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Reconciling IMF rules and international investment agreements: An innovative derogation for capital controls

by
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There is currently no universal framework governing capital controls. As a result, a conflict has arisen due to the different approaches taken by various international organizations and many international investment agreements (IIAs). In particular, the International Monetary Fund (IMF) -- established to manage the international financial system -- preserves national autonomy over capital controls when such measures are deemed necessary; in contrast, IIAs, and especially bilateral investment treaties (BITs) -- crafted primarily to protect investors -- typically do not allow for the imposition of restrictions on capital outflows associated with foreign investments for balance-of-payments reasons.

More specifically, countries that significantly limit the policy space for capital controls in their IIAs (that is, do not allow for a balance-of-payments derogation) can potentially come in direct conflict with the IMF. For instance, a senior IMF lawyer, expressing concern that this approach might be contrary to a request by the Fund that a government adopt capital controls, observed that there is a risk that, "in complying with its obligations [under Free Trade Agreements] … a member could be rendered ineligible to use the Fund's resources under the Fund's articles."[1] Recent volatile capital flows to developing countries, as well as the greater acceptance of capital controls today, make it likely that this issue will stay on the international agenda. This dilemma

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[1] Deborah E. Siegel, "Using free trade agreements to control capital account restrictions: Summary of remarks on the relationship to the mandate of the IMF," *International Law Student Association Journal of International and Comparative Law*, vol. 10 (2004), p. 301.

has been recognized in the international community, as demonstrated by several attempted solutions.[2]

In response to this issue, IIAs should incorporate derogations for countries when treaty obligations conflict with IMF recommendations. More specifically, if and when the IMF suggests that a government employ capital controls for a limited time to respond to severe economic hardship, the employing country would have a complete defense against investor lawsuits under IIAs incorporating such derogations.

This recommendation may be more politically palatable than other proposed derogations that might afford greater discretion to treaty parties in the implementation of capital controls and therefore should be the most politically feasible. Moreover, the IMF has the preeminent role in international economic rule-making on this issue; the General Agreement on Trade in Services defers to IMF authority on the question of transfer restrictions and some countries have already demonstrated a willingness to rely on IMF judgment on this subject: the North American Free Trade Agreement's balance-of-payments derogation relies upon IMF statistical information and recommendations. US Treasury Secretary Timothy Geithner has even advocated a greater role for the IMF in policing international capital flows.[3]

This proposal could be especially useful for US IIAs and the US Model BIT; the US has been particularly reluctant to incorporate any derogation for capital controls into its IIAs. This plan offers several advantages over the potential balance-of-payments derogation currently debated by the US State Department. First, an IMF exemption could allow controls to prevent a crisis from escalating, rather than addressing problems purely retrospectively; this problem has already occurred regarding the NAFTA balance-of-payments exception. Though permission to use capital controls in this manner would likely be extremely rare, the possibility may prevent a costly and potentially unnecessary buildup of reserves, as occurred in Mexico.[4] The requirement of an IMF recommendation to use controls would also limit abuse of the flexibility by host countries. It is also more objective and therefore promotes legal predictability, as the existence of a balance-of-payments crisis can be subjective. A country may be threatened with lawsuits even if it believes capital controls are needed to respond to a clear balance-of-payments dilemma; IMF permission to impose capital controls would remove this uncertainty. If the IMF states that capital controls are needed to address a financial difficulty, a country may proceed without fear of lawsuits.

Most importantly, this proposed derogation would directly address the IMF's concern that its authority to recommend capital controls could be undermined by IIAs. While rules of international institutions are carefully designed to ensure that they do not create conflicting

[2] E.g., some IIAs state that in exceptional cases restrictions to the transfer of funds provisions are allowed when they conform with relevant WTO agreements and IMF regulations. Furthermore, more recent IIAs increasingly incorporate balance of payments exceptions. However, in contrast, the new 2012 US Model BIT does not allow for capital controls.

[3] Statement by the United States Secretary of the Treasury Timothy Geithner in the twenty-third meeting of the International Monetary and Financial Committee, April 16, 2011, available at: http://www.imf.org/external/spring/2011/imfc/statement/eng/usa.pdf.

[4] Manuel Perez-Rocha, "Mexico's hot money challenge," *The Epoch Times*, March 6, 2011, available at: http://www.theepochtimes.com/n2/opinion/mexicos-hot-money-challenge-52467.html.

obligations, this is not the case for most treaties crafted in the investment area. Currently, it is possible that a country in crisis will have to face two potentially conflicting international obligations: an IMF recommendation to employ capital controls, and IIAs that allow investors to sue if controls are imposed. A simple derogation in IIAs would remove this risk and enhance the compatibility of such agreements with international rule-making.

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