottom line.
The Fund and Bank do not operate in a normative, intellectual vacuum either. As organizations staffed overwhelmingly by economists, they claim that the policy prescriptions attached to their lending arrangements and promoted through other means are not some arbitrary concoction but grounded in the accepted economic theories of the time. While they may be slow to adapt, they cannot remain fully indifferent to evolving scholarly convictions about what constitutes sound economic policy and effective development strategy. Such shifts, however, may deeply contradict deep-seated organizational incentives or the conjunctural preferences of their shareholders and borrowers.

Given these intertwined forces that act upon the IMF and the World Bank, it is somewhat surprising that most critics of the IFIs on the left focus on a simplified image of the organizations—unwieldy bureaucracies that advance dominant interests in the leading countries of the North by imposing a narrow interpretation of a particular economic paradigm at a global scale. Although simplistic, this image is not without foundation, and the explanation can be traced to the Washington Consensus policies of the 1980s and 1990s. This consensus represented an important break for both the IFIs and their borrowers.

The Fund and the Bank are products of the postwar American conviction that a degree of controlled multilateralism was necessary to put the international economic system back on track after the bitter experience of the 1930s and the devastation of the Second World War. The IMF was given the responsibility of maintaining monetary stability in the system by managing exchange rates and, somewhat less crucially at the time, by extending short-term loans to members that encounter balance of payments difficulties. The World Bank, meanwhile, was established as the International Bank for Reconstruction and Development (IBRD) with the primary purpose of providing longer-term loans for rebuilding physical infrastructure in war-torn Europe. Yet despite their ambitious mandates, both organizations remained in the shadow of US attempts to more centrally manage the Bretton Woods order of the 1950s and 1960s. In ensuring monetary stability the Fund played second fiddle to the dominant US dollar that served as the vehicle currency for international payments. It extended loans relatively rarely, its biggest client being Britain. The Bank also had a slow start. Having faced fatal competition from the Marshall Fund in its European operations, it was compelled to gradually shift its attention to Third World countries, and decidedly so after the creation in 1960 of the International Development Association (IDA), its concessional lending arm to low-income, mostly postcolonial members. This led to the expansion of Bank lending from public infrastructure projects to domains such as rural development and poverty alleviation by the 1970s, but for the majority of its clients its main policy impact still consisted of technical assistance.

What transformed the Fund and the Bank into organizations with more direct, substantive and increasingly controversial leverage over borrowing
governments was the international economic turbulence of the late 1970s and the 1980s. The debt crisis saw a surge of demand for official loans from developing members. In most cases, these loans came attached to comprehensive reform programs that reflected the emergent neoliberal policy principles in mainstream economics at the time.

It would be misleading to perceive this neoliberal turn as a mere ideational shift. Rather, the Washington Consensus facilitated an interlocking realignment of the normative, governmental, and intra-bureaucratic incentives over the core business of the IFIs. On the normative side, measures such as fiscal austerity, deregulation, trade opening, financial liberalization, and privatization neatly fit the fast-consolidating convictions in mainstream economics. They were easily framed as complementary recipes for addressing short-term macroeconomic imbalances while kick-starting a longer-term course correction for Third World economies toward a market-oriented developmental path. For influential Northern governments as well, the Washington Consensus was very appealing. It represented both a rapid diffusion of emergent policy norms originating from the Anglo-American core and the most efficient way of (partially) recovering the sovereign losses of Western commercial banks exposed to the debt crisis. Meanwhile, on the bureaucratic side, the Washington Consensus gave the Fund and Bank a straightforward template that allowed making loans to virtually any developing country with detailed but practically identical policy conditions. It thereby helped to standardize the design and monitoring of programs in a rapidly expanded client base.

Seen this way, the Washington Consensus transformed what we have identified as an otherwise complex operation into a relatively straightforward one. The outcome was an unprecedented degree of direct policy and institutional influence over scores of Third World and postsocialist members, rendering the period from the early 1980s to the mid-1990s a “golden age” for the IMF and the World Bank.

The Villains of Globalization?

As the IFIs’ transformative leverage increased, so did the scrutiny of their operations, with three major, interrelated strands of criticism steadily gaining ground. The first concerned the economic outcomes of IFI-led liberalization policies; the second focused on mechanisms of lending and problems of program implementation; the third questioned the governance structure of these organizations and the allegedly undue influence of their major shareholders.

By the early 1990s, there was already a burgeoning debate on the poor record of Fund-Bank programs, drawing on evidence from the preceding “lost decade” of stabilization and structural adjustment in Latin America and Sub-Saharan Africa (e.g., Killick 1995). Implementation results from postsocialist
economies and others in Asia and the Middle East throughout the 1990s confirmed this pattern of poor economic performance under IFI tutelage. This in turn squarely challenged the orthodox view that market-friendly Fund-Bank programs would deliver significant developmental gains, usually meant in the narrow sense of accelerated economic growth. To the contrary, several statistical analyses discovered a negative correlation between repeated IMF and World Bank adjustment loans and overall macroeconomic performance (Przeworski and Vreeland 2000; Easterly 2005; Dreher 2006; Stein 2008).

A related charge concerned the lending framework of these organizations and its effects on program implementation. At the core of the Fund and Bank's policy leverage is their long-standing preference for conditionality-based lending. Especially in IMF facilities, the emphasis had been on ex post conditionality, that is, a set of policies and reforms a borrowing government is asked to undertake after the start of a program, often specified in quantitative performance criteria (e.g., cut fiscal deficit or inflation by a certain percentage point by a certain date) and structural benchmarks (e.g., privatize a government firm or restructure pension policy). But studies have found that conditionality seldom achieved its objectives. Extensive evidence from programs in the 1980s and 1990s showed that policy compliance remained typically weak, leading to lapses in adjustment as defined by the IFIs. This largely explains why so many countries were stuck in repetitive cycles of Fund and Bank programs with similar conditions in a context of ever worsening macroeconomic fundamentals (Dreher 2005; Evrensel 2002).

External political influences over lending decisions have been a third major strand of criticism. Whereas the Fund's and Bank's governance structures openly favor major shareholders via larger voting rights, the institutions have long claimed impartiality toward borrowing governments. This means the size, conditions, and enforcement of a loan would depend on negotiations of a technical nature with borrowing governments alone; the preferences of other members are irrelevant. Yet evidence from Fund-Bank operations does not support this presumption of political insulation. In the Middle East, for example, US strategic priorities have cast a long shadow over IFI lending (Momani 2004; Harrigan et al. 2006). Programs in Latin America and postsocialist Europe were marked by a similar lack of autonomy, especially in the form of favoritism toward systemically significant countries (Pop-Eleches 2008). Even in Sub-Saharan Africa, a region of limited geostrategic importance to leading advanced states, “[c]ountries that have influence with developed-country patrons . . . [were] subject to less rigorous enforcement” (Stone 2004, 577). The Fund's and Bank's multilateralism and presumed autonomy were therefore sharply laced with the dynamic preferences of the largest shareholders and in particular the United States. The imbalance in voting rights translated into a vehicle for politicization, contradicting the organizations’ claim to accountability to the breadth of their membership.

The critical development in solidifying the three major criticisms outlined above was the string of emerging market financial crises from the mid-1990s
onward. On the one side, meltdowns in Mexico, Russia, Brazil, Turkey, and Argentina revealed the growing systemic vulnerabilities in countries that pursued policies of neoliberalism, especially financial openness. On the other side, and more crucially, was the IFIs’ involvement in the Asian Crisis of 1997, which most observers characterized as short-sighted and counter-productive. What followed from these episodes was an outpouring of public criticism, exemplified by stinging protests from former insiders such as Stiglitz (2002) and Easterly (2001) and by greater skepticism on the part of key donors, especially the United States (International Financial Institutions Advisory Commission 2000). In a few short years, questioning the Bretton Woods twins ceased to become the prerogative of radical academics and left-wing NGOs, as elite economists and international policymakers joined the chorus of the discontented.

The Fund and the Bank could not remain impervious to this wave of criticism. They did respond, mainly through revisions to their policy advice and lending framework. The most significant change was the gradual move away from hardline neoliberal orthodoxy in Fund-Bank prescriptions, and toward a revisionist policy blend known as the Post-Washington Consensus (PWC). By the mid-1990s, there was already a growing recognition within the agencies that their “market fundamentalist” approach failed to take into account the broad range of political constraints over economic policymaking as well as the social consequences of their development advice. This recognition led to a budding interest in issues such as acceptable forms of state interventionism, the perils of widespread corruption, and enduring problems of poverty and social dislocation. But only in the aftermath of the Asian Crisis of 1997 did this emergent concern for the social and political context of economic policy translate into a revised agenda of Fund-Bank prescriptions.

The PWC was, in essence, a paradigm broadening that mirrored the “social liberal” sensibilities of “Third Way” politics in the North. In its main character it was still deeply market-oriented; however, it differed from its predecessor, the orthodox neoliberalism of the Washington Consensus, by making two important qualifications. First, rather than narrowly focus on output growth, the Fund and especially the Bank now also emphasized social sustainability, with poverty alleviation and human development as core objectives. Second, the attainment of such high-quality growth was no longer seen as a function of adopting the right policies alone, but perhaps more so the acquisition of appropriate market-enhancing institutions. At the macro level, this corresponded to the Bank’s “good governance” agenda, which builds on the assumption that improvements in such broad domains as the rule of law, public transparency, political rights, and bureaucratic capacity should yield significant gains. At the micro level, there was more interest in sectoral and policy area-specific reforms, stretching from judicial and education infrastructure to financial regulation, corporate governance, labor markets, fiscal regimes, social safety nets, and so on (Burki and Perry 1998; Stiglitz 1998; World Bank 2002).
Paralleling this revised reform agenda were changes in the lending framework. On the one hand, and in an effort to deflect the stigma attached to the term “structural adjustment,” the IFIs rebranded their preexisting loan instruments with minor modifications that also reflected their broadened policy focus. The IMF discontinued its controversial Enhanced Structural Adjustment Facility (ESAF) toward low-income members, replacing it with the Poverty Reduction and Growth Facility (PRGF) in 1999. In a similar move, the Bank began using the term Development Policy Loan (DPL) to describe its policy-based lending operations instead of the ill-famed rubric, the Structural Adjustment Loan (SAL).

On the other hand, attempts toward more participatory, accountable, and realistic design of loan programs aimed at improving program compliance and counteracting the IFIs’ hardened image as foreign imposing tough policy measures. A key theme in that regard was “country ownership”—the quest to enlist stronger domestic political support for loan programs through wide-ranging consultations at the design stage with borrowing country politicians, bureaucrats, civil society organizations, and other stakeholders. A similar emphasis was placed on an initiative called “streamlining conditionality,” which sought to lower the number of loan conditions and refocus them on key areas of institutional competence given the rapid expansion of policy goals under the broad PWC agenda. Enhanced transparency, by making available some past and current program documents, also reflected the same broad context.

In retrospect, neither the social and regulatory focus of the PWC nor were the various revisions in lending practice sufficient to assuage the critics of the IMF and the World Bank. The PWC was attacked for expanding the mandate of the IFIs far beyond their capabilities (Barnett and Finnemore 2004, 72ff), for advocating a reform agenda that is too comprehensive to fulfill by governments already marked by low capacity (Grindle 2004), and for sidestepping the global dynamics underlying many of the problems it promises to remedy (Öniş and Şenses 2005). Meanwhile, efforts to increase “country ownership” were found to create new legitimacy dilemmas (Best 2007), and the “streamlining conditionality” initiative was declared a failure even by the IMF’s own Independent Evaluation Office (IEO 2007). Still, considerably less public attention was being paid to these enduring challenges than in previous years; the 2000s proved tumultuous for the organizations for reasons beyond any of these issues. The sharp twists in their fortunes reflected not problems of program design or implementation, but sea changes in the international economy.

A Turbulent Decade

An important feature of the 2000s until the crisis was that the Bretton Woods twins no longer seemed to be the crucial players in the global economy they had been in the 1980s and the 1990s. The conclusion of emerging market financial
shocks in the early 2000s ushered in an unprecedented period of expansion in trade and financial flows in the global economy. Awash with opportunities for private (and non-conditionality-based) lending, many developing countries, especially the well-integrated middle-income countries (MICs), which until then had served as the most lucrative clients of the organizations, turned away from official financing.

The Fund was hit hardest by the good times. In the absence of emergencies in major developing economies, it saw its outstanding member obligations decline dramatically, with new commitments collapsing to a record low of about $900 million by 2007, or less than the institution’s administrative overhead (IMF 2007, 36–38). The Bank also experienced a sharp reduction in its loan portfolio, from about $29 billion in 1999 to $18.5 billion in 2003 (World Bank 2004, 104). This trend came against the background of a remarkable growth performance in the developing world, with annual GDP increase in middle-income and low-income countries averaging a staggering 7.4 percent between 2003 and 2007. From their golden age in the mid-1990s to the lull before the storm in the mid-2000s, the institutions turned into considerably smaller operations, both nominally and relative to their traditional client base.

Their waning fortunes caused severe existential problems for the Fund and Bank. To begin, although the core capital of the organizations was provided principally by major non-borrowing members, that is, by the leading advanced economies, over time most of their running costs had come to be financed through interest income from loans (Woods 2006, 194ff). A sharp drop in the volume of lending thus left the agencies open to charges of excess capacity and organizational overstretching, which forced the IMF to downsize its staff by about 15 percent. Another problem concerned their policy influence and, by extension, their relevance as international organizations. Reduced lending, which in the IMF’s case stemmed from its exit as creditor from nearly all major developing economies, meant a structural decline in the institutions’ conditionality-based power over borrowing members and thereby an overall weakening of their transformative leverage. In that sense the Bank and in particular the Fund seemed on the path to de-evolving into their limited role in the international economy before the debt crisis. The irony was that after a quarter century of expansion and capacity building they now looked too large and costly for their new, comparatively humble role.

