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Policy Handcuffs in the Financial Crisis

How U.S. Trade and Investment Policies
Limit Government Power
to Control Capital Flows



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Institute for Policy Studies



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Table of Contents

Key Findings and Recommendations	1
I. Introduction.....	3
II. What are Capital Controls?	4
III. U.S. Trade and Investment Agreements that Restrict Capital Controls	5
IV. A Decade of Debate over Capital Controls	7
IMF Learns Lessons from Asian Crisis.....	7
Bush Administration Refuses to Change Position	9
Box: Statements by Noted Economists on Capital Controls	10-11
V. Enforcement of Capital Control Restrictions.....	13
VI. Capital Controls and the Current Crisis.....	14
VII. Opportunities for Change	15
Notes	17
Appendix 1.....	19
Appendix 2.....	21

Key Findings

- **U.S. Web of Capital Control Limits:** Many countries have used capital controls effectively to address financial market volatility. And yet 52 national governments face restrictions on the use of capital controls as the result of trade or investment agreements with the United States. These countries include 19 in Eastern Europe and Central Asia, 18 in the Americas and the Caribbean, 6 in the Middle East and North Africa, 5 in Sub-Saharan Africa, 2 in South Asia, and 2 in East Asia and the Pacific.
- **IMF Learns from Asian Crisis, U.S. Does Not:** The International Monetary Fund abandoned its blanket opposition to capital controls after some countries used this tool to avoid the worst effects of the Asian financial crisis that erupted in 1997. The U.S. government, on the other hand, forged ahead after that global catastrophe, initiating agreements restricting the use of capital controls with 22 more countries. Such restrictions are also in the pending U.S.-Colombia Free Trade Agreement.
- **Investors Can Sue for Compensation:** Countries that violate these restrictions face potentially expensive lawsuits by private U.S. investors. In the supra-national arbitration tribunals that handle such cases, there is no public accountability, no standard judicial ethics rules, and no appeals process. One government with a U.S. trade or investment agreement – Australia – set an important precedent by refusing to accept U.S. demands for such “investor-state” dispute resolution.
- **Governments Beginning to Challenge “Investor Rights”:** Particularly in South America, government leaders are speaking out against the rules that allow private investors to sue governments over actions, including capital controls that may diminish their profits. Bolivia has withdrawn from an arbitration court that enforces these rules, Ecuador has announced plans to renegotiate a number of its treaties, and Argentina is currently applying capital controls that appear to conflict with a U.S. bilateral investment treaty.
- **Policy Handcuffs are Inherited:** Since trade and investment pacts are designed to “lock in” obligations, current government leaders are constrained by these capital control restrictions, even though the vast majority were not in power when the deals were negotiated. Of the 52 leaders who are now bound to such agreements, only 13 were in office at the time their country’s agreement was signed. Thus, because of decisions of past leaders, many of whom were voted out of power, these current leaders have more restricted policy space for responding to financial crisis.

KEY RECOMMENDATIONS FOR THE OBAMA ADMINISTRATION

1. **Fulfill Commitments to Change U.S. Trade Policy:** On the campaign trail, President Barack Obama committed to making several important changes in U.S. trade agreements, including in the investment chapters. Obama should work with Congress to ensure that all future (and pending) agreements meet the standards laid out during his campaign. Particularly in light of the global economic crisis, the President should broaden his proposed reforms of investment rules to include the elimination of capital control restrictions. Key Obama economic advisors have advocated this position in the past.
2. **Renegotiate the North American Free Trade Agreement:** President Obama should follow through on his promises to renegotiate NAFTA, as a first step towards overhauling existing U.S. trade and investment policies. The capital control provisions are just one of the many problems that need to be fixed in this 15-year-old pact. And yet eliminating restrictions on this policy tool would send an important message that the new U.S. administration is committed to allowing developing countries the policy space they need to resolve and prevent crises and to pursue sustainable development.

- 3. Halt World Trade Organization Talks:** The WTO's General Agreement on Trade in Services already includes some restrictions on capital controls, and further financial services deregulation has been a key goal of U.S. and European negotiators. The Obama Administration should call for an end to current Doha Round negotiations and allow countries to roll back existing GATS commitments to open up their financial services markets.
- 4. Renegotiate Bilateral Investment Treaties:** The Obama administration should reach out to the governments of Bolivia, Ecuador and other countries that have raised strong objections about the impacts of these treaties on democracy, human rights, and sustainable development. They should begin a process of revising these agreements, as well as the dispute settlement system that enforces treaty rules. Renegotiation is far from unprecedented. According to the United Nations Conference on Trade and Development, other countries have renegotiated more than 120 bilateral investment treaties, in some cases to reflect social and environmental concerns.
- 5. Solidify International Financial Institutions' Policy Change on Capital Controls:** While the International Monetary Fund has abandoned its blanket opposition to capital controls, it has been inconsistent in supporting the authority of borrowing countries to use this and other pro-active tools for promoting financial stability. The Obama Administration should direct its representatives to all of the international financial institutions to push for such a policy, as part of a process of building a new international financial architecture to prevent future crises and promote equitable and sustainable development.

I. Introduction

As the global economy descends further into crisis, many governments are searching their tool bags for instruments to protect their people from the ravages of financial volatility. Dozens of governments are lacking one particular tool that has proved effective in past crises: capital controls.

For more than 20 years, the U.S. government has pushed other governments to give up their power to restrict the speed with which money flows in and out of financial markets. This effort was part of a broader agenda to handcuff policymakers, limiting their ability to intervene in the economy in ways that curb the power of global corporations and financial firms.

