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Capital Account Regulations and Investor Protections in Asia*

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Why Capital Account Regulations

Since at least the early 1990s, countries that sought to regulate the capital account risked self-inflicted stigma in the international investment arena, even in the face of uncontroverted analytical reasons for their appropriateness.[1] Subsequent events, including the Asian financial crisis in 1997, have not eliminated the stigma risk from capital account controls but the analytical discussion has shifted to when, not if, such controls are warranted.[2]

There are compelling reasons for capital account regulations. One can classify three levels of objectives, of increasing scale and permanence, for capital account regulation:

(1) As a tool for responding to balance of payments crises;

(2) As a tool for regaining and maintaining countercyclical macroeconomic policy space;

(3) As a tool for harnessing resources of the financial sector to support industrial development and the creation of a productive domestic financial sector.

The evaluation of the impact of free trade agreements and bilateral investment treaties on the scope for capital account regulations can be undertaken in terms of how their provisions constrain the attainment of these three objectives.

This brief takes as a starting point the view elaborated in Gallagher, Griffith-Jones, and Ocampo (2012) that capital account controls (called by those authors as "capital account regulations") must be an essential part of the toolkit for macroeconomic policy. Ocampo (2012) demonstrates that capital account regulations are necessary to establish the tools for countercyclical macroeconomic policy. This view is more expansive than the one taken in the recent International Monetary Fund (IMF) staff (Ostry and others, 2010) view that capital controls could be appropriate principally to forestall financial fragility[3]. An immediate implication of a view that capital account regulations are permanent features of macroeconomic management is that governments must establish and maintain bureaucratic capabilities to implement such regulations. Governments must also stand ready to continually amend regulatory approaches in response to the continuing evolution of private agents' tactics to evade them (Spiegel, 2012).

To these two justifications must be added that capital account regulations are essential tools for achieving longer-term development objectives. In a paper first published in 1993, Akyuz (2012) identifies the analytical reasons for restricting the participation of foreign portfolio managers and foreign banking institutions in the domestic financial sector if the priority is to achieve industrial development objectives and, indeed, to concomitantly develop the domestic financial sector itself as part of the overall development strategy.

The core of the developmental argument against fully open capital accounts is that "most international financial transactions are portfolio decisions, largely by rentiers, rather than business decisions by entrepreneurs" (Akyuz, 2012, p. 29). This means that:

"The bulk of capital movements is motivated primarily by the prospect of short-term capital gains, rather than by real investment opportunities and considerations of long-term risk and return. The speculative element is capable of generating gyrations in exchange rates and financial asset prices by causing sudden reversals in capital flows for reasons unrelated to policies and/or the underlying fundamentals. Rather than penalizing inappropriate policies, capital flows can help to sustain them" (Akyuz, 2012, p.29).

Akyuz (2012) cites the United States and Italy as cases where capital flows have sustained inappropriate policies in his 1993 analysis. Since then, as other countries sought to internationalize their financial sectors, many emerging countries, including the main participants in the Asian financial crisis, have seen extended periods of self-fulfulling short-term capital inflows through the creation of domestic asset price bubbles. These extended - but ultimately unsustainable - periods of exchange overvaluation aggravates the trade deficit and can cause long-term damage to the traded goods sector. Government efforts to dampen the inflationary impact of the inflows lead to costly sterilization policies and a regime of high domestic interest rates, further depressing incentives for long-term domestic investment. As Akyuz (2012) pointed in 1993, these unfavorable impacts of open capital accounts on long-term development are independent of whether there

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are chronic fiscal deficits or if trade and/or domestic financial liberalization have been completed. The issue therefore is not one of the order of liberalization; it is one of development.

If the objective is to engender long-term investment and economic diversification, a certain amount of stability in exchange rates and the availability of finance at reasonable rates of interest for long-term domestic investments are required. In most situations in developing countries, capital control regulations are the least costly measures for exchange rate and domestic price stability. Hypothetically, these measures can also be used to change the maturity structure of foreign capital flows, even though these measures cannot really change the basic nature of portfolio flows from external sources. The actual measures applied will depend on many factors and these measures will need to be often updated to respond to evasive actions of the private sector. These measures must be fit to the size and diversity of a country's trade linkages, the ease of movement of asset claims across borders, the level of real sector and financial system development, and so on.