The global crisis of the late 2000s appears to have reversed these bleak prospects in dramatic fashion. Both organizations increased their lending by leaps and bounds to meet the record demand from members reeling from uncertainties in credit and export markets. Combined IBRD-IDA loans quickly doubled to an annual average of $50 billion in 2009–2011. Teetering on the verge of financial marginalization before the crisis, the IMF’s resurgence was the most impressive, with over $500 billion worth of total loan commitments...
from 2008 to 2012 (note, however, that less than half that amount has actually been disbursed).

What is curious about this sudden upswing in the IMF’s and World Bank’s fortunes is that so far it has resulted in minimal change in the three main areas of widespread criticism discussed in the previous section—policy content, lending framework, and governance structure. In terms of policy content, the crisis lending of the Fund and Bank has been informed mainly by their pre-crisis policy universe, with hardly any sign of extrication from the mixed PWC repertoire of macro stability, institutional reform, and social sustainability (Güven 2012). Nearly all recent Fund arrangements have advocated sweeping fiscal and banking reforms, with other popular PWC items such as pension, taxation, and transparency reforms receiving considerable emphasis in programs, especially in Sub-Saharan Africa and Central and Eastern Europe. In Bank loans as well, fisco-financial reform and social sustainability remain the most prominent themes (ibid. 873ff). In sharp contrast with previous episodes of systemic turbulence, such as the debt crisis that helped consolidate the Washington Consensus, and the emerging market financial shocks that served as a catalyst for the paradigm broadening toward the PWC, the crisis lending of the IFIs this time around has taken place largely in a context of prescriptive continuity. The only notable exceptions are both institutions’ permissive attitude toward countercyclical policy (Keynesian fiscal stimulus) during the early stages of the crisis and the reluctant embrace of capital controls in some Fund reports at the height of the global imbalances debate in 2010. But in hindsight these divergences should be seen as ad hoc responses to what was already taking place on the ground. It is hard to imagine that either policy will ever be incorporated into the IFIs’ standard repertoire.

In lending instruments and governance structure, there are indeed elements of change, but not of a genuinely transformative kind. World Bank lending continues to be divided between investment projects and policy loans (DPLs). The IMF, however, unveiled several new lending instruments since 2009, including the Flexible Credit Line (FCL) toward countries with strong macro fundamentals, and the Extended Credit Facility (ECF), which replaced the PRGFs. It also discontinued structural performance criteria (hard conditionality) in its traditional Stand-By Arrangements (SBAs). While these measures look promising, upon closer inspection they hardly represent a major change for the Fund’s borrowers. The FCL, which has accounted for more than half of Fund commitments for the past three years, remains unused. The three countries that are in the FCL group (Colombia, Mexico, and Poland) are reluctant to access the funds for fear of affirming trouble and scaring away investors. Meanwhile the ECF for low-income members comes attached to strong conditions similar to the old SBAs. The discontinuation of hard conditionality, announced with much excitement, is also more apparent than real. True, performance criteria have
been abolished, yet they are now replaced with “program reviews” that still take into account “structural measures” and “quantitative conditions.” In short, the Fund continues to wield significant control over the terms of its lending and the policies its borrowers pursue under loan programs, as illustrated in its recent dealings in Southern Europe.

The much-needed reforms in the governance of the Fund and Bank are also evolving very slowly and are so far limited in scope. The fundamental concern here has been the over-representation of Northern (especially European) powers at the expense of developing and emerging nations whose share of the world economy increased significantly over the past decade. Critics have long argued that it is this skewed representation pattern that accounted for much of the institutions’ legitimacy gap and accountability problems. Some progress has been made over the past few years, but the results are cosmetic at best. A voice reform in the World Bank in 2010 shifted less than 5 percent of voting rights to developing countries, with nearly 60 percent still remaining with high-income economies; the next round of negotiations will not take place until 2015. A reform of similar magnitude had taken place in the IMF in 2008 but a further deal in 2010, which proposed the transfer of two Executive Board seats from European to emerging and developing powers in addition to changes to the appointment procedure of board members, has been blocked by the US Congress.

The Challenge Ahead

The IMF and the World Bank have entered the present decade with a policy repertoire, lending philosophy, and governance structure inherited predominantly from their heyday in the late twentieth century. In policy they continue to advocate comprehensive reforms whose main purpose is to provide suitable domestic environments for uninterrupted market-driven globalization, recently with some concern for regulatory and social sustainability. In lending framework they prefer to make loans based on stringent conditionality as the main guarantor of their transformative leverage. And their governance, despite efforts toward more equitable representation of their membership, lags far behind the shifts in the global distribution of economic and political power. This is not to say that the Fund and Bank are frozen in time; progress has been made in each of these fronts. But the normative, organizational, and political contexts within which the institutions operate do not seem to permit breakthrough changes. An invisible shield, resilient if not impenetrable to reform initiatives, seems to surround the conventional parameters of their existence.

One obvious upshot of this relative continuity in Fund-Bank practices is that many of the criticisms leveled against them remain pertinent today. A
vivid illustration is the IMF’s recent involvement in the Eurozone crisis. Countries endowed with limited competitive punch in their productive sectors for sustainable international market integration but were nonetheless lulled into a false sense of security in the heyday of unruly, finance-led globalization are now required to implement orthodox neoliberal austerity packages that carry all the hallmarks of standard Fund programs in the developing world in previous decades. The outcome so far is not unfamiliar: the “bitter pill” of negative growth, ever-increasing debt, and massive social suffering. As usual, the loans provided are tied to strict qualitative and quantitative conditions that leave little leeway for borrowers. And acting as part of the triumvirate (alongside the EU and the European Central Bank), the Fund once again finds it difficult to extricate itself from the strategic preferences of its larger shareholders, in this instance particularly Germany.

Crucially, the lack of reform momentum in the Fund and Bank is just as big a threat to the institutions themselves. The key problem here is their declining policy influence over emerging powers—large middle-income countries (MICs) that have increased their economic and political might considerably over the past decade. This constraint is abundantly clear in the Fund’s case. The emerging economies have been the main drivers of global growth since the crisis, but they do not count much in the Fund as either borrowers or shareholders. The slow pace of voting reforms that would give these countries more voice in the institution has already been discussed. It is equally noteworthy that for the past decade large developing countries are making a point of avoiding Fund lending. Brazil and Argentina repaid their loans early in 2003–2004, and Turkey was the last remaining large MIC client until its program concluded in 2008. Since then, and despite the global crisis, the Fund has been unable to lend to any major emerging country, including such hard-hit cases like Russia and Mexico, the latter having signed up for but never tapped into a precautionary FCL. Consequently, the bulk of the IMF’s crisis lending has been oriented toward smaller economies that on their own are not systemically significant—three minor Eurozone countries (Greece, Ireland, and Portugal), a few others in the European semi-periphery (Hungary, Romania, and Ukraine), and a very large number of (more than 50) low-income and lower middle-income economies in Africa, Asia, and Latin America.

The Bank’s involvement in emerging powers is somewhat more complicated. On the one hand, large MICs are still the Bank’s bread and butter. During the crisis, from 2007 to 2010, IDA commitments rose by only 25 percent, whereas IBRD commitments tripled to over $44 billion, due in part to the surge in lending to the Bank’s traditional “big seven” borrowers, that is, Argentina, Brazil, China, India, Indonesia, Mexico, and Turkey (Güven 2012, 876–9). On the other hand, and unlike the Fund’s more standard recipes, large countries seem to have gained more control over how much and what kind of policy conditions
come attached to Bank loans. India and in particular China access Bank funds principally toward infrastructure investment, while in Latin America there is considerable emphasis on social protection and the environment. PWC-inspired loans heavy in policy and institutional reform are more common in smaller borrowers in Sub-Saharan Africa and Central and Eastern Europe; unsurprisingly, these happen to be regions where the Fund is also actively involved.

The point is that emerging powers have grown unmistakably reluctant to relate to the IFIs on a conditionality basis. The wealthier and more self-confident they get, the less palatable it becomes for them to accept policy guidance from organizations within which they have little voice. This in turn engenders two problems for the IFIs. The first, to zoom out a decade, is about their financial fortunes. The MICs have traditionally been the IFIs’ most lucrative clients, and their declining demand for official funds in the 2000s before the crisis had threatened the organizations profoundly. The same situation will likely catch up with the organizations once again. IBRD lending is already returning to pre-crisis levels, from $44 billion in 2010 to $26 billion and $20 billion in 2011 and 2012, respectively. Meanwhile the Fund’s handful of large non-Eurozone facilities are drawing to a close, and once (or, if) the Eurozone crisis is over, the organization is set to encounter precisely the same problem it did in the mid-2000s, that is, a clientele which may be too small to sustain its business.

The second problem is more immediate, and admittedly more important for the rest of us. For all their flaws, the IMF and the World Bank are still the two largest platforms of global economic governance. Their remit goes beyond one-on-one dealings with member governments. The World Bank’s motto is “working for a world free of poverty.” The IMF is expected to assist in the efforts to strengthen the global financial regulatory regime and in the attempts to address the sticky problem of global imbalances. Neither organization can hope to play an effective coordinating role in these areas without directly connecting with the rising nations. Yet if the only form of engagement they could offer to these countries is the old-fashioned, paternalistic conditionality-based lending and an unfair structure of representation, that is no engagement at all. How can the World Bank hope to tackle global poverty without bringing large MICs actively into the fold when Chinese banks alone commit more funds in Latin America and Africa than IBRD-IDA, when Brazil, Russia, India, China and South Africa are setting up their own BRICS development bank, and when most rising powers have already made the transition from being recipients to major donors of international aid (Mawdsley, 2012)? If conditionality remains the principal (if not the only) instrument for the IMF to exert policy influence, can it reasonably address surplus countries such as China on the issue of global imbalances? What chance does it have to bring large MICs on board to coordinate efforts to reform the global financial regulatory regime when its governance structure is monopolized by the countries that are responsible for
the ongoing financial turmoil and yet remain reluctant to rein in unruly banks and hedge funds? These questions become more vexing when one considers increased emerging power participation in other global fora such as the G20 and the Financial Stability Board.

Ultimately, what the IFIs need to do to remain relevant in the changing global power architecture is not so different than the agenda of organizational reforms most of their critics on the left have long been prescribing. The orthodox policy rigidity inherited from the Washington Consensus era must be permanently abandoned, and the regulatory and social focus of the PWC must be both deepened and expanded. This would require a further round of paradigm broadening to embrace heterodox policies, but not just temporarily to counter emergencies as illustrated in the timid approval of Keynesian interventionism at the height of the global crisis. Rather, policy diversity and innovation must be systematically encouraged. At the same time, opportunities for feasible policy and institutional transfer, especially from effective developmental and redistributive experiments in emerging countries, should be explored. Such a flexible approach would also entail a comprehensive rethinking of lending instruments and conditionality, which should insist less on short-term quantitative criteria and the implementation of singular reforms, and more on sociopolitical feasibility and long-term outcomes. Finally, governance reforms in both organizations must be expedited to better reflect the ongoing shift in the balance of global economic power.

There is no shortage of obstacles to this demanding agenda either from within or outside the institutions. But before dismissing these proposals as utopian, we should bear in mind that the IFIs have already been moving broadly in these directions for the past 15 years, albeit at a slow pace. The secular threat of curtailed financial capacity and diminished policy leverage due to their growing disconnection from emerging powers might very well accelerate this process, with tangible gains for global economic coordination.

References


Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements

Kevin P. Gallagher

This article examines the extent to which measures to mitigate the current financial crisis and prevent future crises are permissible under a variety of bilateral, regional and multilateral trade and investment agreements. US trade and investment agreements, and, to a lesser extent, the World Trade Organization, leave little room to manoeuvre with capital controls, despite increasing evidence that certain controls can prevent or mitigate crises. Investment rules under the treaties of most capital-exporting nations allow for at least the use of temporary controls as a safeguard measure. The article offers a range of policies that could be deployed to improve US investment rules.

Key words: Financial crises, trade agreements, capital controls

1 Introduction

At least since the Great Depression of the 1930s, and very much so in the run-up to and the wake of the current financial crisis, some nations have relied on capital controls as one of many possible tools to mitigate or prevent the financial instability that can come with short-term inflows and outflows of capital. In the bubble years before the current crisis became acute, nations such as China, Colombia, India and Thailand regulated inflows of capital in order to stem these bubbles. When the crisis hit, countries like Iceland, Indonesia, Russia, Argentina and Ukraine put capital controls on outflows of capital to ‘stop the bleeding’ related to the crisis (International Monetary Fund, 2009).

As will be shown in this article, the economic evidence is fairly strong about the use of capital controls, especially on a temporary basis. However, there is concern that the myriad trade and investment treaties across the world may prohibit the use of measures to prevent and mitigate financial bubbles and subsequent crises. A number of studies examine the policy space for industrial development, but very few examine that for measures pertaining to financial stability (Kolo and Wilde, 2009; Shadlen, 2005; Gallagher, 2005; Anderson, 2009a and b; Mayer, 2009). This article conducts a comparative analysis to pinpoint the extent to which nations have the policy space for capital controls in the world economy.

The major findings of this research are shown in Table 1. Policy space under the World Trade Organization, US bilateral investment treaties (BITs) and free trade...
agreements (FTAs), and other BITs and FTAs by other capital-exporting countries is presented. Under no regime are capital controls permitted for current transactions unless they are sanctioned by the International Monetary Fund. For the capital account, however, there is interesting variation.

**Table 1: Policy space for capital controls: a comparison**

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<td>no</td>
<td>yes*</td>
</tr>
<tr>
<td>capital</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>inflows</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>outflows</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td><strong>No. of countries covered</strong></td>
<td>69</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td><strong>Dispute resolution format</strong></td>
<td>state-to-state</td>
<td>investor-state</td>
<td>investor-state</td>
</tr>
<tr>
<td><strong>Enforcement instrument</strong></td>
<td>retaliation</td>
<td>investor compensation</td>
<td>investor compensation</td>
</tr>
</tbody>
</table>

Notes: a) capital controls fully permissible for countries that have not committed to liberalising cross-border trade in financial services; b) permitted only under IMF approval.