U.S. officials have eroded capital controls both indirectly, through their influence with international financial institutions, and also directly, through bilateral investment treaties and the investment chapters of trade agreements. To put teeth into these deals, they required that governments respect the “rights” of investors to file claims against them in international tribunals.

The United States is not solely responsible for removing capital controls from the tool bags of governments

around the world. Similar rules exist in agreements between European and developing countries, as well as between developing countries. Nevertheless, the U.S. agreements carry extra weight, given that the United States is the largest source of foreign investment in the world. U.S. companies accounted for approximately a quarter of all corporate investment activity internationally in 2007.¹

With the election of President Barack Obama, there is a tremendous opportunity to wipe away the relics of a policy agenda that turned the global economy into a financial casino. The Wall Street meltdown and spreading crisis has discredited the “one-size-fits-all” free market formula that has been pushed on countries around the world for nearly three decades.

The new U.S. administration should commit to making the policy changes necessary to allow governments to cast off their handcuffs and build their own paths to sustainable development. Eliminating obsolete restrictions on capital controls would be one important step.

II. What are Capital Controls?

Over the past century, most countries, including the United States, have experimented with various policy tools aimed at limiting or redirecting capital flows across their borders. Although this paper does not attempt to provide a detailed discussion of all the different types of capital controls (see end-notes for more comprehensive analyses), here is a brief summary of the major policy objectives and structure of controls used in recent years.

MAJOR POLICY OBJECTIVES OF CURRENT CAPITAL CONTROL POLICIES²

Preserve domestic macroeconomic and financial stability: Controls on capital outflows can limit the vulnerability of a national currency to speculative attack and stem panic-driven capital flight. Controls on inflows can prevent surges of investment that lead to inflation and create pools of capital that can leave abruptly during a crisis. A common objective is to discourage short-term, speculative “hot money” in favor of longer-term, productive investment.

Increased monetary policy autonomy: Capital controls can give countries policy space to undertake expansionary economic policies (more spending and lower interest rates), as their local currency becomes somewhat decoupled from international financial markets.³

TYPES OF CAPITAL CONTROLS⁴

To meet various objectives, capital controls have taken many different forms that can be loosely grouped into direct or indirect controls.

1. **Direct:** These measures seek to directly affect the volume of cross-border financial transactions through outright prohibitions, quantitative limits, or government approval procedures.

Examples:

Malaysia: At the height of the Asian financial crisis, Malaysia placed a one-year ban on the repatriation of capital (for details, see p. 7).

Argentina: When the country’s financial and currency crises of 2001 became unsustainable, the government prohibited domestic and foreign investors from transferring funds abroad, required central bank approval of wire transfers, and banned foreign currency futures transactions.

2. **Indirect:** These measures seek to make cross-border flows more costly. One of the most common is a reserve requirement with a central bank, set at a certain percentage of the investment and for a certain length of time.

Examples:

Chile: From 1991-1998, the government required foreign investors to place a deposit in a non-interest paying account with the central bank for one year (for details, see p. 7).

Colombia: In 2007, the government acted to combat inflation by introducing a special deposit requirement on short-term foreign portfolio capital and requiring foreign direct investment to stay in the country for a minimum of two years.⁵ These controls were relaxed in September 2008.



Argentina’s financial meltdown sparked an economic and political crisis.

Photo Credit: Beatrice Murch (c) Creative Commons. Available at: <http://flickr.com/photos/blmurch/2406045981>

III. U.S. Trade and Investment Agreements that Restrict Capital Controls

The United States has negotiated restrictions on capital controls through both bilateral investment treaties (BITs) and free trade agreements (FTAs) with 52 national governments. In the 1980s, U.S. officials began pursuing BITs, primarily with developing countries. These deals require each party to uphold long lists of investor rights, including the right to transfer capital into and out of their territory “freely and without delay.” To date, the United States has forged 40 such treaties that have entered into force. Another seven BITs have been signed but not yet ratified.⁶

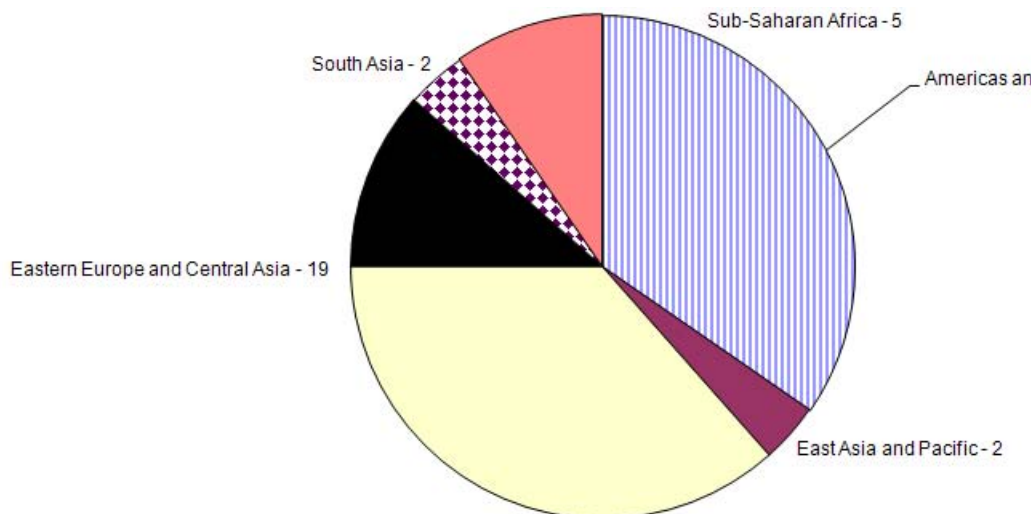
In the 1990s, the U.S. government began insisting that capital control restrictions also be included in trade agreements. Beginning with the 1994 North American Free Trade Agreement (NAFTA), the United States has negotiated bilateral or regional FTAs that include capital control restrictions with 12 countries. The regions with the highest number of such agreements are Latin America/Caribbean and Eastern Europe/Central Asia – areas where many countries have gone through rapid free market reforms (see Appendix 1 for a list of countries). As explained in further detail in section V, governments that violate these capital control restric-

tions are subject to being sued by private U.S. investors in supranational tribunals.