The analysis in this paper suggests that the investor protections that many Asian countries have undertaken in the investment chapters of their free trade agreements excludes the possibility of capital account measures because most of these protections apply in a blanket manner to all financial investments, including those not yet in existence at the time of the treaty. All kinds of portfolio, short-term and speculative investments are protected under these commitments. There are also often explicit transfer provisions requiring free movement of capital (without having to frame it as an expropriation). These commitments do not recognize the distinction between legitimate regulatory activity and state actions which can be interpreted as indirect (so-called "regulatory takings") expropriation. Under these commitments, indirect expropriation is ground for investor actions to seek to stop regulatory actions and launch arbitration proceedings to obtain compensation. According to these agreements, these investor actions can be started without the need to course grievances through domestic regulatory and judicial processes.

There are also interactions among commitments undertaken by one country to its partners. The existence of a most favored nation treatment can mean that even if safeguards have been included in one treaty they would not apply if other treaties do not have such safeguards.

Regional/Bilateral Trade Agreements and Investment Treaties

Countries in the Asian region have been as active as those in other regions in negotiating and acceding to bilateral and regional trade agreements which have investment chapters or provisions that potentially involve restrictions on capital account regulations. Chapter 8 in Khor (2008) analyzes the kinds of provisions that tend to be part of these investment chapters. In particular, free trade agreements with the United States consistently include these provisions. In this section, we shall review the free trade agreements for which there is a notification to the World Trade Organization (WTO) for key Asia-Pacific countries.

The WTO lists 14 notifications[4] of Free Trade Agreements (FTAs) for India, of which four have investment chapters. Except for the FTAs with Chile and Mercosur, Indian FTAs include investment chapters with countries outside the subcontinent, including Japan, the Republic of Korea, and Malaysia. Pakistan has six notifications, of which two, with China and Malaysia, have investment chapters. China has seven notifications, and only those with Macau and Hong Kong do not have investment provisions.

ASEAN countries follow the China pattern in that it is the exception that FTAs notified to the WTO do not have an investment chapter. In the case of Thailand, out of 10 notifications, only two, do not have investment chapters.

Asian countries have recently been active in acceding to Bilateral Investment Treaties (BITS), particularly in the last decade with the ramping up of the treaty facilitation activities in the investment division of the United Nations Conference on Trade and Development (UNCTAD). UNCTAD's data base lists 37 BITS for Thailand, 88 for China, 30 for the Philippines, 36 for Malaysia, 32 for Viet Nam, 52 for Indonesia, 19 for Singapore, 19 for Cambodia, 33 for India, 39 for Pakistan. It is notable that Singapore, an important investment destination, has relatively fewer treaties listed in the data base. As will be explained in a subsequent section, because of the effect of most favored nation provisions and the definition of an investor, the number of treaties is not necessarily a good indication of the constraints imposed on countries of bilateral investment provisions.

Constraints on Capital Account Regulations

Overall framework

The purposes of regional agreements and preambular phrases in bilateral agreements indicate that Asian countries overwhelmingly subscribe to the notion of removing barriers to the free flow of goods, services, and investment as a guarantor of growth and development. In actual practice, the reinstatement of capital account regulation was not one of the lessons countries in the region learned from the Asian crisis. In fact, Asian emerging countries "are now much more closely integrated into the international financial system than they were in the run-up to the 1997 crisis" (Akyuz, 2010, p. 17).

Both official pronouncements and the recent policy changes indicate that Asian countries either do not fully understand or do not place high priority on the third justification for capital account regulation – to mobilize resources for industrial development and to ensure the stable development of domestic financial resources. Asian countries have instead demobilized enormous domestic and externally borrowed resources in building up international reserves, thereby insuring themselves against balance of payments crises and procyclical IMF adjustment policies. On this basis, they have deployed other measures for the first objective of capital controls at the expense of being able to perform on the other two objectives. In developing countries, in particular, the reserve build-up also involves an opportunity cost on the resources that could have been applied to industrial development or the development of domestic financial services themselves.

What is notable is that in some agreements undertaken by countries in the region, there are provisions that appear to be based on a different overall framework which, instead, recognizes the need for domestic authorities to impose capital account regulations and other barriers to the free flow of external finance flows. For example, Article 10.8 of the India-Malaysia FTA lists the fund transfers that must be undertaken "freely and without delay" as (a) initial capital and additional amounts to maintain or increase investment; (b) returns; (c) proceeds from the total or partial sale or liquidation of any investment; (d) payments made under a contract, including a loan agreement; (e) payments made pursuant to compensation for losses from expropriation; (f) payments arising out of the settlement of a dispute; and (g) earnings and other remuneration of personnel from the other Party employed and allowed to work in connection with that investment." While some of these transfers could also prove problematical in a balance-of-payments crisis, there is no blanket commitment against capital transfer restrictions.