The WTO allows for countries to deploy capital controls on both inflows and outflows as long as they have not committed to the liberalisation of certain financial services. If a country has made commitments in financial services, restrictions on inflows are not permitted. However, it will be shown that there are safeguard measures that may apply. In terms of recourse, if a country that has liberalised financial services does restrict capital inflows or outflows, it could be subject to a dispute panel that could rule that the measures be brought against it.

US BITs and FTAs do not permit restrictions on inflows or outflows. If a country does restrict either type of capital flow, it can be subject to investor-state arbitration whereby the government of the host state would pay for the ‘damages’ accrued by the foreign investor. The BITs and FTAs of other major capital exporters such as those negotiated by the European Union, Japan, China and Canada, either completely ‘carve out’ host-country legislation on capital controls (hence permitting them) or allow for a temporary safeguard on inflows and outflows to prevent or mitigate a financial crisis. The US does not have either measure. However, a handful of FTAs have recently allowed for a grace period under which foreign investors are not allowed to file claims against a host state until after the crisis period has subsided.
Following this brief introduction, the article is divided into four more sections. Section 2 provides a brief overview of the economic theory, policy and evidence regarding capital controls. Section 3 examines policy space for capital controls under the WTO. Section 4 conducts a comparative analysis that juxtaposes US treaties alongside the WTO and the regional and bilateral treaties of other major capital-exporting countries. Section 5 summarises the key findings and offers policy recommendations.

2 Capital-account liberalisation and capital controls: theory and evidence

Advocates for capital-market liberalisation argue that, by liberalising the flows of international capital, developing countries would benefit by getting access to cheaper credit and investment from developed markets, thus promoting growth and stability. Indeed, conventional theory implies that investment tends to flow to developing countries, where the marginal returns may be higher (Barro, 1997). This view, based on the assumption of perfect capital markets, has been largely discredited by the recent experiences of currency crises (Ocampo et al., 2008). International capital flows tend to be pro-cyclical, creating excess inflows during booms, and causing capital flight in moments of instability, thus further aggravating crises.

Moreover, it has been shown that capital-market liberalisation in developing countries is not associated with economic growth (Prasad et al., 2003). Indeed, the most recent research has shown that capital-market liberalisation is associated with growth only in countries that have reached a certain institutional threshold – a threshold that most developing countries have yet to achieve (Kose et al., 2009). This is partly due to the fact that the binding constraint for some developing-country growth trajectories is not the need for external investment, but the lack of investment demand. This constraint can be accentuated through foreign capital flows because such flows appreciate the real exchange rate, thus reducing the competitiveness of goods and reducing private-sector willingness to invest (Rodrik and Subramanian, 2009).

Capital controls have been found to stabilise short-term volatile capital flows: they can give policy-makers additional policy instruments that allow them more effective and less costly macroeconomic stabilisation measures; they can promote growth and increase economic efficiency by reducing the volatility of financing and of real macroeconomic performance; and they can discourage long-term capital outflows (Ostry et al., 2010). The literature on capital controls generally discusses at least six (somewhat overlapping) core reasons why nations may want to deploy them (Magud and Reinhart, 2006). These can be referred to as ‘the six fears’ of capital flows:

(i) **fear of appreciation.** Capital inflows cause upward pressure on the value of the domestic currency, making domestic producers less competitive in the international market, and hurting exports and therefore the economy.

(ii) **fear of ‘hot money’**. The large injection of money into a small economy may cause distortions, and eventually a sudden reversion if foreign investors try to leave simultaneously.
(iii) **fear of large inflows.** Large volumes of capital inflows, even if not all hot money, can cause dislocations in the financial system.

(iv) **fear of loss of monetary autonomy.** A trinity is always at work. It is not possible to have a fixed (or highly managed) exchange rate, monetary policy autonomy and open capital markets. Specifically, when central banks intervene in the exchange market, buying foreign currency in order to curb the appreciation of the exchange rate, they effectively increase the domestic monetary base. Trying to raise interest rates to offset this effect causes more capital inflows, as foreign investors rush in to take advantage of higher yields.

(v) **fear of asset bubbles.** Raised by Ocampo and Palma (2008), this was a particularly important issue in the 2008 financial crisis, since the bursting of the real-estate bubble was the root cause of the banking crisis around the globe.

(vi) **fear of capital ‘flight’.** Capital may rapidly leave a country in the event of a crisis or because of contagion (Grabel, 2003; Epstein, 2005).

Table 2 presents a sample of various types of capital controls that have been deployed by countries to address these fears.

**Table 2: Capital controls and capital-management techniques**

<table>
<thead>
<tr>
<th>Inflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on currency mismatches(^a)</td>
</tr>
<tr>
<td>End use limitations(^b)</td>
</tr>
<tr>
<td>Unremunerated reserve requirements(^c)</td>
</tr>
<tr>
<td>Taxes on inflows</td>
</tr>
<tr>
<td>Minimum stay requirements</td>
</tr>
<tr>
<td>Limits on domestic firms and residents borrowing in foreign currencies</td>
</tr>
<tr>
<td>Mandatory approvals for capital transactions</td>
</tr>
<tr>
<td>Prohibitions on inflows</td>
</tr>
<tr>
<td>Outflows</td>
</tr>
<tr>
<td>Limits on ability of foreigners to borrow domestically</td>
</tr>
<tr>
<td>Exchange controls</td>
</tr>
<tr>
<td>Taxes/restrictions on outflows</td>
</tr>
<tr>
<td>Mandatory approvals for capital transactions</td>
</tr>
<tr>
<td>Prohibitions on outflows</td>
</tr>
</tbody>
</table>

Notes: a) borrowing abroad only allowed for investment and foreign trade; b) only companies with foreign currency reserves can borrow abroad; c) percent of short-term inflows kept in deposit in local currency for specified time.

Sources: Ocampo et al. (2007); Epstein et al. (2008).

Economists usually differentiate between controls on capital inflows and outflows. Moreover, measures are usually categorised as being ‘price-based’ or ‘quantity-based’ controls. Table 2 lists examples of controls on inflows and outflows, though sometimes the distinction can be murky (Epstein et al., 2008; Ocampo et al., 2007). Examples of quantity-based controls are restrictions on currency mismatches, and minimum-stay
requirements and end-use limitations. Many of these have been used by countries such as China and India. Examples of price-based controls include taxes on inflows (Brazil) or outflows (Malaysia). Unremunerated reserve requirements (URR) are both. On the one hand, they are price-based restrictions on inflows, but they also include a minimum-stay requirement which can act like a quantity-based restriction on outflows.

Controls are most often targeting foreign-currency and local-currency debt of a short-term nature. Foreign direct investment (except for FDI in the financial sector) is often considered less volatile and worrisome from the standpoint of macroeconomic stability. Inflow restrictions on currency debt can reduce the overall level of such borrowing and steer investment towards longer-term productive investments and thus reduce risk. Taxes on such investment cut the price differential between short- and long-term debt and thus discourage investment in shorter-term obligations. Outflow restrictions and measures are usually deployed to ‘stop the bleeding’ and keep capital from leaving the host country too rapidly.

**Table 3: Literature on the effectiveness of capital controls**

<table>
<thead>
<tr>
<th>Controls on inflows</th>
<th>Reduce the volume of capital flows?</th>
<th>Alter the composition of flows?</th>
<th>Reduce real exchange-rate pressures?</th>
<th>Make monetary policy more independent?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Unclear</td>
<td>Yes</td>
<td>No</td>
<td>Unclear</td>
</tr>
<tr>
<td>Chile</td>
<td>Unclear</td>
<td>Yes</td>
<td>Unclear</td>
<td>Yes</td>
</tr>
<tr>
<td>Colombia (1993)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Colombia (2007)</td>
<td>No</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>No</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia (1989)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Malaysia (1994)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Thailand</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Croatia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Controls on outflows</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia (1998)</td>
<td></td>
<td></td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Spain</td>
<td>Unclear</td>
<td>Unclear</td>
<td>Unclear</td>
<td>Yes</td>
</tr>
<tr>
<td>Thailand</td>
<td>Yes</td>
<td>Unclear</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Multi-country studies</td>
<td></td>
<td></td>
<td></td>
<td>No</td>
</tr>
</tbody>
</table>

Source: Magub and Reinhart (2006); IMF (2010).

The literature on the effectiveness of capital controls is too vast to cover here. However, two comprehensive assessments have recently been conducted. In sum, the literature strongly supports the use of capital controls on inflows. Evidence on outflows is more controversial. Magud and Reinhart (2006) conduct the most assessment of the literature to 2006. In their analysis, they express concern over the lack of a unified theoretical framework to analyse the macroeconomic consequences of the controls, the
heterogeneity of countries and control measures, the multiplicity of policy goals and what constitutes ‘success’. As most studies investigate a few country cases (mainly Chile and Malaysia), it is difficult to make generalised conclusions from the literature in the field. Theirs is the most valiant attempt to overcome these shortcomings. What is more, they also ‘weight’ the findings in the literature with respect to their econometric rigour.

To summarise, say Magud and Reinhart, ‘capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows and reduce real exchange rate pressures’. In terms of outflows, it is clear that such provisions were successful in Malaysia, but it is not so clear in the case of other countries.

In a February 2010 Staff Position Note, the IMF staff reviewed all the evidence on capital controls on inflows, pre- and post-crisis and concluded:

capital controls – in addition to both prudential and macroeconomic policy – are justified as part of the policy toolkit to manage inflows. Such controls, moreover, can retain potency even if investors devise strategies to bypass them, provided such strategies are more costly than the expected return from the transaction: the cost of circumvention strategies acts as ‘sand in the wheels’.

To come to this conclusion, this recent and landmark IMF study reviews the experiences of post-Asian-crisis capital controls. In addition, the IMF conducted its own cross-country analysis in this study, which also has profound findings. The econometric analysis examined how countries that used capital controls fared versus countries that did not use them in the run-up to the current crisis. It found that countries with controls fared better: ‘the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility’ (ibid.: 19).

There has even been some attention by prominent economists to the need for restrictions on outflows. Calvo (2009) argues that capital controls could be deployed to dampen the impact of capital flight during crises. Even in ‘normal’ times, however, he argues that prudential regulations should sometimes be coupled with foreign-exchange restrictions to reduce capital flight.

To summarise, there is an emerging consensus in the economics profession regarding capital controls. Capital controls, especially those on inflows, are increasingly seen as a prudential measure for developing countries hoping to prevent and mitigate financial crises.

3 Policy space for capital controls at the WTO

This section examines the extent to which the WTO grants nations the policy space to deploy capital controls. The key of WTO law that covers capital flows is the General Agreement on Trade in Services (GATS). The GATS is currently the only binding multilateral pact that disciplines capital controls, though specific countries may have certain freedoms if their governments in place in the 1990s did not make widespread commitments in the financial-services sector. More specifically:
A member is most protected from a WTO challenge over capital controls if it committed no financial-services sectors to GATS coverage in any mode.

However, even countries that have made widespread commitments in financial services may have recourse – if challenged – to various exceptions, although these have not been tested and the record of WTO exceptions in other contexts is not reassuring.

The policy space for controls on current-account transactions defers to the IMF.

### 3.1 The General Agreement on Trade in Services (GATS)

The GATS is part of the Marrakesh Treaty that serves as an umbrella for the various agreements reached at the end of the Uruguay Round of GATT negotiations that established the WTO. It provides a general framework disciplining policies ‘affecting trade in services’ and establishes a commitment for periodic future negotiations. The GATS is divided, on the one hand, into a part on ‘General Obligations’, which binds all members. These include the obligation to provide most-favoured-nation treatment to all WTO members (Article II), and some disciplines on non-discriminatory domestic regulations that are still being fully developed (Article VI).

On the other hand, the GATS also includes a part dealing with ‘Specific Commitments’, which apply only to the extent that countries choose to adopt them by listing them in their country-specific schedules. These cover primarily the disciplines of Market Access (Article XVI) and National Treatment (Article XVII) (Raghavan, 2009).

Numerous annexes cover rules for specific sectors: the Annexes on Financial Services are of particular relevance for capital controls. However, trade in services occurs across the four services modes discussed in the GATS in general:

- **Mode 1: Cross-border supply** is defined to cover services flows from the territory of one member into the territory of another member (for example, banking or architectural services transmitted via telecommunications or mail).

- **Mode 2: Consumption abroad** happens when the consumer travels outside the country to access a service such as tourism, education, health care and so forth.

- **Mode 3: Commercial presence** occurs when the user of a financial service is immobile and the provider is mobile, implying that the financial-service supplier of one WTO member establishes a territorial presence, possibly through ownership or lease, in another member’s territory to provide a financial service (for example, subsidiaries of foreign banks in a domestic territory).

- **Mode 4: Presence of natural persons** is when financial services are supplied by individuals of one country in the territory of another.

IMF analysts have found that about 16 countries have significant Mode 1 commitments in financial services, while around 50 each have significant Mode 2 and 3 commitments for the sector. This includes most OECD countries (Valckx, 2002; Kireyev, 2002).

Generally speaking, GATS negotiations and commitments follow a ‘positive list’ approach, whereby countries only commit to bind specified sectors to GATS disciplines. This stands in contrast with a ‘negative list approach’, which is more common for goods negotiations and in most FTAs. In a negative list or ‘top-down’
approach, negotiators assume that all sectors will be covered in some way, apart from a handful that are listed by particular countries.

WTO members have recourse to binding dispute-settlement procedures, where perceived violations of GATS commitments can be challenged and retaliatory sanctions or payments authorised as compensation.

### 3.2 Capital-account liberalisation, capital controls and GATS

Unbeknownst to many, GATS commitments require the simultaneous opening of the capital account. Those countries that make commitments under Modes 1 and 3 for financial services are required to permit capital to flow freely to the extent that it is an integral part of the service provided – though some exceptions may apply. GATS Article XVI on Market Access contains a footnote (8) that references capital liberalisation:

> 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 [i.e. Mode 1] and if the cross-border movement of capital is an essential part of the service itself, *that Member is thereby committed to allow such movement of capital.* 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 [i.e. Mode 3], *it is thereby committed to allow related transfers of capital into its territory.* (emphasis added)

While Modes 1 and 3 are explicitly referred to here, Article XI, paragraph 2 also refers to capital liberalisation:

> 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)

Taken together, these provisions indicate that a country that makes GATS financial-service commitments in the modes of cross-border trade (Mode 1) and establishment of commercial presence (Mode 3) may explicitly be required to open its capital account. In such instances, the country’s ability to deploy capital controls related to capital inflows would be restricted. The text is silent on whether capital controls related to capital outflows are similarly disciplined.