The United States has also promoted financial liberalization through the World Trade Organization. Under the WTO’s General Agreement on Trade in Services (GATS), countries can be restricted from imposing capital controls related to trade in financial services (e.g., inter-bank loans). Currently, these rules do not apply to all WTO members. The GATS is a framework agreement, through which governments make individual commitments to liberalize particular industries.⁷ Moreover, the GATS grants exceptions for times of balance of payments crises and does not allow investor-state dispute settlement. While the GATS rules on capital controls are not as far-reaching as those in U.S. FTAs and BITs, negotiators from the industrialized countries, backed by powerful financial sector lobbies, have been seeking to expand financial services commitments. It remains to be seen what approach the Obama administration will take on this matter.

What’s the theory behind the drive to eliminate capital controls? The argument is that only through

Countries with U.S. Trade or Investment Agreements – Regional Breakdown



financial liberalization can countries attract the foreign investment and make the economic efficiency improvements necessary for development. This claim, however, is unfounded. Studies have failed to find a strong correlation between capital market liberalization and increased foreign investment. In fact, 6 of the top 10 developing-country FDI recipients (China, Hong Kong, Russia, Brazil, Saudi Arabia, and India) have never signed a U.S. agreement restricting capital controls.⁸ Columbia University economist Jagdish Bhagwati, a strong advocate of trade liberalization, has charged that the inclusion of capital control restrictions in FTAs “seems therefore to be ideological and/or a result of narrow lobbying interests hiding behind the assertion of social purpose.”⁹

Current government leaders are handcuffed by these capital control rules, even though the vast majority were not in power when the deals were negotiated. Of the 52 leaders that are now bound to such agreements, only 13

were in office at the time their country’s agreement was signed.¹⁰ And once BITs are in force, they operate much like straitjackets. The U.S.-Bolivia treaty is typical. After the initial 10 years, either party can give one year’s written notice of intent to terminate the treaty, but the treaties’ protections continue to apply for another 10 years. Hence, this treaty, enacted in 2001, is designed to lock in both countries’ commitments at least until the year 2022. Only if both countries agree to renegotiate can changes be made in a shorter timeframe. Free trade agreements typically have less onerous termination clauses. NAFTA, for example, requires only six months’ notice. This more liberal approach is likely based on the assumption that governments would be loathe to withdraw from a comprehensive trade pact for fear of provoking a “trade war.” Indeed, in response to President Obama’s calls for NAFTA renegotiation, Mexico’s ambassador to the United States declared that this “would be nothing short of opening Pandora’s box.”¹¹



Europeans and Bolivians protest investor-state case brought by Telecom Italia in 2008.

IV. A Decade of Debate Over Capital Controls

THE IMF LEARNS LESSONS FROM THE ASIAN FINANCIAL CRISIS

Until the past decade, the International Monetary Fund was a powerful and devoted partner in the U.S. government's crusade to eliminate capital controls. Even though the IMF's Articles of Agreement explicitly allow for the use of capital controls to limit the destabilizing impact of massive capital transfers, the Fund consistently pressured countries to dismantle them.

It took a global financial crisis of epic proportions for the IMF to lift its blanket opposition to capital controls. Beginning in May 1997, nervous investors began pulling billions of dollars worth of short-term investments out of Asian countries whose economies were strapped by huge external debts. This began a chain reaction of currency devaluations and stock market plunges throughout Asia and into other regions of the world. By the end of 1998, numerous countries were struggling with skyrocketing unemployment, widespread bankruptcies, and consumer price increases that in some cases led to political unrest.

The IMF came under fire not only for its handling of the crisis, but also for creating the conditions for the meltdown by pressuring countries to lift controls on capital flows. The most prominent critic was former World Bank Chief Economist Joseph Stiglitz, who wrote that “the single most important factor leading to the troubles that several of the East Asian countries encountered in the late 1990s—the East Asian crisis—was the rapid liberalization of financial and capital markets.”¹²

Several countries that used capital controls to weather the crisis emerged relatively unscathed. Again, quoting Stiglitz: “It is no accident that the two large developing countries spared the ravages of the global economic crisis—China and India—both had capital controls. While developing world countries with liberalized capital markets actually saw their incomes decline, India grew at a rate in excess of 5% and China at close to 8%.” The IMF has also noted that these two countries' capital control policies were effective in shifting the composition of capital flows to favor longer-term, stable investment.¹³

Both China and India had capital control policies in place before the storm hit. And economists who support capital controls tend to agree that these measures are most useful if they are enacted “when the sun is shining.” Once the dark clouds of crisis become evident, it can be too late for such controls to be effective.