In the same India-Malaysia FTA, the space for capital account regulations is further reserved by a subsequent provision (Article 10.8.3) that explicitly recognizes the possibility of prohibitions or delays on fund transfers in situations related to protecting domestic investors, dealings in securities, futures, options, and derivatives, and ensuring compliance with orders and judgments from administrative and judicial proceedings.

The India-Malaysia FTA is also notable for provisions, in Annex 10-1, which define when an action can be deemed an indirect expropriation. This Annex provides that "determination of whether an action or series of actions by a Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers" a set of factors, such as whether the character of a government action is disproportionate to its stated objective.

Balance of payments safeguards

Most Asian FTAs contain balance of payments safeguards, allowing countries to implement capital control measures in the event of balance of payments crises. For example, Article 17.2 in the ASEAN-Australia-New Zealand FTA provides that:

"Nothing in this Chapter[5] shall affect the rights and obligations of any of the Parties as members of the International Monetary Fund under the IMF Articles of Agreement, including the use of exchange actions which are in conformity with the IMF Articles of Agreement, provided that a Party shall not impose restrictions on any capital transactions inconsistent with its specific commitments regarding such transactions, except under Article 4 (Measures to Safeguard the Balance of Payments) of Chapter 15 (General Provisions and Exceptions) or at the request of the International Monetary Fund."

Asia is home to one of the two most egregious FTAs, the Singapore-US FTA, which includes "blanket prohibitions on capital restrictions" (Siegel, 2003-2004, p.297). The IMF[6] has expressed its reservations about these prohibitions because of its contravention to the use of capital controls during balance of payments crises. Siegel puts a spotlight on the fact that, depending on how investments are defined in BITs "investors in hot money transactions (e.g. high yielding overnight deposits and other derivative financial products) could seek protections of the investment rules" (Siegel, 2003-2004, p. 298). Her analysis concludes that a US Treasury official opinion that accepts a cooling off period of one year in which investors could not sue for damages in a balance of payments crisis does not reduce the level of Singapore's liability.

Because IMF members have the right to impose capital controls and the IMF has the power to request members to impose controls, the inconsistent rights and obligations emanating from the Singapore-US FTA creates "a risk that in complying with its obligations to the FTA, a member could be rendered ineligible to use the Fund's resources under the Fund's Articles" (Siegel, 2003-2004, p.301).

Definition of investment or investor

Asian FTAs and BITs tend to have an expansive definition of "covered" investment and the definition of "investor." Investment definitions tend to be of the form "including, but not limited to." Particularly in a situation of balance of payments crisis, an expansive definition of investment will create state liabilities to private investors in the kind of controls Malaysia imposed during the Asian financial crisis of the late 1990s.

Some definitions of investment manage to specifically exclude current account transactions, such as in Article 1.j in the ASEAN-Korea FTA which provides:

"The term investment does not include claims to money that arise solely from: i) commercial contracts for the sale of goods or services by a natural or juridical person in the territory of a Party to a natural or juridical person in the territory of any other Party; or ii) the extension of credit in connection with a commercial transaction, such as trade financing."

This would permit countries to impose restrictions on the use of trade credits for carry trade transactions. But the exclusion of current account transactions are also sometimes weakened by definitions that include specific protection for intellectual property rights even though royalty payments are categorized as current account transactions.

Article 88.d in the Malaysia-Pakistan FTA possibly provides a restriction on investment from local laws and policies by defining investment as "every kind of asset owned or controlled, directly or indirectly, by an investor of a Party in the territory of the country of the other Party, in accordance with the latter's laws, regulations and national policies."

The definition of who has standing as an investor to initiate an investor-state claim is also critical. Most BITs and FTAs define investors as those with juridical standing in contracting governments. This extends investor protection to multinational companies which are incorporated in the contracting government territories, even if they are not headquartered or undertake significant operations in these locations. By sourcing an investment project in a front office in a jurisdiction that has an investment agreement, an investor obtains protection even though s/he does not have any significant operations in that locality. Some provisions restrict the kind of parties that can be considered investors. For example, the Philippines-Japan FTA restricts "juridical persons" which have access to the protections of the treaty to those owned by fifty per cent or more by investors from the contracting countries. The same treaty further provides that the branch of a juridical person of a "non-Party" located in the area of a "Party" shall not be considered an investor.