As an aside, capital-account transactions are not restricted under the IMF Articles Agreement, and thus countries are free to choose whether capital controls are part of their arsenal to prevent and mitigate financial crises. However, a distinction needs to be made with respect to financial services and capital flows. Under the GATS countries liberalise specific types of financial services, such as banking, securities, insurance and
so forth – which does not necessarily imply capital movements or changes in fundamental capital-account regulation.

However, there are scenarios where the liberalisation of financial services will require an open capital account. The IMF cites the following Mode 1 example, where ‘a loan extended by a domestic bank to a foreign customer using internationally raised capital creates international capital flows and international trade in financial services. To the extent that a financial services transaction involved an international capital transaction, the capital account needs to be opened for the former to take place freely’ (Kireyev, 2002). Another study by an IMF official provides examples of how the GATS Mode 1 essentially requires the liberalisation of a capital account:

to the extent that a member restricts its residents from borrowing from non-residents, a member’s commitment to allow banks of other members to provide cross-border lending services to its nationals would require a relaxation of this restriction. Similarly, if a member also makes a commitment to permit non-resident banks to provide cross-border deposit services, such a commitment would require the member to liberalise restrictions it may have imposed on the ability of residents to hold accounts abroad. In these respects, the GATS serves to liberalise the making of both inward and outward investments. (Hagan, 2000)

This is echoed in a recent book by Sydney Key who says: ‘The bottom line is that if a country makes a commitment to liberalise trade with respect to a particular financial service in the GATS, it is also making a commitment to liberalise most capital movements associated with the trade liberalisation commitment’ (2003: 963). The WTO, in a recent Note (2010), quoted from Key’s work to make the same point. In other words, liberalising cross-border trade in financial services (Mode 1) may need an open capital account to facilitate such trade, which, of course, results in international capital flows. A similar scenario can be outlined in terms of Mode 3 liberalisation. A loan extended by a foreign bank to a domestic client requiring capital to be transferred from the parent company of the foreign bank to its subsidiary abroad would also require an open capital account. In any event, it is worth noting that WTO panels are not bound by the IMF’s distinction between service transactions and capital flows.

If a country has not listed cross-border trade in financial services (Mode 1) or commercial presence of foreign services (Mode 3), that country may be free to deploy capital controls as it sees fit. Indeed, numerous developing countries have not ‘listed’ the liberalisation of cross-border trade in financial services nor Mode 3 commitments under the GATS. According to the WTO, the majority of them made relatively fewer commitments in financial services related to capital markets (WTO, 2010).

It is also possible that certain types of measures may be more GATS-compliant than others. Article XVI, paragraph 2 is seen as a non-exhaustive list of the types of financial services whereby a host nation ‘shall not maintain’ restrictions on the flow of capital. The list does not explicitly mention any of the capital controls and other capital-management techniques found in Table 2 of this study. A case could therefore be made that capital controls of the kind shown in Table 2 are not even covered by the GATS.
If a country’s capital controls were found to be in violation of its GATS commitments, it could invoke one or more exceptions in the GATS text. A first option would be to claim that the measure was taken for prudential reasons under Article 2 (a) of the Annex on Financial Services. This exception reads:

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.

Inflows controls such as unremunerated reserve requirements or inflows taxes could be argued to be of a prudential nature, especially given the new IMF report discussed earlier. However, the sentence stating that prudential measures ‘shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement’ is regarded by some as self-cancelling and thus of limited utility (Tucker and Wallach, 2009; Raghavan, 2009). Others, however, do not see the measure as second-guessing but rather ‘as a means of catching hidden opportunistic and protectionist measures masquerading as prudential’(Van Aaken and Kurtz, 2009). Yet others point out that, in contrast with other parts of the GATS that require a host nation to defend the ‘necessity’ of the measure, there is no necessity test for the prudential exception in the GATS. This arguably gives countries more room to deploy controls. Indeed, Argentina lost cases related to controls under BITs because they failed such a ‘necessity test’ (Burke-White, 2008). Countries have requested that the WTO elaborate on what is and is not covered in the prudential exception, but such requests have fallen on deaf ears (Cornford 2004). And at the time of writing, the prudential exception has not been tested.

If a country’s capital controls were found to be in violation of its GATS commitments in financial services, it could also invoke Article XII ‘Restrictions to Safeguard the Balance of Payments’. Paragraph 1 of Article XII states:

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 recognised 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.

The next paragraph specifies that such measures can be deployed as long as they do not discriminate among other WTO members, are consistent with the IMF Articles (thus pertaining only to capital-account controls), ‘avoid unnecessary damage’ to other
members, do ‘not exceed those necessary’ to deal with the balance-of-payments problem, and are temporary and phased out progressively.

It may be extremely difficult for a capital control to meet all of these conditions, especially the hurdles dealing with the notion of ‘necessity’ – a slippery concept in trade law that countries have had difficulty proving. Moreover, concern has been expressed about the extent to which the balance-of-payments exception provides countries with the policy space for restrictions on capital inflows that are more preventative in nature and may occur before ‘serious’ balance-of-payments difficulties exist (Hagan, 2000). If a country does choose to use this derogation, it is required to notify the WTO’s Balance-of-Payments Committee (described below).

Table 4 lists the 36 nations that have committed to scheduling the liberalisation of some combination of Modes 1, 2, and 3 under the GATS (Valckx, 2002). They would be the most prone to being disciplined under the GATS. Finally, there is not a reassuring record of countries being able to invoke exceptions at the WTO.

**Table 4: Countries most vulnerable to actions against capital controls under GATS**

<table>
<thead>
<tr>
<th>Countries</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Japan</td>
<td>Panama</td>
</tr>
<tr>
<td>Australia</td>
<td>Kuwait</td>
<td>Philippines</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Kyrgyz Republic</td>
<td>Qatar</td>
</tr>
<tr>
<td>Canada</td>
<td>Latvia</td>
<td>Romania</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Macau</td>
<td>Sierra Leone</td>
</tr>
<tr>
<td>Estonia</td>
<td>Malawi</td>
<td>Singapore</td>
</tr>
<tr>
<td>Gabon</td>
<td>Mauritius</td>
<td>Solomon Islands</td>
</tr>
<tr>
<td>Gambia</td>
<td>Mongolia</td>
<td>South Africa</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Mozambique</td>
<td>Switzerland</td>
</tr>
<tr>
<td>Hungary</td>
<td>New Zealand</td>
<td>Tunisia</td>
</tr>
<tr>
<td>Iceland</td>
<td>Nigeria</td>
<td>Turkey</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Norway</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td></td>
<td></td>
<td>United States</td>
</tr>
</tbody>
</table>

Source: Valckx (2002).

### 3.3 Capital controls and current transactions

Capital controls on the inflows or outflows of dividends, interest payments and the like are *current-account* restrictions. Remember that, as a rule, the IMF Articles of Agreement do not permit current-account restrictions. However, the IMF may recommend diversion from those rules during a crisis and/or under an IMF financial programme. In these circumstances, Article XI, paragraph 2 of the GATS applies. It states that the IMF has jurisdiction over these types of circumstances and the GATS
does not apply. Therefore, when a country is permitted by the IMF as part of an IMF financial programme to pursue capital controls on current transactions, as has been the case with Iceland in 2008-9, then the WTO has no jurisdiction over the use of controls.

When a country seeks to pursue capital controls related to the current account and such actions are not part of an IMF financial programme, it has the potential to do so but has to submit a request to the WTO’s Balance-of-Payments Committee.

3.4 The Balance-of-Payments Committee

Any capital control involving capital- or current-account restrictions must be submitted to the Committee on Balance-of-Payments Restrictions, which was established for the earlier BOP safeguard under the GATT, and was traditionally responsible for consultation dealing with trade restriction for balance-of-payments purposes. The same body and procedures now apply to financial and other services.

The Committee has never pronounced on any current- or capital-account restrictions related to financial services, but the GATS text specifies that consultations related to these matters can evaluate whether the capital management techniques (CMT) meet the various criteria outlined above, whether ‘alternative corrective measures … may be available’, and ‘in particular’ whether the measure is progressively phased out.

This is a unique procedure in the GATS. While the WTO compatibility of a country’s domestic policy is normally tested only through formal dispute-settlement proceedings, CMTs face an additional set of hurdles and proceedings under Article XII.

Returning to some of the key questions outlined above, the following can be said about the WTO in relation to capital controls. While the WTO’s financial-services provisions remain untested in formal dispute settlement, they nonetheless represent the world’s only multilateral body with enforcement capacity to discipline capital controls, on terms that provide less policy space than the IMF Articles of Agreement. Capital controls may be disciplined under the WTO for approximately 50 of its members. If a country has made commitments in financial services, restrictions on inflows are explicitly mentioned in the market-access provisions of the GATS (though not one capital control is explicitly listed in the non-exhaustive list) but outflows may also be covered. In terms of compliance, the potential penalty for non-compliance is sustained cash payments or cross-retaliation rights to a large set of complaining countries. When countries file claims, the dispute-resolution process is ‘state-to-state’ rather than ‘investor-state’ which will be discussed later in this article.

4 Capital controls in US trade and investment treaties

The US has engaged in investment treaty-making since its War of Independence through what were called Friendship, Commerce and Navigation treaties. The successors to these agreements are bilateral investment treaties (BITs), which the US has been negotiating since 1977. The US did not invent BITS; Europeans have BITS going back to 1959. Indeed, there are now close to 2000 BITS in existence. Beginning with NAFTA in 1994, US Free Trade Agreements also have investment provisions
analogous to those found in BITs. Finally, BITs and FTAs also include provisions on financial services.

The US has concluded 46 BITS since 1977, and more recently has used very similar language to the BITS as part of investment chapters in 12 US FTAs (Vandevelde, 2008). This section reveals that US-style investment rules run far deeper and include many more limitations on the ability of nations to deploy capital controls. Specifically, US investment rules:

- elevate the rights of US capital investors over those of domestic capital investors, whereby US investors can file claims against violating parties through an investor-state dispute-settlement process and receive financial compensation for violations, while domestic investors do not have such rights;
- do not permit restrictions on both capital inflows and outflows; and
- provide no clear exceptions for balance-of-payments exceptions, though some FTAs provide a grace period for filing investor-state claims.

This section is in two parts: first, a short background on the purpose and main provisions of US BITS and investment components of FTAs; second, an examination of the extent to which countries may deploy capital controls under US BITS and FTAs.

### 4.1 Investment provisions in US BITS and FTAs

BITS and investment provisions in US FTAs have evolved over time to have at least five general features. Normally, through an inter-agency process and with input from outside experts and interests, the US puts together a ‘Model BIT’ that serves as the template for negotiations for BITS and FTAs:

The model would be tendered to the other party at the beginning of negotiations with the hope that agreement would be reached on a text that did not differ substantively or even in a significant stylistic way from the model. If too many departures from the model were demanded by the other party, then no BIT would be concluded. (Vandevelde, 2008: 1)

Scholars have characterised the model BITS and subsequent treaties as occurring in three ‘waves’: from 1981 to early 1989, where 35 BITS were negotiated; from the early 1990s to 2002, where the NAFTA and a handful of BITS were signed; and from 2002 to the present, where FTAs with Chile, Singapore and Central America were negotiated (Vandevelde, 2008). Table 5 lists all US BITS and FTAs with investment provisions based on the various models. In 2009 the US engaged in a review of the 2004 Model BIT that formed the core of most US BITS and investment components of FTAs. The new model was scheduled for release in mid-2010 and may be used for negotiations of BITS with China, India and Brazil, and in FTA negotiations with Pacific nations.

This article will focus on the treaties completed up to and including the 2004 Model BIT, the last being the BIT with Rwanda and the FTAs with Peru, Colombia, Panama and South Korea (the last three signed but not ratified at the time of writing).
Table 5: US BITs and FTAs

<table>
<thead>
<tr>
<th>Countries with BIT</th>
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<tbody>
<tr>
<td>Albania</td>
<td>Jordan</td>
</tr>
<tr>
<td>Argentina</td>
<td>Kazakhstan</td>
</tr>
<tr>
<td>Armenia</td>
<td>Kyrgyzstan</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Latvia</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Lithuania</td>
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<tr>
<td>Bangladesh</td>
<td>Moldova</td>
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<tr>
<td>Bolivia</td>
<td>Mongolia</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Morocco</td>
</tr>
<tr>
<td>Cameroon</td>
<td>Mozambique</td>
</tr>
<tr>
<td>Congo, Democratic Republic of (Kinshasa)</td>
<td>Panama</td>
</tr>
<tr>
<td>Congo, Democratic Republic of (Brazzaville)</td>
<td>Poland</td>
</tr>
<tr>
<td>Croatia</td>
<td>Romania</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Senegal</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Slovakia</td>
</tr>
<tr>
<td>Egypt</td>
<td>Sri Lanka</td>
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<tr>
<td>Estonia</td>
<td>Trinidad and Tobago</td>
</tr>
<tr>
<td>Georgia</td>
<td>Tunisia</td>
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<tr>
<td>Grenada</td>
<td>Turkey</td>
</tr>
<tr>
<td>Honduras</td>
<td>Ukraine</td>
</tr>
<tr>
<td>Jamaica</td>
<td>Uruguay</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Countries with FTA</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Israel</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Jordan</td>
</tr>
<tr>
<td>Canada</td>
<td>Mexico</td>
</tr>
<tr>
<td>Chile</td>
<td>Morocco</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Nicaragua</td>
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<tr>
<td>Dominican Republic</td>
<td>Oman</td>
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<tr>
<td>El Salvador</td>
<td>Peru</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Singapore</td>
</tr>
<tr>
<td>Honduras</td>
<td></td>
</tr>
</tbody>
</table>

In terms of coverage, whereas the earliest BITS and FTAs focused almost solely on foreign direct investment, contemporary treaties cover both inflows and outflows of virtually all types of investment, including equities, securities, loans, derivatives, sovereign debt and the financial-services facilitators of such flows. According to Vandevelde (2008), there are five general components of US BITs and subsequent provisions in US FTAs:

(i) **Minimum standard of treatment** that an investor should enjoy, including national treatment and most-favoured-nation states in both the pre-establishment and post-establishment rights. On an absolute level, US investors are to receive ‘fair and equitable treatment and full protection in accordance with customary international law’.