CHILE'S ECAJE

Chile is often cited as an example of effective use of capital controls through an ongoing policy. Throughout most of the 1990s, the Chilean government subjected capital inflows to the *encaje* (“strongbox” in Spanish)—a one year, non-interest paying deposit with the central bank. The deposit requirement varied from 10% to 30%, and the penalty for early withdrawal ranged from 1% to 3%. Chile fared better than most other Latin American countries during the Mexican peso crisis in 1994 and the Asian crisis a few years later. While the role of capital controls has been intensely debated, an IMF research review concluded that Chile's *encaje*, combined with other financial sector reforms, allowed the government more monetary policy autonomy and shifted the composition of foreign investment towards the longer term.¹⁴ After entering into discussions of a possible trade agreement with the United States, the Chilean government eliminated the *encaje* in 1998. In recent years, however, Argentina, Colombia, Peru, and Thailand have used Chilean-style controls on inflows.¹⁵

MALAYSIA'S CONTROLS ON CAPITAL OUTFLOWS

Malaysia adopted capital controls at a moment when the sun was decidedly not shining. At the height of the Asian financial crisis in 1998, the government abruptly imposed a mix of exchange and capital controls. “It was the moment of truth,” explains Third World Network Director Martin Khor. “They had followed the IMF policies for a year and the economy had still collapsed. Fortunately, our Prime Minister was not an economist—it's what saved Malaysia. He ignored the economists and put in place common sense policies.”¹⁶

The Malaysian controls prevented repatriation of capital for one year, an action that would be a clear violation of standard U.S. investment and trade agreements. The government also banned transfers between domestic and foreign accounts, fixed the local currency to the U.S. dollar, and restricted the amount of currency and investments that residents could take abroad.

An IMF report in 2000 gave the Malaysian plan a fairly favorable review: "In conjunction with other macroeconomic and financial policies, the controls helped to stabilize the exchange rate. Since the introduction of the controls, there have been no signs of speculative pressures on the exchange rate, despite the marked relaxation of fiscal and monetary policies to support weak economic activity. Nor have there been signs that a parallel or nondeliverable forward market is emerging; and no significant circumvention efforts have been reported."¹⁷

Three years later, Stiglitz wrote that "it was clear that Malaysia's capital controls allowed it to recover more quickly with a shallower downturn, and with a far smaller legacy of national debt burdening future growth. The controls allowed it to have lower interest rates than it could otherwise have had; the lower interest rates meant that fewer firms were put into bankruptcy and so the magnitude of publicly funded corporate and financial bailout was smaller. The lower interest rates meant too that recovery could occur with less reliance on fiscal policy, and consequently less government borrowing. Today, Malaysia stands in a far better position than those countries that took IMF advice."¹⁸

Of course no one argues that capital controls are effective 100% of the time. Wily investors often find ways to evade them. There are risks of high administrative costs, of unintentionally discouraging valuable investment, and of distracting from the root causes of financial instability. However, a growing number of noted economists maintain that on balance, governments are better off with capital controls in their tool bag than without them.¹⁹ (See box, p. 10-11.)

SIGNS OF IMF'S CHANGE IN POSITION

In the aftermath of the Asian crisis, IMF officials did not suddenly become enthusiastic cheerleaders for capital controls. But in 2000, they released a paper that reviewed experiences with capital controls and admitted that "where prudential standards are weak, other measures, including capital controls, may prove useful in

managing the specific risks associated with international capital flows."²⁰

The change in the IMF's position started becoming evident in their advice to national governments. A November 2000 IMF Article IV consultation report on Russia states that "in view of the need to avoid a potentially sharp increase in capital outflows [...] the staff recommended temporary approval of the exchange restrictions and [other measures]."²¹ In a February 2001 Article IV report for Tunisia, the IMF notes the government's worry about the potentially destabilizing effects of full capital market liberalization. The IMF document then states that "it was indeed premature to envision a broad-scale liberalization of financial market transactions."²²

In 2003, then-IMF Chief Economist Kenneth Rogoff published a strong defense of his employer, but did concede that "In some cases—most famously South Korea and Mexico—the fund didn't warn countries forcefully enough about the dangers of opening up to international capital markets before domestic financial markets and regulators were prepared to handle the resulting volatility." He added that "Temporary controls on capital outflows may be important in dealing with some modern-day financial crises, while various kinds of light-handed taxes on capital inflows may be useful for countries faced with sudden surges of inflows."²³

That same year, IMF officials hardly batted an eye when the Argentine government announced the introduction of Chilean-style controls on short-term capital inflows. The country's economy minister stated "We want to make it clear that short-term speculative flows are not compatible with the Argentine economy."²⁴ IMF spokesperson Thomas Dawson responded by stating that "It's not an issue on which we have strong theological views. Indeed there have been a number of countries where controls on short-term incoming flows, where the rules of the game are fairly well established, have worked out quite well. And the case that is normally cited is Chile."²⁵

A December 2008 IMF study of 11 countries in Eastern Europe and Central Asia found that the Fund has advised two of those countries—Bulgaria and Croatia—to increase reserve requirements on capital inflows in recent years.²⁶ And when Iceland imposed capital controls in the aftermath of the country's banking sector meltdown, the IMF advised the government "not to lift these restrictions before stability returns to the foreign exchange market."²⁷

While the IMF appears to have lost religion on the issue of capital controls, U.S. officials, particularly in the Treasury Department, have remained true believers.

BUSH ADMINISTRATION REFUSES TO CHANGE POSITION

In the wake of the global financial crisis of the late-1990s, U.S. officials not only refused to review capital control bans in existing trade agreements and investment treaties, they continued to negotiate additional agreements with these very same rules. Since 1997, U.S. agreements that restrict the use of capital controls have gone into effect in 22 countries.