Most favored nation (MFN) provisions

Almost all Asian investment agreements include a standard most favored nation provision. Most clauses apply to agreements that could be finalized subsequent to the particular agreement. This extends to the countries in the agreement with the MFN clause the best treatment available to investors in these other countries. In investor-state disputes, arbitration panels can apply the most favorable treatment to investors from other treaties/agreements, even if the investor is covered under another agreement or treaty.

MFN provisions could bite most specifically in efforts to re-regulate the financial sector, reversing years of financial deregulation in Asian economies. Such an effort would be consistent with recent re-regulation efforts underway under the Financial Stability Board (FSB). At this point, having not suffered too heavily in the first phase of the global financial crisis, it is unclear whether Asian countries have an immediate interest in re-regulating finance beyond complying with future FSB standards.

National treatment

National treatment clauses require equal treatment of foreign investors as locals. With the participation of foreign firms in the domestic financial sector, financial re-regulation efforts, particularly those aimed at building domestic capability in the financial sector, expose Asian countries to liabilities from violating national treatment.

A developing country which allows a domestic company to operate a hedge fund domestically, is likely to have to permit hedge funds from the developed country party to enter and operate under pre-establishment national treatment obligations under a BIT[7]. The financial resources, not to mention the external market links, of the domestic company would often be much smaller than those of the foreign company. The foreign company would have an undue advantage and greater capacity to destabilize the economy, through exchange rate transactions for example.

There are additional implications in a situation of bailing out domestic financial companies. National treatment will require symmetrical treatment of foreign companies, severely curtailing domestic authorities' capacity to supervise and assist local financial companies (UNCTAD, 2011). An example is the Ecuador-Netherlands BIT which does not appear to have exceptions for subsidies, grants or government-supported loans, guarantees or insurance.

Asian Challenges

Asian policymakers have indicated a revealed preference for a policy combination of self-insurance through reserve accumulation and continuing capital account liberalization and strengthened investor protection.

The capacity of Asian economies to withstand financial and balance of payments crises based on this strategy remains untested. Reserves proved equal to the task in the 2007-2008 crisis but there are no analytical guidelines for when reserve accumulations are too much and too little. It is clear that the strategy entails opportunity costs. The resources of the Chiang Mai intiative, which has been multilateralized, have never been called upon.

Most importantly, the continued accession by Asia-Pacific countries to FTA investment chapters and BITs using standard provisions under a long-term purpose of financial liberalization cum foreign investor protection will severely restrict the abilities of these countries to channel capital resources toward industrial and financial development.

End Notes

[1] For a historical example on the Philippines, during an earlier period of burgeoning yen carry trade, see Montes (1997).

[2] IMF staff discussions have shifted to *when* instead of *if* capital controls are justified. This *when* position still fundamentally contradicts the fact that the IMF Articles of Agreement reserves to member countries the sovereign right to impose capital controls.

[3] See also Gallagher (2010) for a discussion of the impact of US FTAs and BITs, particularly Table 6 which lists capi-

tal control measures, such as restrictions on currency mismatches and minimum stay requirements, which could potentially run afoul of these agreements with the US.

4 We cannot presume that the notifications to the WTO are a complete set of existing FTAs. We assume that these notifications provide a sufficient sample to discern patterns related to investment provisions.

5 There is a different balance of payments safeguard that applies to trade such as Article XII of GATT 1994 and the Understanding on the Balance-of- Payments Provisions of the General Agreement on Tariffs and Trade 1994 in Annex 1A to the WTO Agreement. See for example, Article 21 of the Japan-ASEAN comprehensive partnership agreement.

6 While the article being cited has the usual disclaimer that the opinions are those of the author (who was then a Senior Legal Counsel at the IMF), footnote 1 states that "much of the analysis is drawn from from an article by Mr. Sean Hagan, Deputy General Counsel, Legal Department, IMF" (Siegel, 2003-2004, p. 297).

7 Such as the 2004 US Model BIT. (See also Khor (2008) Chapter 8 for a discussion of impact of "pre-establishment" rights in US FTA agreements.)

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