(ii) **Restrictions on expropriation.** BITS and FTAs strictly forbid the direct or indirect expropriation of US investments without prompt and full compensation.

(iii) **Free transfers.** US nationals and firms must be permitted to freely transfer payments in and out of a host country ‘without delay’. This will be discussed in detail below.

(iv) **No performance requirements.** US BITS forbid nations from imposing performance requirements such as local content rules, joint venture and research and development requirements, export requirements, rules related to personnel decisions, and so forth.

(v) **Investor-state arbitration.** In stark contrast to dispute settlement under the WTO and all other aspects of FTAs other than investment rules, US firms have the right to binding arbitration of disputes related to violations of the agreements. As is the case with most BITS across the world, foreign firms do not have to file claims through governments but can take a claim to an arbitral panel, often the International Centre for the Settlement of Investment Disputes (ICSID) at the World Bank, for any perceived violation of the above principles.

In addition to these core elements, US treaties often have some so-called ‘exceptions’ such as for essential security, matters related to taxation (where there is another body of US international law), and others. Finally, post-2004 BITS have putative limitations on the ability of host states to reduce environmental or labour laws to attract foreign investment. Before moving forward, it should be underscored that these treaties elevate foreign-investor rights over those of domestic investors, as they do not require the host country’s firms to liberalise their investments, nor do they permit host-country investors to use investor-state arbitration (Hagan, 2000). Table 5 lists those nations with a BIT or FTA with the United States.

### 4.2 Capital controls and US BITS and FTAs

The free transfer of funds to and from the US is a core principle of US BITS and FTAs, as well as those of most other capital-exporting countries. When a host country violates this principle, or if capital transfers violate the other principles, a country could be subject to an investor-state arbitration claim where it could be sued for damages. All the US BITS and FTAs therefore restrict the ability of host countries to deploy capital...
controls (Anderson, 2009a). Argentina, after its crisis in 2001-2, was subject to numerous such claims in hundreds of millions of dollars.

All US BITs and FTAs require host countries to permit free transfers without delay of all types of covered investments. Moreover, financial services are covered in BITs and comprise a separate chapter in FTAs. Analogous to the GATS, if a country commits to liberalising financial services, the free flow of such investment is covered there as well. It should be noted, however, that under the services chapters of FTAs, dispute resolution is state-to-state.

Over the years US treaties have listed numerous types of investments covered, such as securities, loans, FDI, bonds (both sovereign and private) and derivatives. Treaties also make a point of saying that such a list is non-exhaustive. Taken together, the transfers provisions, along with the other principles of the agreements, ensure that an investment can enter and leave a country freely. If such an investment is restricted, a host country can be subject to arbitration.

Of all the treaties the US has signed, there is only one clear exception to this rule, the balance-of-payments exception found in NAFTA. Article 2014(1) can be invoked when the host state ‘experiences serious balance-of-payments difficulties, or the threat thereof’. Like similar exceptions at the WTO and OECD, use of the exception must be temporary, non-discriminatory, and consistent with the IMF Articles of Agreement (thus capital controls can only be aimed at capital-account transactions if approved by the IMF).

4.3 ‘Cooling-off’ provisions

As discussed earlier, Chile is a nation that has deployed capital controls with some success. The US negotiated FTAs with Chile and Singapore (which had also used capital controls in the wake of the 1997 Asian crisis) at the turn of the century; both came into force in 2004. The limits in the US model on capital controls became major sticking-points for both countries. In fact, during the negotiations with Chile, US trade relations head, Robert Zoellick, had to intervene with the Finance Minister of Chile to salvage the negotiations over this issue. During the negotiations the US negotiated a ‘compromise’ that, with some variation, has been used in agreements with Singapore, Peru and Colombia. Interestingly however, it has not become a matter of practice. Such a cooling-off period was not included in the 2004 Model BIT nor the FTAs with DR-CAFTA,1 Panama and others.

The compromise has since become known as the ‘cooling-off’ provision, whereby the US cannot file a claim as in violation of the investment provisions until a period of one year after the provision has been deployed. The cooling-off periods are illustrated in an Annex to the agreements. The rationale would be that the host country may need to address or stem a financial crisis and that it should not be subject to claims in the middle of such action. However – and this is important – the cooling-off period allows a foreign investor to sue for damages related to capital controls that were deployed during the cool-off year, but cannot file the claim until after that year. In other words, an investor has to wait one year to file a claim related to capital controls to prevent and

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1. United States, Dominican Republic and Central American Free Trade Agreement.
mitigate crises, but that claim can be for a measure taken during the cooling-off year
(Hornbeck, 2003).

It should also be noted that these provisions are not mutual. The cooling-off period
is only for investors suing ‘a Party other than the United States’. Finally, the Annexes
agree that, once the claim is brought, only ‘actual reduction of the value of the transfer’
counts as a loss. Loss of profits, loss of business, and other similar consequential or
incidental damages cannot be recovered. All of these agreements include some
exceptions to the Annex, instances where the cooling-off period and limitation on
damages do not apply: payments on current transactions, on transfers associated with
equity investments, and loan or bond payments.

The cooling-off language triggered controversy in the US, leading to hearings
specifically on the subject on 1 April 2003 at the Subcommittee on Domestic and
International Monetary, Trade and Technology of the Committee on Financial Services
in the House of Representatives (US House of Representatives, 2003). The lively
hearings, chaired by Congressman Michael Oxley (R-Indiana, majority), with the
minority head being Barney Frank (D-Massachusetts), revealed that most Republicans
were against the use of capital controls, whereas Democrats favoured more flexibility.

The leading advocate for restricting capital controls was John Taylor, then Under-
Secretary of the US Treasury for International Affairs in the Bush Administration. As a
Stanford University economist he had become famous for the ‘Taylor Rule’ which sets
a formula for inflation targeting. Insiders thus began referring to the cooling-off
provisions as the ‘Taylor Provisions’. Interestingly, the hearings included harsh
rebuttals to Taylor from Nancy Birdsall of the Center for Global Development, Jagdish
Bhagwati of Columbia University, and Daniel Tarullo, then of Georgetown University
and now on the Board of Governors of the US Federal Reserve System. These
individuals are staunch supporters of free trade in goods, but argued that capital-account
liberalisation without exceptions is dangerous from the economic and foreign policy
perspectives. Congresswoman Carolyn Maloney (D-New York, now chair of the Joint
Economic Committee) argued in favour of flexibility. At the hearings, Barney Frank
famously remarked that ‘ice is in the eyes of the beholder’, arguing that the cooling-off
period still effectively restricts Chile and Singapore from using capital controls.

Around the same time senior IMF officials in the legal department wrote articles
arguing that BITS should have at least temporary derogations for balance-of-payments
difficulties and that the cooling-off period was not sufficient. Hagan (2000) expresses
concern that if one nation forbids a host country to use capital controls on a temporary
basis but the host country is permitted to use controls under agreements with other
nations, then the controls will be discriminatory in nature and will lead to distortions.
Siegel (2004), who called the cooling-off provisions ‘draconian’, expressed concern that
the US transfers provisions raised jurisdictional issues with the IMF. The US provisions
call for free transfers of all current transactions but, unlike WTO, OECD and other
capital exporters, the US provisions do not include mention of the ability of the IMF to
recommend capital controls as part of a financial programme. Siegel argues that FTAs
‘create a risk that in complying with its obligations under the FTA, a member could be
rendered ineligible to use the Fund’s resources under the Fund’s articles’ (Siegel, 2004:
4). Finally, in meetings with IMF officials concern was expressed over the lack of
consistency between US agreements and others. For instance, South Korea has a broad
exception under the OECD codes and its other BITs, but not with the US. Which measure holds?

### 4.4 Illustrative discussion of capital controls and violations of US investment rules

It should be clear from the above discussion that capital controls are in fundamental violation of the core principle in US trade and investment treaties that requires the free transfer of funds without delay. That said, it is important to understand exactly how these provisions work in relation to various types of controls. Such an exercise reveals that it is possible that some kinds of capital controls may be able to slip through US investment rules. However, given that there are no derogations in US treaties, such possibilities are far from certain. Some of the avenues in which capital controls could be actionable under US BITs and FTAs are exhibited in Table 6.

<table>
<thead>
<tr>
<th>Capital control</th>
<th>Potential conflict</th>
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<tbody>
<tr>
<td>Restrictions on currency mismatches</td>
<td>Absolute violation of transfers and services provisions; diminishes value of investment</td>
</tr>
<tr>
<td>Unremunerated reserve requirements</td>
<td>Absolute violation of transfers provisions; diminishes value of investment and analogous to an expropriation if an investor wanted to retrieve its funds during the ‘minimum stay’ portion of the URR</td>
</tr>
<tr>
<td>Taxes on inflows</td>
<td>Relative violation of pre-establishment national treatment; diminishes value of investment, could be seen as expropriation</td>
</tr>
<tr>
<td>Minimum-stay requirements</td>
<td>Absolute violation of transfers provisions analogous to an expropriation if an investor wanted to retrieve its funds during the ‘minimum stay’</td>
</tr>
<tr>
<td>Taxes/restrictions on outflows</td>
<td>Absolute violation of transfers and services provisions, possible expropriation</td>
</tr>
</tbody>
</table>

Source: Compiled by the author.

Capital-inflow restrictions such as unremunerated reserve requirements (URR), minimum-stay requirements, and outright prohibitions on certain types of inflows are designed to keep out or slow down the flow of short-term inflows into an economy. On the surface, restrictions on inflows may escape violation because an investor has to show that s/he has been ‘damaged’ or that the value of an investment has been diminished in order to file a claim. Instruments to prevent an investment before it occurs may therefore have more ‘cover’ under the agreements. However, restrictions on inflows violate the ability of investors to have market access and national treatment pre-establishment. A claim could arise simply on those grounds, or because an investor that may have made regular previous investments in a host country and suddenly cannot could claim that s/he no longer enjoys fair and equitable treatment and the minimum standard of treatment under the agreement. What is more, if an investor wanted to pull
funds from a country that were held by a URR or minimum-stay requirement (as a form of outflow then), the capital control would restrict the free transfer out of the country and clearly be subject to a claim – as would almost all the other outflows measures listed in Table 2. Indeed, not only are restrictions on outflows violations of transfers provisions, they can also be seen as expropriations. Moreover, if a country has committed to liberalising financial services under the services chapter of an FTA, all inflows and outflows that pertain to the (negatively) listed service could not be restricted.

One other possible avenue for policy space may be available for limits by domestic firms or domestic residents in borrowing or lending abroad. Remember that investment rules do not cover domestic investors, nor are domestic investors able to resort to investor-state dispute settlement. On the surface, such a provision would not be subject to a claim as a violation of the transfers provisions because such restrictions do not consider a covered investment. However, it may be possible that a claim could arise by an investor arguing that national treatment principles had been violated. By restricting US banks from lending in dollars it could possibly be claimed that a country is treating its domestic currency more favourably. An investor may attempt to claim that a measure of this kind is in violation of fair and equitable treatment for the reasons discussed above.

One window that would appear to be available to countries is the ability to tax capital inflows and outflows. Brazil taxed inflows of capital in late 2009; Malaysia taxed outflows in 1999. All US treaties have a chapter or series of paragraphs discussing taxation, saying that ‘nothing in Section A shall impose obligations with respect to taxation measures’. But it distinguishes between traditional taxation and taxation that may be expropriating. Thus the evidence is not clear-cut. In one of the numerous cases against Argentina in the aftermath of its 2000-1 crisis, an ICSID tribunal ruled that a tax on outflows was tantamount to an expropriation (Salacuse, 2010).

It may be possible that a country can claim that actions taken during a financial crisis are measures needed to protect its essential security. Language like that of Article 18 of the 2004 US Model BIT is found in most treaties:

> to preclude a Party from applying measures that it considers necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

The article does not mention economic crises per se but ‘all tribunals that have considered the matter thus far have interpreted the rules broadly enough to include such crises’ (Salacuse, 2010: 345). However, tribunals differ greatly over how grave the difficulties may be. In Argentina again, only one of three tribunals ruled that it could not be held liable for actions it took to halt its crisis (Salacuse, 2010). A key matter is whether or not a measure taken by a country to stem a crisis can be seen as ‘self-judging’. In other words, can the country deploying the control be the judge of whether or not the measure taken was necessary to protect its security? The language quoted above in the 2004 Model BIT, which says ‘that it considers’ is now seen as meaning that a measure is self-judging (because of the ‘it’), but Argentina’s BITs with the US and others did not include such precise language at the time.
Finally, Article 20.1 of the 2004 Model BIT includes a provision on prudential measures that has almost the exact language found in the GATS under domestic regulations. It reads:

Notwithstanding any other provision of this Treaty, a Party shall not be prevented from adopting or maintaining measures relating to financial services for prudential reasons, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party’s commitments or obligations under this Treaty.

This language is only to be found in the US-Rwanda BIT that is yet to be ratified, and is not found in US FTAs. Regarding capital controls, the US government has stated that it is not its intention that controls be covered under this provision (United States Department of State Advisory Committee on International Economic Policy, 2009). As discussed earlier, some have expressed concern that the last sentence of this paragraph may be self-cancelling; others see it as quite flexible (Key, 2003; Raghavan, 2009; Stumberg, 2009; Tucker and Wallach, 2009; Van Aaken and Kurtz, 2009).

5 US investment provisions vs those by other major capital exporters

The investment provisions in US FTAs and BITS stand in stark contrast to the treaties of other major capital-exporting nations. This section reviews the measures in the OECD codes of liberalisation, and some specific treaties by the European Union, Canada, Japan and China.