Two countries—Singapore and Chile—put up some resistance to capital control limits in negotiations over bilateral free trade agreements with the Bush Administration, but to no avail.²⁸ In testimony before Congress in April 2003, John B. Taylor, then-Under Secretary of Treasury for International Affairs, explained that the Asian financial crisis had not changed the views of the U.S. government one iota. Plus, he explained, “The right of free transfers is considered by the business community as one of the most important protections conferred in these treaties.”²⁹

The Bush administration even refused to allow Singapore and Chile to maintain the authority to use capital controls temporarily during periods of severe economic crisis. The only concession U.S. officials made for crisis situations was to require foreign investors to wait one year before filing claims for compensation against these countries. Even a senior IMF legal counsel called the U.S. refusal to grant a waiver for crisis periods “draconian” and (in an ironic twist) complained that the rules might interfere with the IMF’s own power to request capital controls.³⁰

Obama economic advisor Daniel Tarullo³¹ has also cautioned of the foreign policy debacles that could result if a country subjected to these rules goes ahead and uses short-term capital controls during a severe financial crisis: “As the country struggles to emerge from its recession...U.S. investors file their claims for

compensation. And, of course, under the bilateral trade agreement they are entitled to that compensation. Thus the still-suffering citizens of the country are treated to the prospect of U.S. investors being made whole while everyone else bears losses from an economic catastrophe that has afflicted the entire nation. Regardless of what one thinks of the merits of capital controls, one would have to be naïve not to think that an anti-American backlash would result.”³²



Americans, Europeans, and Bolivians protest investor-state cases against Bolivia.

During President George W. Bush’s final days in office, and as the international financial system spiraled out of control, he continued to pressure Congress to pass a free trade agreement with Colombia that restricts capital controls (see agreement text in Appendix 2).

Statements by Noted Economists on Capital Controls

“Our government’s insistence on such provisions is bad financial policy, bad trade policy, and bad foreign policy.”

– **Daniel Tarullo**, Obama economic advisor and Federal Reserve Board nominee¹

“Credit lines, like those extended by the Fed to struggling nations, need to be paired with regulations to discourage capital flight, and capital controls more generally should be viewed as useful tools for particular circumstances.”

– **Guillermo Calvo**, former President of the International Economic Association (until 2008) and former Chief Economist of the Inter-American Development Bank²

“Small developing countries are like small boats. Rapid capital market liberalization, in the manner pushed by the IMF, amounted to setting them off on a voyage on a rough sea, before the holes in their hulls have been repaired, before the captain has received training, before life vests have been put on board. Even in the best of circumstances, there was a high likelihood that they would be overturned when they were hit broadside by a big wave.”

– **Joseph Stiglitz**, Nobel Prize-winning economist³

“Countries should have appropriate capital controls in place to avoid undesirable and excessive capital inflows when not needed, and to stem sudden, disruptive large outflows.”

– **Jomo Kwame Sundaram**, U.N. Assistant Secretary General for Economic Development⁴

“Developing nations need to rely on a broader set of instruments, targeting the capital account directly. Deposit requirements on capital inflows and financial transaction taxes are some of the tools available.”

– **Dani Rodrik**, Harvard University, and **Arvind Subramanian**, Peterson Institute for International Economics⁵

“Capital controls are not necessarily the answer for every country that experiences a financial crisis; sometimes confidence can be restored without the need for coercive measures, and even when calming words fail, ‘burden sharing’ by banks and other lenders will often be enough. But it would now be foolish to rule out controls as a measure of last resort.”

– **Paul Krugman**, Nobel Prize-winning economist⁶

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1. Daniel Tarullo, “Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Committee on Financial Services, U.S. House of Representatives,” April 1, 2003. <http://financialservices.house.gov/media/pdf/040103dt.pdf>.
 2. Barry Eichengreen and Richard Baldwin, editors, “What G20 leaders must do to stabilise our economy and fix the financial system,” Centre for Economic Policy Research (London), 2008. http://www.voxeu.org/reports/G20_Summit.pdf.
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 4. Interview with Jomo K.S., Sun2Surf, December 5, 2008. <http://www.thesundaily.com/article.cfm?id=28272>.
 5. Dani Rodrik and Arvind Subramanian, “We must curb international flows of capital,” *Financial Times*, February 25, 2008. http://www.ft.com/cms/s/0/bec0b4b2-e3a5-11dc-8799-0000779fd2ac.html?nclink_check=1.
 6. Paul Krugman, “Capital Control Freaks,” *Slate*, Sept. 27, 1999. <http://www.slate.com/id/35534/>.

Statements by Noted Economists on Capital Controls (cont.)

“Capital flows are like fire...It is easy to say: follow sound macroeconomic policies, adjust your exchange rates, improve your banks, eliminate cronies; etc. But can anyone seriously maintain that these conditions can be fulfilled or that, even if they are, panic-fed outflows of huge quantities of capital in the absence of controls will not materialize? Both empirical evidence and theoretical models strongly indicate that we have to be less gung-ho and more prudent than was the case in the years prior to the Asian financial crisis and its spread through contagion.”

– **Jagdish Bhagwati**, Columbia University⁷

“The U.S. Treasury should rethink its knee-jerk opposition to capital controls.”

– **Paul Blustein**, former Washington Post reporter and author⁸

“Recent financial crises and frequent recourse by countries to controls to contain the effects of swings in capital flows, point to the case for continuing to accord governments such autonomy. Flexibility rather than additional constraints or obligations would appear to be necessary.”

– **United Nations Conference on Trade and Development**⁹

“In my view the whole management of the domestic economy depends upon being free to have the appropriate interest rate without reference to the rates prevailing in the rest of the world. Capital controls is a corollary to this.”

– **John Maynard Keynes**¹⁰

“While capital account openness has an ambiguous impact on growth, there are clearer implications for its effect on factor shares. Specifically, liberalization is associated with a decreased share of productive income going to labor.”

– **Gerald Epstein**, Political Economy Research Institute¹¹

“I have some sympathy for those who argue that controls on the inflow, as opposed to the outflow, of short-term investments might make sense as a transitional device. Chile had some apparent success in reducing reliance on volatile funds through restrictions on the inflow of short-term capital.”

– **Robert Rubin**, former Treasury Secretary¹²

“The freeing of financial markets to pursue their casino instincts heightens the odds of crises.”

– **Lawrence Summers**, director of the White House National Economic Council¹³

7. Jagdish Bhagwati, “U.S. House of Representatives Committee on Financial Services Testimony Subcommittee on Domestic and International Monetary Policy, Trade and Technology,” April 1, 2003. <http://www.columbia.edu/~jb38/testimony.pdf>

8. Paul Blustein, “And the Money Kept Rolling In (And Out)” Public Affairs, 2005.

9. UNCTAD, Trade and Development Report, 1998.

10. Keynes, Collected Works, Vol. XXV, p. 149.

11. Gerald Epstein, editor, Capital Flight and Capital Controls in Developing Countries (Edward Elgar Publishing, 2005).

12. Robert Rubin and Jacob Weisberg, In an Uncertain World: Tough Choices from Wall Street to Washington (Random House, 2003), p. 257.

13. Lawrence Summers and Victoria Summers, “When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax,” Journal of Financial Services Research, December 1989. Note: Lawrence Summers expressed criticism of capital controls as Treasury Secretary in the Clinton Administration.

V. Enforcement of Capital Control Restrictions

Countries that violate the capital control restrictions in U.S. bilateral investment treaties or free trade agreements are subject to being sued by private investors in supranational tribunals. Of the 52 governments that have such agreements with the United States, only Australia refused to accept U.S. demands for “investor-state” dispute resolution.

Civil society groups and many elected officials around the world have been harshly critical of the investor-state dispute system, arguing that it represents the privatization of justice. Under these rules, foreign investors are allowed to bypass national courts and sue governments directly in commercial arbitration courts. The most-often used is the International Center for the Settlement of Investment Disputes (ICSID), which is associated with the World Bank.

The Institute for Policy Studies has written extensively on the investor-state dispute regime. See, for example, the report “Challenging Corporate Investor Rule: How the World Bank’s Investment Court (ICSID), Free Trade Agreements (FTAs), and Bilateral Investment Treaties (BITs) have Unleashed a New Era of Corporate Power and What to Do About It.”³³ Here is a short summary of some of the most controversial aspects of this system:

- 1. Investor-state cases involve a government in its sovereign capacity and often deal with matters that have sweeping implications for the public interest.** Such cases are inappropriate for private arbitration. Cases against governments for actions taken to ameliorate a financial crisis certainly fall into this category. And yet, for example, Argentina has faced 44 investor-state cases that relate at least in part to actions taken in response to that country’s severe crisis in earlier in this decade.³⁴
- 2. Tribunals lack public accountability, transparency and citizen participation.** In only a very few cases have citizen’s groups been allowed to submit an amicus brief or even attend a hearing, much less gain access to court documents or provide testimony to the proceedings.

- 3. In the arbitration system, there is no separation between the role of judge and lawyer.** In the public judicial system, no practicing lawyer is permitted to also be a member of the judiciary. However, in the arbitration system there is little distinction between the two roles. Lawyers or arbitrators also serve the role of judges when they serve on arbitration panels or tribunals. This creates both the perception of conflict of interest and/or an actual conflict of interest.

- 4. Arbitrators lack expertise in issues other than commercial matters.** Obama economic advisor Daniel Tarullo has pointed out that “the arbitral panels that decide such cases have generally been composed of people with the kinds of backgrounds one finds among traditional commercial arbitrators. They will not likely have macroeconomic expertise. Indeed, by the terms of the agreements, it does not matter how good a reason the country had for imposing controls in the first place.”³⁵

The U.S. and other rich country governments have not been immune to investor lawsuits. The United States and Canada have faced dozens of expensive suits filed under the investment chapter of the North American Free Trade Agreement. Canada even repealed an environmental health regulation in the face of one threatened lawsuit by a U.S. corporation. The U.S. government is currently facing a suit by a Canadian company over regulations to reduce the environmental damage of a gold mining project. However, by far the most typical case involves a private investor based in a richer nation against a government in a poorer nation. According to UNCTAD, 90% of known investor disputes in 2007 were initiated by firms based in developed countries.³⁶

VI. Capital Controls and the Current Crisis

Although the current crisis originated in the United States rather than Asia, the effects on the rest of the world are reminiscent of those in the late 1990s crisis—plunging stock markets, withering consumer confidence, capital flight, and currency devaluations. In the face of this spreading crisis, some countries have maintained capital controls (e.g., China³⁷ and Thailand³⁸), while others have imposed or tightened them (e.g., Iceland,³⁹ Ukraine,⁴⁰ and Argentina⁴¹). There has been much speculation that Russia may be considering some type of controls, as it continues to hemorrhage capital in the midst of both the financial crisis and the conflict with Ukraine. In 2008, the country lost a record \$130 billion through capital flight.⁴² Other countries facing severe capital flight are as far-flung as Pakistan, Indonesia, South Korea, Mexico, and Nigeria.

Currency devaluation can make a country's exports more competitive, but only if markets for the products exist—hardly a given during a global recession. In the meantime, government budgets are strained by high prices for imports and for foreign debt payments. But when countries do not have the option of using capital controls, they have only a few other tools they can use to respond to capital flight.