5.1 OECD codes

In many respects the OECD has the most expansive investment rules, since they cover all types of capital flows whether from the current or capital account. However, it also has the broadest level of temporary derogations. Similar scope and derogation can be found in the OECD-sponsored Multilateral Agreement on Investment (MAI), which has never been agreed upon. In terms of policy space for capital controls under the OECD Codes and the MAI:

(i) members (OECD members) are expected to liberalise both the current and capital account;
(ii) members have a broad but temporary derogation where capital controls on both inflows and outflows are permitted; and
(iii) the OECD’s draft MAI included a broad derogation analogous to that of the Codes.
Incorporated in the early 1960s, two legally binding ‘Codes’ govern capital flows in OECD countries: the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations – usually referred to as the Capital Movements Code and the Current Invisible Code. These codes cover all types of investments – inflows and outflows from the current and capital account – and require their liberalisation.

Initially, speculative capital was excluded from the Codes on the grounds that short-term capital would disrupt the balance-of-payments position of OECD members and make it difficult for countries to pursue independent monetary and exchange-rate policies. This was changed in 1989 when a group of countries led by the UK and Germany argued that all OECD members by then had sufficiently sophisticated money markets to be able to withstand liberalisation of short-term flows. All countries that acceded to the OECD since 1989, regardless of their level of development, also liberalised their capital accounts fully to include short- and long-term maturities. South Korea, however, in its accession argued that it should have a grace period to open its capital account gradually as it developed. The OECD denied this request, conditioning membership on an open capital account. In the end, South Korea conceded (Abdelal, 2007).

Alongside the broad mandates for OECD countries, there are also broad exceptions. Article 7 (in each set of Codes) holds ‘clauses of derogation’ that govern the temporary suspension of commitments. Under these safeguards a country may suspend liberalisation. Article 7b allows a member to put in place temporary capital controls; to stem what may ‘result in serious economic disturbance in the Member State concerned, that Member may withdraw those measures’. Article 7c is the balance-of-payments exception. ‘If the overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious that Member may temporarily suspend the application of measures of liberalisation taken’ (OECD, 2009). Greece, Iceland, Portugal, Spain and Turkey have all used the derogation. The OECD permitted them to do so because they were seen to be at a lower stage of development relative to the other members of the OECD (Abdelal, 2007).

The OECD-sponsored Multilateral Agreement on Investment was launched in 1995 as an attempt at a global treaty that would have similar provisions to the Codes – for OECD and non-OECD (developing) countries alike. The draft text of this treaty included a broad safeguard for capital controls and other measures for balance-of-payments problems. In the end the MAI was abandoned in 1998 (OECD, 1998).

### 5.2 BITS and FTAs for other major capital exporters

The EU, Japan, Canada, and increasingly China are major capital exporters. Each of them has numerous BITs and FTAs with countries across the world, and their BITs have roughly the same general characteristics as are found in US BITs. However, in the case of the use of capital controls to prevent and mitigate financial crises, the BITs and investment provisions of all BITs and FTAs by these exporters contain either a broad ‘balance-of-payments’ temporary safeguard exception or a ‘controlled-entry’ exception that allows a country to deploy its domestic laws pertaining to capital controls.
Examples of the balance-of-payments approach can be found in the EU-South Africa and EU-Mexico FTAs (Mexico also negotiated such a provision in NAFTA), the Japan-South Korea BIT, and the ASEAN agreements. The Korea-Japan BIT contains language that clearly allows for restrictions on both inflows and outflows, presumably inspired by the 1997 crisis. The BIT states that nations may violate transfers provisions (a) in the event of serious balance-of-payments and external financial difficulties or threat thereof; or (b) in cases where, in exceptional circumstances, movements of capital cause or threaten to cause serious difficulties for macroeconomic management, in particular, monetary or exchange-rate policies (Salacuse, 2010: 268).

‘Controlled entry’ means that a country’s domestic laws regarding capital controls are deferred to. Canada’s and the EU’s FTAs with Chile and Colombia each have a balance-of-payments safeguard and a controlled-entry deferment (Canada Foreign Affairs and International Trade, 2009). As an example of controlled entry, the investment chapter of the FTA between Canada and Colombia has an Annex which states: ‘Colombia reserves the right to maintain or adopt measures to maintain or preserve the stability of its currency, in accordance with Colombian domestic legislation.’

Controlled-entry provisions are to be found in BITs as well. The EU does not sign many BITs as a union, but its individual Member States do. The China-Germany BIT states that transfers must comply with China’s laws on exchange controls (Anderson, 2009b). In the case of China, this country has to approve all foreign inflows and outflows of short-term capital (IMF, 2009).

Interestingly, EU Member States’ BITs vary a great deal. Some, like the China-Germany BIT and the UK-Bangladesh BIT, allow for a country to defer to its own laws governing capital controls. On the other hand, Sweden and Austria have US-style BITs with no exceptions whatsoever. However, the European Court of Justice ruled in 2009 that the BITs of Sweden and Austria with several developing countries were in violation of their obligations under the EU treaty. While this treaty requires EU Members to allow for free transfers, it also allows them to have exceptions. The Court found that the treaties of Sweden and Austria were incompatible with the EU treaty and that such treaties would need to be renegotiated to include exceptions to the transfer provisions (Salacuse, 2010).

Echoing concerns expressed by the IMF earlier in this article, host countries facing a diversity of commitments through different treaties can cause jurisdictional issues and economic distortions. The pending US-South Korea Free Trade Agreement is illustrative of the jurisdictional issue. If South Korea decides that it needs to deploy controls on inflows as a prudential measure to prevent a crisis, it may have all the leeway to do so under the exceptions to the OECD codes, but not under the FTA with the United States. A conflict over which regime should prevail could arise. This could be further accentuated if the IMF was asked to conduct a country programme for South Korea and advised it to deploy capital controls.

The US FTAs with Chile and Colombia just discussed are examples of potential discrimination problems. If Chile or Colombia wished to deploy a non-discriminatory URR to all short-term capital inflows, their treaty commitments would not permit the measures to be truly non-discriminatory. They would only be able to apply the measure to the EU or to Canadian firms and capital, not to capital flowing from the United...
States, thereby distorting capital markets and defeating the purpose of the non-discriminatory prudential measure.

Returning to some of the key questions outlined above, the following can be said about the BITS and FTAs in relation to capital controls. The US holds 58 signed or pending BITs and FTAs with other countries. Almost all capital controls are actionable under these treaties. Recourse can be in the form of a one-time compensatory pay-off.

### 6 Summary and recommendations for policy

This article has shown that US trade and investment agreements, and to some extent the WTO, leave little room for deploying capital controls to prevent and mitigate a financial crisis. This is the case despite the increasing economic evidence that certain capital controls can be useful in this respect. It also stands in contrast with investment rules under the treaties of most capital-exporting nations.

That having being said, there is room for developing countries to deploy capital controls to prevent and mitigate financial crises under the following circumstances:

(i) the controls are on capital, not current, transactions unless sanctioned by the IMF;
(ii) the country has not committed to financial services under the GATS at the WTO; and
(iii) it does not have a BIT or FTA with the United States.

In terms of the WTO, close to 100 nations have not made financial-services commitments under the GATS and are therefore free to deploy whichever type of capital control on capital-account transactions they see necessary. However, the 37 economies listed in Table 4 have made significant commitments on either Modes 1 or 3 for financial services and could be significantly vulnerable to actions against the use of capital controls.

Those nations that still retain the policy space to deploy capital controls and have not reached the threshold (identified by Kose et al., discussed earlier) necessary to withstand capital-account liberalisation should pursue Mode 1 (cross-border trade in financial services) commitments with caution in the Doha Round. As this article has shown, such commitments implicitly require an opening of the capital account. Moreover, they should exercise even more caution in terms of Mode 3 (FDI in financial services) commitments. The IMF study discussed in this article shows that those developing countries that liberalised FDI in financial services fared worse during the current crisis (Ostry et al., 2010). Regarding those countries that have already made commitments with respect to financial services under the GATS (the countries in Table 4), their only recourse will be the untested exceptions for prudential regulation and balance-of-payments exceptions.

Many countries fall under this category, of course, including China, Brazil, India and others which frequently deploy capital controls either on a permanent or temporary basis to ensure macroeconomic stability. A more plausible option is reforming current and future agreements. Especially in the wake of the current global financial crisis, countries should co-ordinate their policies so as to avoid discrimination and jurisdictional inconsistency. Based on the analyses in this article, there are 5 non-
exclusive examples that the US could consider that would give countries the proper policy space for capital controls:

(i) Remove short-term debt obligations and portfolio investments from the list of investments covered in treaties. This has been raised as a possibility by actors ranging from the IMF to civil society (Hagan, 2000; International Institute for Sustainable Development-IISD, 2005).

(ii) Create ‘controlled-entry’ Annexes in BITs and FTAs analogous to the Canada-Chile, Canada-Colombia, Chinese, and EU agreements with those countries. Controlled entry grants a nation the full ability to use capital controls on capital-account transactions as it sees fit.

(iii) Design a balance-of-payments exception that covers both inflows and outflows, such as the provisions found in the Japan-South Korea BIT.

(iv) Clarify that the Essential Security exceptions cover financial crises, and that measures taken by host nations are self-judging.

(v) Resort to a state-to-state dispute-resolution process for claims related to financial crises, analogous to the WTO and the other chapters in most FTAs.

The last recommendation is an important one. Scholars argue that under a state-to-state dispute-resolution system the state can take a much broader view regarding financial stability than an individual firm can. Whereas individual speculative firms may stand to lose from a capital control in the short term (unless their clients default, of course), the net welfare benefits of a measure may be positive. The state is seen as being in a better position to ‘screen’ for such benefits and also to weigh a dispute case against a variety of other geopolitical and economic concerns it may have with a host country. Given that BITs and FTAs currently lack state-to-state dispute systems with appropriate screening mechanisms, some scholars predict that these will be used most by the private sector to file claims in response to measures taken to mitigate the global financial crisis (Van Aaken and Kurtz, 2009).

Leading political scientists have been puzzled as to why the US continues its policy of capital-account liberalisation, given the economic evidence, the treaties of its peers, and given that it has been shown in the political-economy literature that governments should favour capital controls (Alfaro, 2004). Cohen (2007) attributes the US stance to a combination of ideology and domestic politics. Regardless of the party in power in the US, Treasury officials and Presidential advisers have largely held neo-liberal beliefs and training. Perhaps more importantly, Cohen illustrates that while the costs of capital controls are directly felt by a handful of politically organised US constituents – Wall Street – the beneficiaries are diffuse and do not feel the direct effects. Thus a collective-action problem persists where Wall Street organises around capital-account liberalisation.

The arguments posed by the community lobbying against flexibilities for capital controls in the US are threefold. It is argued, first, that capital controls simply do not work and that US treaties help nations get rid of sub-optimal policy; second, that such controls hurt US investors by restricting their ability to mobilise funds; and third, that changing these treaties would send a signal that earlier treaties are problematic and jeopardise commitments previously taken.
The evidence and politics may be changing. As discussed earlier in the article, the evidence in favour of many capital controls is positive. Secondly, the current crisis has made it clear that, while it is recognised that some individuals in the short term may incur damage, that damage may be minimal relative to what it could be in a crisis. Stability among our investment partners helps US investors and exporters have more certainty with regard to markets. Crises could lead to defaults and large losses to US assets and export markets. And crises can cause contagion that spreads to other US investment and export destinations. Thirdly, the US may now be more sensitive, given that it has taken numerous prudential measures in the wake of the current crisis – measures that may not survive the scrutiny of various trade and investment treaties with capital exporters who have investments in the US (Van Aaken and Kurtz, 2009).

References


The World Credit Crisis: Understanding It, and What to Do

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1. WHAT CAUSED THE CRISIS?

WHAT caused the crisis? It is a story in four stages, summarised as follows:

1. Too much credit? An international perspective.
2. Too much risk – reaction to low real interest rates.
3. The fatal flaw – the new complex financial instruments.
4. The panic – bank lending dries up.

a. Too Much Credit? The International Savings Glut

The story begins with the ‘international savings glut’. Various countries at various times have run high current account surpluses, reflecting an excess of savings over domestic investment. For many years, up to 2003, Japan has had the biggest surplus (in US dollar terms). Then from 2004 the oil exporters’ combined surplus became large, so too that of Germany. But there have been many other surplus countries. Above all, in 2005 the Chinese surplus increased, and by 2007 it was the biggest surplus of all. In 2007, combining all the surplus countries, 21.4 per cent of the total world surplus was accounted for by China, 19.7 per cent by the major oil exporters, 12.6 per cent by Japan and 11 per cent by Germany (IMF, 2008a, p. 131).

Naturally this ‘savings glut’, as it has been called, would reduce world real interest rates. World exports of capital must be equal to total world imports of...
capital, so that current account surpluses in total will be matched by current account deficits. The decline in world real interest rates will bring this about. The US fiscal deficit became high from 2002 (3.8 per cent of GDP) and in 2003 was about equal to the US current account deficit. It had the opposite effect on world real interest rates, tending to raise them. But on balance, real interest rates fell. The effect of the savings glut coming from Japan, China, Germany, the oil exporters, and some other countries outweighed the effect of the Bush deficit policy.

As borrowing became cheaper and more readily available, spending both for consumption and for investment increased in some countries, especially the United States, and, indeed, that was the process by which the world total of current account deficits became equal to total surpluses. In 2007 nearly half of the total world deficits belonged to the United States. Other significant deficit countries were Spain, the UK and Australia (but there were also many others).

The story of these ‘global imbalances’ has been told in many places (see, for example, Corden, 2007). The essential point is that, for various reasons, net savings outside the United States increased from about 1999, and this reduced world real interest rates. This, in turn, induced higher private sector spending in the United States and some other countries, notably Spain, the UK and Australia.

One might distinguish those changes that were exogenous and those that were endogenous, the latter brought about by the decline in real interest rates, and hence equilibrating the world system (Corden, 2007). The most important endogenous effect was to stimulate housing booms in the United States and some other countries, notably the three just listed.