In the case of Mexico, foreign investors withdrew more than \$22 billion from the country's stock exchange or debt bonds in the last few months of 2008.⁴³ The government, which is restricted from using capital controls because of NAFTA, has struggled to prop up the value of its currency by buying up pesos. Between October 8 and December 1, the Mexican government auctioned off \$14.8 billion of its dollar reserves, or nearly 18% of its total foreign reserves.⁴⁴ Depleting reserves to fight devaluation is a risky strategy. Not only does it reduce the funds available for development, it also raises the risk of even further capital flight, as low reserve levels undermine investor confidence.

Countries with U.S. BITs or FTAs with significant currency devaluations in 2008

Country	% change in the value of national currency against the U.S. dollar, Jan. 1, 2008 to Jan. 1, 2009
Ukraine	-35
Turkey	-24
Chile	-21
Australia	-21
Mexico	-21
Canada	-19
Poland	-17
Romania	-14
Uruguay	-12
Kyrgyzstan	-10
Costa Rica	-10
Argentina	-8
Mongolia	-8
Jamaica	-7
Haiti	-7
Dominican Republic	-7

Source: calculated by the author, based on data from: <http://www.oanda.com>.

Other Policy Handcuffs in U.S. Investment Agreements

In addition to capital control restrictions, governments that accept the U.S.-promoted investment rules surrender other economic tools as well. With only small variations, the following rules are found in all U.S. bilateral investment treaties and all trade agreements signed by the United States since 1993:

1. Restrictions on “Indirect” Expropriation

Whereas expropriation in past international agreements applied to physical takings of property, current rules also protect investors from “indirect” expropriation, interpreted to mean regulations and other government actions that significantly reduce the value of a foreign investment. Hence, corporations can sue over environmental, health, and other public interest laws developed through a democratic process. While the tribunals cannot force a government to repeal such laws, the threat of massive damages awards can put a “chilling effect” on responsible policy-making.

2. Limits on Performance Requirements

Governments must surrender the authority to require that foreign investors use a certain percentage of local inputs in production, transfer technology, and other conditions used in the past as responsible economic development tools.

3. National Treatment and Most Favored Nation Treatment

Governments must treat foreign investors and their investments at least as favorably as domestic investors and those from any third country. While this is touted as a basic principle of fairness, it strips the power of governments to pursue national development strategies used in the past by nearly every successful economy to strengthen domestic industries.

4. Vague “Fair and Equitable Treatment” Standards

These terms have no definable meaning and are inherently subjective. This allows arbitrators to apply their own interpretations to government actions in countries with diverse histories, cultures and values systems and has had a “chilling” effect on regulatory regimes.

VII. Opportunities for Change

During the election campaign, Barack Obama made several statements indicating a commitment to revise the investment rules in U.S. trade policies. For example, in response to a survey by the Pennsylvania Fair Trade Coalition, he wrote that “With regards to provisions in several FTAs that give foreign investors the right to sue governments directly in foreign tribunals, I will ensure that foreign investor rights are strictly limited and will fully exempt any law or regulation written to protect public safety or promote the public interest.”⁴⁵

On this issue, President Obama will find much common ground with counterparts in other countries. Particularly in South America, political leaders have already begun exploring ways of challenging excessive international investor protections and advancing proposals for more just and sustainable trade and investment regimes.

On May 2, 2007, the Bolivian government became the first in the world to withdraw from ICSID, the investment arbitration court associated with the World Bank. On November 23, 2007, the Ecuadorian government notified ICSID that it would not accept its jurisdiction in cases stemming from disputes over nonrenewable resources. The Ecuadorian government also announced plans to renegotiate at least nine of its BITS. The Argentine government has raised concerns over flaws in the system, after being hit by more than 40 investor claims in recent years, many of them in retaliation for actions taken to alleviate the pain of financial crisis on average citizens. Venezuela and Nicaragua joined Bolivia in a joint declaration criticizing ICSID on April 29, 2007.⁴⁶ The Brazilian government has steadfastly refused to enter into these types of agreements.

Some developed countries have also been critical. As previously mentioned, the Australian government refused to accept investor-state dispute settlement in the 2004 U.S.-Australia Free Trade Agreement. The Norwegian government has drafted a new model BIT that aims to balance investor protections with a government’s ability to regulate in the interest of the public and the environment.⁴⁷ South Africa and Pakistan have also refused to sign BITS based on the U.S. model.⁴⁸

In this time of growing backlash to the excessive

power of corporate investors, it is critical that policy-makers not only revise restrictions on capital controls, but also commit to building a new global framework that allows democratic governments to play responsible roles in ensuring that foreign investment supports sustainable development.

The Obama administration should take advantage of several opportunities for eliminating the obsolete restrictions on capital controls, as part of a broader effort to build a new global architecture to govern international trade, finance, and investment in ways that promote democracy, stability, human rights, and sustainable development.

RECOMMENDATIONS:

- 1. Fulfill Commitments to Change U.S. Trade Policy:** Obama should work with Congress to ensure that all future (and pending) agreements meet the standards laid out during his campaign. Particularly in light of the global economic crisis, he should broaden his proposed reforms of investment rules to include the elimination of capital control restrictions.
- 2. Renegotiate the North American Free Trade Agreement:** President Obama should follow through on his promises to renegotiate NAFTA, as a first step towards overhauling existing U.S. trade and investment policies. The capital control provisions are just one of the many problems that need to be fixed in this 15-year-old pact. And yet eliminating restrictions on this policy tool would send an important message that the new U.S. administration is committed to allowing developing countries the policy space they need to resolve and prevent crises and to pursue sustainable development.
- 3. Halt World Trade Organization Talks:** The WTO’s General Agreement on Trade in Services already includes some restrictions on capital controls, and further financial services deregulation has been a key goal of U.S. and

European negotiators. The Obama administration should call for an end to current Doha Round negotiations and allow countries to roll back existing GATS commitments to open up their financial services markets.