The US fiscal deficit was exogenous. It accounted for approximately the whole of the US current account deficit in 2003 (4.8 per cent of GDP), but after that it declined relative to GDP, and hence relative to the private sector deficit. By 2007 the US current account deficit was 5.7 per cent of GDP while the fiscal deficit was only 2.6 per cent. (This refers to the ‘general government fiscal deficit’.)

\[ b. \text{Why a US Housing Boom?} \]

The question arises why so much of the world savings glut was absorbed, at least since 2005, by the US private sector and, indeed by the household rather than the corporate sector. Overwhelmingly it was absorbed by consumption and by housing construction, all resulting from a housing boom. There seem to be three reasons why the world savings glut ended up specifically in a US housing boom, which resulted then in the various well-known consequences discussed in this paper.

First, the US economy is about 30 per cent of the world economy; that is sufficient to explain why any effect in the US is likely to be relatively large in the world. Even the big housing boom in Spain (higher relative to GDP than the
US boom) could not have such a marked worldwide effect even if all the details had been the same as in the US. Second, private non-financial corporations in the US and some other countries did not expand and hence borrow very much during the relevant period because of their caution resulting from the earlier bursting of the ‘dotcom’ bubble. Third, many developing countries, especially in Latin America, were reluctant to borrow and thus generate current account deficits, because of the traumatic effects of their earlier debt crises. Similarly, some Asian countries – notably Korea and China – ran surpluses partly for that reason: to build up foreign exchange reserves, and thus make them independent of the IMF in case of a crisis.

c. The Monetary Policy Reaction

The main conclusion at this point is that the world savings glut lowered world real interest rates and made credit more readily available, and thus underlies the further effects to be discussed here. But there is something I have left implicit. Where do the monetary policy reactions of central banks, especially the US ‘Fed’, fit in? During the period under discussion inflation has been low and employment high. It has been a wonderful period – the ‘Great Moderation’. Thus, I have assumed so far that central banks in general, especially the Fed, successfully pursued policies of ‘internal balance’. This raises a question: can the ready availability of credit in the United States – which underlies our story here, and which allowed a housing bubble to develop – be attributed to the international savings glut or to the policy of the Fed? I shall come back to this interesting issue in Section 2.

d. Too Much Risk? The Search for Yield

Low real interest rates led to the ‘search for yield’. In general, only investments believed to be risky are likely to offer substantially higher returns. This meant that the various financial intermediaries, notably the commercial and the investment banks, were willing to run more risk for the sake of getting higher returns. One could argue that this was a rational response. After all, capitalism is all about risk taking. ‘Nothing ventured, nothing gained’. The lower the return from safe investments the more rational it is to go for risky, higher return investments. At the time when the investment decision is made, the probability of the bad event happening may be very low. Why not gamble for the sake of the immediate high return and hope for the best?

Only with hindsight does it look like a mistake, or even just bad luck. And so banks and other institutions borrowed short term at low interest rates and made splendid profits by lending at higher rates. There were wonderful private equity deals, and much else. Huge salaries and bonuses were extracted. Leverage went
up, and liquidity went down. There is much evidence that many banks became increasingly dependent on short-term borrowing from the wholesale market relative both to their retail deposit base and, above all, their own capital. And this was risky.

But was it rational, or just bad management or judgement? As has happened before, the possibility of crises, and that high returns usually involved serious risk, was forgotten because there had been a long period of high growth and macroeconomic stability. This was particularly true because so many of the potential risk-takers were young and had never experienced a crisis.

e. The Principal–Agent Problem

There was another factor, much talked about recently. This was the principal–agent problem applied to banks. The people that took the risks – and so got the business for the firm – received short-term rewards in the form of high salaries and, above all, bonuses, and suffered no losses – indeed may have left the firm – when the crisis came. They had no interest in the long-term success or even survival of the firm. This was not always so; for example, the employees of Lehman Brothers had much (or a substantial part) of their wealth invested in the firm. There was also sometimes a failure of corporate governance, when management failed to supervise and reign in the risk-takers within the firm. In any case there was a divergence of interest between the personal interests of the risk-takers who were rewarded for short-term results and the long-term interests of the firm, its shareholders and its long-term employees.

f. The Fatal Flaw: The New Financial Instruments

The new financial instruments, or ‘structured finance’, were the reason that a crisis which might have been confined to a few US States actually spread all over the USA and indeed the world.

As is well known, it began with the application in the US housing finance sector of the ‘originate-to-distribute’ model. The aim was to spread the risks of mortgage loans, and this was indeed done. Let me quote from IMF (2008a), which is the best exposition. ‘Structured finance normally entails aggregating multiple underlying risks (such as market and credit risks) by pooling instruments subject to those risks (e.g. bonds, loans or mortgage-backed securities) and then dividing resulting cash flows into “tranches” or slices, paid to different holders’.

The US originators, in effect, sold their risks into a market where the buyers were literally everywhere, in the USA and abroad. The principal instruments were MBSs (mortgage-backed securities) and CDOs (collateralised debt obligations). Also important were CDSs (credit default swaps), which were a form of insurance against default. These depended on the liquidity and solvency
of the insurer, for example the huge insurance company AIG which the government had to take over.¹

One might note here that, while the originators of the loans were local US banks and mortgage companies of various kinds, the actual construction of the new instruments was done primarily by investment banks (such as Lehman Brothers) for whom this was a very profitable activity, at least unless they retained a significant quantity for themselves to hold.

g. Three Problems of the New Model

Focusing on US housing loans, where the whole disaster began, there were three problems.

First, the originators of the mortgages had little or no incentive to ensure that the mortgagees could afford to take out the mortgages without default. Only if they retained some of the loans or instruments would they have an incentive. This is very different from the old-fashioned way when local banks retained the risks and therefore made themselves adequately familiar with the mortgagees. It is not surprising that the new procedure is called the ‘originate-to-distribute’ model.

Second, it became impossible for mortgagees to renegotiate the loans with the ultimate lenders, since the latter were effectively dispersed. One might contrast this with the negotiations that took place in the 1980s between the governments of developing countries and the international banks in resolving the LDC debt crisis.

Third, there was an effect that was fatal, and indeed set off the world credit crisis. Once the US housing market went into decline and a proportion of ‘sub-prime’ mortgagees defaulted, there was a critical information problem. Holders of these instruments, which were composites of many different mortgages, did not know – and could not know – what risks they were running. All they knew was that they could make big losses – or they might not. As a result they wanted to get rid of them, and the market value of the instruments fell dramatically. A device which was meant to off-load and spread risk – which indeed it did – spread fear. And this led to the next step: panic.

h. Why Buy ‘Toxic’ Securities?

Before going on, one might ask a simple question: why did banks, and other financial entities, such as insurance companies, mutual funds and investors of various kinds, buy these ‘toxic’ securities and put them in their portfolios? The answer was that, in the absence of any default, the returns were expected to be

¹ For details of various instruments, see IMF (2008a).
high. The decline of the US housing market was not anticipated. It was another case of ‘the search for yield’ which in old-fashioned language some might describe as ‘greed’. In effect buyers of these products of structured finance were sold poison – ‘toxic’ was a later description – even though the sellers might not have realised they were selling poison. Assuming that the sellers were not consciously fraudulent, one must assume instead that both sellers and buyers were misled by the extraordinary complexity of these structured instruments. As is well known by now, they were also misled by the credit rating agencies. One should not buy or sell what one cannot understand!

i. The Panic

The final stage has been a panic, which has converted a US housing market crisis into a worldwide banking crisis. And, in turn, a banking crisis is likely to create a serious recession, and – in the absence of adequate policy reaction – would create a depression.

The process is fairly simple. Banks become unsure about their own balance sheets and, in addition, the balance sheets of other banks – the counterparties – with which they deal regularly through the interbank market. Even if retail deposits are guaranteed by the government, so that a classic run on deposits is avoided, any bank or other financial institution that depends on the interbank market or the wholesale funds market is in trouble. Illiquidity is severely punished.

It all began with the information problem caused by the combination of a downturn in the US housing market and the complexity of structured finance. Banks stop lending, so that ordinary non-financial corporations, small businesses and large, are drained of life-blood. A crisis in Wall Street creates a crisis in ‘Main Street’. It is for that reason, and not for the sake of rescuing Wall Street, that the US government has needed to intervene.

This is where we now are.

2. SOME ISSUES AND COMPLICATIONS

a. How the Crisis Spread around the World

It is amazing that a crisis that began in the US housing market, and apparently resulted from the making of unwise ‘sub-prime’ loans to US mortgagees, spread like wildfire around the world. There have actually been three channels through which this has happened.

First, the mortgage-backed securities (MBS) and other ‘toxic bonds’ were bought by banks and investors all around the world. Everywhere they lost value.
This was particularly important in Europe. Everywhere owners of such bonds felt unsure about their true value.

Second, there is the drying up of the wholesale market. The uncertainty about the value of these ‘toxic’ bonds, and hence uncertainty not just what a bank’s own position was but also about the financial situation of ‘counterparties’ – other banks and institutions – led to the credit crisis; I have already discussed this. Any institution that had been depending on borrowing short term in the wholesale market was affected. This effect was very widespread and was felt even when an institution did not own any of the ‘toxic bonds’. Two examples are the British mortgage bank Northern Rock, which depended heavily on borrowing short term in the wholesale market, and had very little capital of its own, and also a surprisingly low base of retail deposits. Other examples are the three Icelandic banks that had greatly expanded internationally, financing themselves also by borrowing short term on the international wholesale market.

Third, many countries were affected by the expectation of a severe US recession (and perhaps a European recession) and no doubt will be affected by the actual recession that, at the time of writing, seemed to be on the way. This effect goes mainly through trade, especially the fall in world commodity prices. This expectation no doubt explains both the sharp decline in the value of the Australian dollar and in the Australian stock market. This transmission process can be important, as in the Australian case, even when the other two transmissions, just discussed, are not.

b. Too Much Monetary Expansion? Was Greenspan at Fault?

It is common in the US to blame the Fed – and specifically its former chairman, Alan Greenspan – for excessive credit expansion, which then gave rise to the speculative housing boom, leading eventually to a bubble, which ended with disastrous effects. In other words, the argument is that it was excessive US monetary expansion rather than the international savings glut that caused the US housing boom and thus the troubles that followed. This raises a question: what is the relationship between US monetary policy and the international savings glut which I have regarded above as the first step in the process that led to the crisis?

The answer can be put very simply in words, but can also be expounded clearly with the help of a familiar diagram. While one could interpret my analysis as referring purely to the United States, I have in mind here a One World story, in effect treating the whole world – tied together by the international capital market – as one country.

An increase in savings would be deflationary if the real interest rate did not change, or did not fall sufficiently. A fall in the real rate of interest is then required to stimulate both investment and dissaving, and in this way employment
could be maintained. I shall call the maintenance of the initial employment and inflation rate – assumed to be a desirable combination – ‘internal balance’. Appropriate monetary expansion can bring this about. In practice, the Fed was very successful in maintaining ‘internal balance’ in the United States once the economy had recovered from the ‘dotcom’ boom and slump. Hence credit expansion fostered or permitted by the Fed’s monetary policy was required if internal balance was to be maintained while the economy was hit by the deflationary impulse of the savings glut.

c. The IS–LM Diagram

Figure 1 is the Hicksian IS–LM diagram. The vertical axis shows the real rate of interest \( r \) and the horizontal axis shows real income and output \( Y \). The \( LM \) curve is drawn for a given real money supply (defined broadly), and the \( IS \) curve shows the level of income for any given interest rate.\(^2\)

We start with \( LM_0 \) and \( IS_0 \), and equilibrium at point \( A \). Increased net savings shift the \( IS \) curve to \( IS_1 \). If the interest rate remained constant, equilibrium would be at the deflationary equilibrium at \( B \). But, suppose the interest rate is flexible, being determined by monetary (credit) policy. If the money supply stayed constant (Mr Greenspan did nothing) equilibrium would be at \( C \). But if he followed an ‘internal balance’ policy designed to restore income (and output, as well as

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\(^2\) An exposition of the IS–LM diagram can be found in any macroeconomics textbook. See, for example, Mankiw (1994, Ch. 9).
the inflation rate) at its original level $Y_0$, he would have to increase the money supply, shifting the $LM$ curve to $LM_1$.\(^3\)

The new equilibrium will then be at $D$. The interest rate will have fallen, and it would appear that this was brought about by central bank monetary policy that had shifted the $LM$ curve to $LM_1$. But it was actually the inevitable by-product of the increase in saving, given the commitment to an ‘internal balance’ policy. It follows that critics of the Greenspan policy are really criticising his ‘internal balance’ policy. Given the international savings glut, this policy made monetary expansion, and hence a decline in the real interest rate, inevitable.

\medskip

\textit{d. Should Monetary Policy have Pierced the Bubble?}

There is a related criticism, which is actually more serious and raises a question about the pursuit of an ‘internal balance’ policy. Such a policy ignores asset bubbles provided the bubbles do not affect real income and the inflation rate. Asset prices affect this policy only insofar as they affect the cost-of-living index and thus the rate of inflation as this term is generally understood.

It is possible to have an asset bubble, such as a housing boom, while the inflation rate is unaffected, or perhaps is kept down by some offsetting factor. Indeed, this is what happened initially in the United States. But once the bubble ends – often with a crisis – aggregate demand is likely to be reduced, as indeed has happened recently when the housing market crashed. Thus the Greenspan policy seems to involve no monetary policy concern with the bubble when an asset market bubble starts, or no intervention to prevent the start of such a bubble, but it does call for intervention when the bubble ends if this ending reduces spending and thus aggregate demand.

The problem is that there are potentially two objectives of monetary policy, namely the preservation of ‘internal balance’ as defined here, and the prevention or moderation of asset bubbles. The main examples of such bubbles are in housing and in the stock market. But if there is only one instrument of policy – namely monetary policy – some sacrifice of ‘internal balance’ would be required if there is to be a significant impact on asset prices. This is a genuine dilemma. Increasing the interest rate in order to kill a nascent housing bubble may involve serious effects on output and employment.

One should then consider whether a second policy instrument (or set of instruments) could be found to influence housing and stock market bubbles. I cannot pursue this here, though I suspect the answer involves special taxes or controls. This needs to be explored further.

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\(^3\) The distinction needs to be made between the nominal and the real money supply. The $LM$ curve represents the real money supply, while monetary policy acts on the nominal money supply. But the general argument I wish to make here is not affected by this distinction.
e. Is China to Blame?

In the developing country debt crisis of the 1980s the blame was put on the borrowers, who had apparently borrowed unwisely and had used their borrowed funds inefficiently. But now, when the principal borrowers are in the United States, the blame is often put not on the borrowers but on the countries that generated the high savings, and especially China. It is argued that China ought not to have run such high current account surpluses, reaching 11 per cent of GDP in 2007. Here it must be remembered (as I have noted earlier) that China, while the largest exporter of capital in 2007, only accounted for 21.4 per cent of total capital exports in 2007, and indeed its surplus was only significant from 2005. There were many other capital exporters, notably Japan over a long period, Germany, and since 2003 the oil exporters.

Whether it is in the interest of the various savings-glut countries to run high current account surpluses is a matter for them, for their governments and their various corporations and individuals. A careful study might suggest that China would have been wise to increase its domestic consumption. On the other hand, it may be sensible for a fast growing high-investment country like China to temporarily park some of its savings abroad. (I have called this the ‘parking theory’ in Corden, 2007). Each country has its own story. Surely one does not have to agree with Polonius (in Hamlet) ‘Neither a borrower nor a lender be’, especially internationally. It is the job of the various firms in the international capital market, notably banks, to intermediate capital flows from lenders to borrowers as efficiently as possible.

There will always be savers who want to lend and others who want to borrow, whether within a country or across borders. This is a form of intertemporal trade, and there are potentially gains from such trade, as from ordinary trade in goods and services. It should also be remembered that in countries with rapidly ageing populations (notably Japan and Germany), it is likely to be thoroughly rational to have a high level of savings relative to income for certain periods, while fruitful investment opportunities may be limited. They are thus likely to have current account surpluses (see Cooper, 2007). We can always expect periods when some countries have high savings levels, perhaps temporary, while others have investment booms leading to current account deficits.

One should plan to achieve an international economic system where there can be global imbalances, usually temporary, but without crises. One can think of important examples in the nineteenth and early twentieth centuries when there were significant imbalances. But it is certainly desirable that current account deficit countries use their funds for investment rather than consumption, other than during wars and environmental disasters. The fault and the failures in this recent crisis have been not with ultimate lenders or borrowers – other than US sub-prime mortgagees – but with the financial intermediaries, often highly paid.
f. How Can Worldwide High Savings be Accommodated? The Need for Negative Real Interest Rates

An issue does remain. What should happen when world savings are high while good, safe borrowing prospects are hard to find? Can a crisis then be avoided?

Let us suppose that there is an increase in world savings, coming from any or many countries, and the world real interest rate falls. Indeed it may approach zero. Further, borrowers with sound investment proposals and thus good, safe prospects are hard to find. Of course, one can see in many countries the need for new investment – for example, currently in infrastructure in developed, and especially in developing countries. But the question is whether the borrowers – governments, usually, in the latter case – will be willing and able to service the debts – pay interest and gradually repay the principal. Suppose it is difficult to find borrowers who appear to have the capacity or willingness to pay interest reliably and gradually to repay principal. Yet savings have to be invested somewhere. There are then three alternatives.

The first is the ‘search for yield’ which I have discussed and which clearly has played a major role in the recent crisis. A higher interest rate is obtained by making more risky loans. This is what has actually happened. Some of the savings have flown to marginal borrowers – as has happened in the US housing market with its sub-prime mortgages. But such risky lending requires a realistic understanding by the financial intermediaries of the degree of risk incurred. The higher interest income obtained from borrowers, and the ease of finding such borrowers, is not a free lunch. For employees in the financial sector it should not just be a way of extracting mighty bonuses. The banks or other intermediaries must use part of the net income to finance an increase in their capital, as an insurance against the risk of default.

This is an important lesson of the current crisis: one reason for current problems is that this has not happened. Alternatively some kind of explicit insurance must be taken out. In the latter case the insurer must have adequate reserves. Naturally one thinks here of the huge insurance company AIG which sold too many CDSs and which the US government has had to rescue.

The second possibility is one that has not been generally discussed. Hence I wish to underline it here. The financial intermediary must be prepared to lend at a negative real interest rate, and must thus charge some kind of fee to the savers for their deposits, rather than paying interest. Lending at negative real interest rates requires the development of new financial instruments. A loan with a zero nominal interest rate and a fixed nominal value in terms of a currency that is expected to lose value because of inflation, and perhaps with a clause that allows some part of the principal to be written down, would achieve this result.

There are many possibilities. In practice, a negative real interest rate has often been the unintended outcome of a loan, as in the developing country debt
crisis. But the aim should be to resolve this problem without depending on crises. Right from the beginning the financial intermediaries should, where appropriate, promise negative real interest rates, and savers should know that – because of a shortage of profitable investment opportunities – that is all they can expect to get.

Third, savers can invest more in equity rather than in making loans. Such investment in equity does not necessarily involve more control of companies by savers since it can be done primarily through diversified mutual and pension funds. This means that for the world as a whole leverage would be reduced: the ratio of capital to debt would be increased. More of the risk would be incurred by the savers. Possibly this tendency can now be observed as part of the process of reducing leverage.

To repeat, all the three possibilities I have discussed here are designed to ensure that when there is a savings glut, savings flow smoothly to borrowers, but without crises.

g. How is this Crisis Related to the Often Expected Crisis of Global Imbalances?

Until this latest crisis, the crisis that was widely expected was one resulting from the ‘global imbalances’, and specifically concerning the US dollar. The United States was running a large current account deficit, and from 2002 to 2005 a large fiscal deficit. It was argued that this was unsustainable and would end in a dollar crisis. Such a crisis would be set off by speculation against the dollar, and then a possibly dramatic drop in the dollar, presumably relative to many currencies, but especially the euro. It was widely argued that something should be done to reduce those imbalances before a crisis resulted.

I argued, by contrast, in Corden (2007) first, that such imbalances were not necessarily undesirable, since they represented intertemporal trade (and there is no reason to favour home bias in the international capital market), and second, even though they must inevitably end or decline, they need not end in crises. Nevertheless, there were various possibilities which I explored. One was a decline in the surpluses of the savings-glut countries – which would lead to a rise in the world interest rate – and another was a decline or end to the US fiscal deficit which would lead, in contrast, to a fall in the world real interest rate.

As I explained earlier, the crisis we have actually had began with a worldwide credit boom which is explained by the same savings glut – the various current account surpluses – which formed the centrepiece of the global imbalances discussion. But the current crisis was not caused by the imbalances. If the US fiscal deficit had been reduced more, or if private savings in the US had increased substantially, the imbalances might have declined, but the credit boom would have been even greater. If savings had increased in most or all countries that
initially had a current account deficit, the imbalances might conceivably have disappeared completely, but the worldwide credit boom would have been huge. Of course, I am assuming that the various countries’ monetary policies would have been expansionary to maintain an internal balance in their countries.

It may seem surprising that the US dollar has actually gone up relative to most other currencies, especially the euro. The explanation is that the initial ‘search for yield’ has been converted by the panic to a ‘flight to safety’. And US Treasury bills have been seen in the market as the safest asset to hold. Thus there has been a movement away from private sector investments of all kinds, reflected in worldwide declines in stock markets, and also away from government bonds of many countries. Only government dollar and yen bonds seem to have been attractive, so that yields (interest rates) on those two have declined, while required yields on many or almost all private bonds and equities worldwide have risen, in many cases very sharply.

The net result is that the value of the dollar in the foreign exchange market has actually gone up relative to almost all floating currencies other than the yen. This is very different from the horror stories of dollar crash envisaged earlier. Thus this crisis is very different from the one that was widely expected.

h. The Keynesian Situation

In my exploration of possible crises or problems that might arise as a result of the global imbalances (in Corden, 2007), one possibility I discussed was what I called the ‘Keynesian situation’. If the US fiscal deficit were reduced or eliminated, while the savings glut in various surplus countries continued, the world real interest rate might fall to zero (assuming appropriate monetary expansion). But then monetary policy will have reached its limits, and Keynesian fiscal expansion, perhaps coordinated among major countries, would be needed. This is a situation very similar to the one we have currently, except that the reason for the worldwide decline in demand is not an elimination of the US fiscal deficit, but rather a breakdown in the world’s financial sector, and the consequent panic reaction. But there is actually a desperate need now for a coordinated – or even uncoordinated – fiscal expansion.

3. WHAT IS TO BE DONE?

a. Do Immediately

Here I can be brief. The situation is changing day by day. Everything I might write on the immediate need is being said and written. Given the panic, for whatever reason, there is a high probability of a severe recession (if not a
depression) if nothing much is done. Efforts in the United States and the United Kingdom (and some other countries) to restore the flow of credit from banks have, so far (February 2009), not been successful. Therefore, in the United States, in Britain, and probably elsewhere, a ‘massive fiscal boost’ is needed. The argument is plain Keynesian. At the time of writing this paper (November 2008) it seemed that China’s government had committed to such a boost, and the prospective Obama Administration had also. Since then the need for some fiscal boost seems to have become the international orthodoxy.4

If a temporary but substantial fiscal boost is supported by monetary expansion, the central bank can buy the government’s bonds that finance the additional budget deficit. Since the government owns the central bank, this will then avoid any increase in the national debt. In any case, since the probable alternative is a massive and permanent loss of output, an increase in the national debt for this purpose would not be a disaster.

I would only add one point. It is desirable that extra government spending and tax reductions are brought about quickly. But this may not always be compatible with ensuring that new government spending is not wasteful. For example, additional public infrastructure spending may take some time to organise. But a credible announcement of a big fiscal boost will affect expectations, and might lead to an immediate boost in confidence, even though the actual increase in spending may take some time. The increase in confidence, in turn, may help in restoring the functioning of the credit system.5

b. Longer-term Lessons

No doubt there will be endless discussions, and numerous working groups and reports, reviewing the lessons of this unexpected crisis. Here I shall list a few provisional conclusions that I have drawn from my overview of the origins of the crisis. Most of what follows applies primarily to the United States.

Since financial institutions have been rescued in various ways, in future those that can expect some kind of guarantee or commitment to rescue will have to be regulated more, while others might be subject to very limited regulations, and with no assurance of rescue. Here I recommend consideration of a proposal made by James Tobin in 1987, entitled ‘The Case for Preserving Regulatory Distinctions’, reprinted in Tobin (1996). He recommended a clear distinction between a

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4 The argument has been clearly put in some detail by Sam Brittan in the Financial Times, 7 November 2008, and was also supported by Martin Wolf in the Financial Times, 12 November 2008.

5 There is a much more comprehensive review of fiscal policy for the crisis in IMF (2008b). It also includes five case studies. Particularly interesting is the Korean case of 1997 when fiscal policy, mostly focused on the financial sector, was very successful.
‘deposited currency’ institution established by the Fed for the benefit of the public, and carefully defined ‘commercial banks’ eligible for deposit insurance. In Tobin’s view at the time, the third type of institution would be investment banks, uninsured, broadly unregulated, but subject to disclosure requirements. But here he would surely have revised his view were he alive now. If investment banks, as they have been constituted, are too big to fail, then they must be regulated. It is now widely agreed that Lehman should have been rescued. Perhaps various activities of investment banks can be separated, with some parts only regulated.

It is clear enough that ‘sub-prime’ lending in the US housing market was unwise. There had been many warnings about the danger of the US government guaranteeing but not adequately controlling Fannie Mae and Freddie Mac. Regulation here was inadequate, and politicians, who succumbed to heavy lobbying from these two organisations, bear some responsibility for the disaster. I leave this to more knowledgeable Americans to consider in detail.

In my judgement, as outlined above, the new financial instruments of ‘structured finance’ were the main reason why the combination of unwise lending in the US housing market and an inevitable downturn in that market led to a huge worldwide financial crisis.

These products of structured finance have been like dangerous or ‘toxic’ pharmaceutical products. Perhaps they should be prohibited, but they do have some potential benefits. At the minimum the products should be labelled properly, with warning signs. New regulations are inevitable here. This is the one topic where there will be universal agreement.

On the general problem of excessive risk-taking and the principal–agent problem, there may be some scope for new regulations of those financial firms, principally commercial banks, where some kind of guarantees will be provided by the government or the central bank. But the main lessons will probably have to be taken on board by the managements of the firms themselves, and by investors who provide them with funds. Possibly increased transparency can be brought about by regulations.

Coming to global imbalances and high savings countries, global imbalances are nothing new. Before the First World War there were substantial flows from France to Russia and from Britain to British Empire countries and to Argentina – and, indeed, the United States. In the 1920s there were flows from the United States to Germany, and after the Second World War, especially in the 1980s, from Japan mainly to the United States. There were the flows from oil exporting countries to certain developing (emerging market) countries after the first oil shock, and, more recently to the United States. The most recent flow is from China to the United States. These net flows between countries are one of the results of international capital mobility. It is not a matter of ending them, but of ensuring that they do not end in crises.
Of course, countries may be mistaken in their domestic policies from their own points of view. Thus China’s government may be mistaken in letting China have such high savings, while the United States Administration may have been acting contrary to the national interest in running a large fiscal deficit to finance a war and also cut taxes. The flow of capital from China to the United States may thus be a by-product of two policies that have each been domestically unwise. On the other hand, it may sometimes be wise to borrow internationally if there are good investment opportunities.

Finally, I have referred to the problem of the firms in the capital market finding suitable, reasonably safe borrowers when world savings are very high, so that the real interest rate becomes very low or even zero. I have suggested that debt instruments that involve negative real interest rates should be considered. The aim would be to accommodate high levels of saving without leading to later crises. I can imagine governments in developing countries wishing to borrow for infrastructure development, selling such bonds.

REFERENCES