4. Renegotiate Bilateral Investment Treaties:

The Obama administration should reach out to the governments of Bolivia, Ecuador and other countries that have raised strong objections about the impacts of these treaties on democracy, human rights, and sustainable development. They should begin a process of revising these agreements, as well as the dispute settlement system that enforces treaty rules. Renegotiation is far from unprecedented. According to the United Nations Conference on Trade and Development, other countries have renegotiated more than 120 bilateral

investment treaties, in some cases to reflect social and environmental concerns.

5. Solidify International Financial Institutions' Policy Change on Capital Controls:

While the International Monetary Fund has abandoned its blanket opposition to capital controls, it has been inconsistent in supporting the authority of borrowing countries to use this and other pro-active tools for promoting financial stability. The Obama administration should direct its representatives to all of the international financial institutions to push for such a policy, as part of a process of building a new international financial architecture to prevent future crises and promote equitable and sustainable development.

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Appendix 1: Countries with Capital Control Agreements with the U.S.

	Country	Type of agreement (bilateral investment treaty or free trade agreement)	Entered into force
1	Albania	BIT	1998
2	Argentina	BIT	1994
3	Armenia	BIT	1996
4	Australia	FTA	2005
5	Azerbaijan	BIT	2001
6	Bahrain	BIT and FTA	BIT - 2001, FTA - 2006
7	Bangladesh	BIT	1989
8	Bolivia	BIT	2001
9	Bulgaria	BIT	1994
10	Cameroon	BIT	1989
11	Canada	FTA (NAFTA)	1994
12	Chile	FTA	2003
13	Congo, Democratic Republic of	BIT	1989
14	Congo, Republic of	BIT	1994
15	Costa Rica	FTA (CAFTA-DR)	2009
16	Croatia	BIT	2001
17	Czech Republic	BIT	1992
18	Dominican Republic	FTA (CAFTA-DR)	2007
19	Ecuador	BIT	1997
20	Egypt	BIT	1992
21	El Salvador	FTA (CAFTA-DR)	2006
22	Estonia	BIT	1997
23	Georgia	BIT	1997
24	Grenada	BIT	1989
25	Guatemala	FTA (CAFTA-DR)	2006
26	Honduras	BIT and FTA (CAFTA-DR)	BIT - 1992, CAFTA - 2006
27	Jamaica	BIT	1997
28	Jordan	BIT and FTA	BIT - 2003, FTA - 2001

	Country	Type of agreement (bilateral investment treaty or free trade agreement)	Entered into force
29	Kazakhstan	BIT	1994
30	Kyrgyzstan	BIT	1994
31	Latvia	BIT	1996
32	Lithuania	BIT	2001
33	Mexico	FTA (NAFTA)	1994
34	Moldova	BIT	1994
35	Mongolia	BIT	1997
36	Morocco	BIT and FTA	BIT - 1991, FTA - 2006
37	Mozambique	BIT	2005
38	Nicaragua	FTA (CAFTA-DR)	2006
39	Oman	FTA	2006
40	Panama	BIT (FTA is pending)	2001
41	Peru	FTA	2008
42	Poland	BIT	1994
43	Romania	BIT	1994
44	Senegal	BIT	1990
45	Singapore	FTA	2004
46	Slovakia	BIT	1992
47	Sri Lanka	BIT	1993
48	Trinidad And Tobago	BIT	1996
49	Tunisia	BIT	1993
50	Turkey	BIT	1990
51	Ukraine	BIT	1996
52	Uruguay	BIT	2006

Appendix 2: Capital Control Restrictions in the Pending U.S.-Colombia Free Trade Agreement

The language in the pending U.S.-Colombia Free Trade Agreement represents the standard text included, with only minor variations, in all U.S. bilateral investment treaties and all U.S. bilateral and regional free trade agreements, beginning with the 1994 North American Free Trade Agreement.

RELEVANT AGREEMENT TEXT:

ARTICLE 10.8: TRANSFERS

1. Each Party shall permit all transfers relating to a covered investment to be made freely and without delay into and out of its territory. Such transfers include:
 - (a) contributions to capital;
 - (b) profits, dividends, capital gains, and proceeds from the sale of all or any part of the covered investment or from the partial or complete liquidation of the covered investment;
 - (c) interest, royalty payments, management fees, and technical assistance and other fees;
 - (d) payments made under a contract, including a loan agreement;
 - (e) payments made pursuant to Article 10.6.1 and 10.6.2 and Article 10.7; and
 - (f) payments arising out of a dispute.
2. Each Party shall permit transfers relating to a covered investment to be made in a freely usable currency at the market rate of exchange prevailing at the time of transfer.
3. Each Party shall permit returns in kind relating to a covered investment to be made as authorized or specified in a written agreement between the Party and a covered investment or an investor of another Party.
4. Notwithstanding paragraphs 1 through 3, a Party may prevent a transfer through the equitable, non-discriminatory, and good faith application of its laws relating to:
 - (a) bankruptcy, insolvency, or the protection of the rights of creditors;
 - (b) issuing, trading, or dealing in securities, futures, options, or derivatives;
 - (c) criminal or penal offenses;
 - (d) financial reporting or record keeping of transfers when necessary to assist law enforcement or financial regulatory authorities; or 10-6
 - (e) ensuring compliance with orders or judgments in judicial or administrative proceedings.

Source: U.S. Trade Representative, U.S.-Colombia Free Trade Agreement, Final Text.

http://www.ustr.gov/assets/Trade_Agreements/Bilateral/Colombia_FTA/Final_Text/asset_upload_file630_10143.pdf



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