CAPITAL CONTROLS AND INTERNATIONAL ECONOMIC LAW

Focusing on capital controls, this study provides rigorous legal analysis to establish whether the mandate of the International Monetary Fund (IMF) extends to the capital account; that is, whether the IMF has the authority to control and/or regulate the use of capital controls by its member states. The book then analyses whether a country's use of capital controls is consistent with the obligations and commitments undertaken in various multilateral and bilateral trade and investment agreements. Finally, it analyses the tension within international economic law, as the IMF now encourages the use of capital controls under certain circumstances, while most trade/investment agreements prohibit or limit their use. Proposing a way forward to alleviate the tension and construct a more harmonious relationship between the norms and standards of finance, trade and investment, this study will be essential reading for academics, practitioners and policymakers.

BRYAN MERCURIO is the Simon F. S. Li Professor of Law at the Chinese University of Hong Kong. He is co-author of World Trade Law: Text, Materials and Commentary (third edition, 2018), co-editor of International Economic Law after the Global Crisis: A Tale of Fragmented Disciplines (Cambridge, 2015) and author of Drugs, Patents and Policy: A Contextual Study of Hong Kong (Cambridge, 2018).

CAMBRIDGE INTERNATIONAL TRADE AND ECONOMIC LAW

Series editors

Processes of economic regionalisation and globalisation have intensified over the last decades, accompanied by increases in the regulation of international trade and economics at the levels of international, regional and national laws. At the same time, significant challenges have arisen with respect to economic liberalization, rule-based systems of trade and investment, and their political and social impacts. The subject matter of this series is international economic law, in this contemporary context. Its core is the regulation of international trade, investment, finance and cognate areas such as intellectual property and competition policy. The series publishes books on related regulatory areas, in particular human rights, labour, environment and culture, as well as sustainable development. These areas are horizontally interconnected and vertically linked at the international, regional and national levels. The series also includes works on governance, dealing with the structure and operation of international organisations related to the field of international economic law, and the way they interact with other subjects of international and national law. The series aims to include excellent legal doctrinal treatises, as well as cutting-edge interdisciplinary works that engage law and the social sciences and humanities.

Books in the series

Capital Controls and International Economic Law
Bryan Mercurio

The Law and Practice of Global ICT Standardization
Olia Kanevskaia Whitaker

Between Market Economy and State Capitalism: China's State-Owned Enterprises and the World Trading System
Henry S. Gao and Weihuan Zhou

New Asian Regionalism in International Economic Law
Pasha L. Hsieh

Essential Interoperability Standards: Interfacing Intellectual Property and Competition in International Economic Law
Simon Brinsmead

Digital Services in International Trade Law
Ines Willemyns

Law and Politics on Export Restrictions: WTO and Beyond
Chien-Huei Wu

Energy in International Trade Law: Concepts, Regulation and Changing Markets
Anna-Alexandra Marhold

Shareholders' Claims for Reflective Loss in International Investment Law
Lukas Vanhonnaeker

Transparency in the WTO SPS and TBT Agreements: The Real Jewel in the Crown
Marianna B. Karttunen

Preferential Services Liberalization: The Case of the European Union and Federal States
Johanna Jacobsson

Emerging Powers in International Economic Law: Cooperation, Competition and Transformation
Sonia E. Rolland and David M. Trubek

Commitments and Flexibilities in the WTO Agreement on Subsidies and Countervailing Measures
José Guilherme Moreno Caiado

The Return of the Home State to Investor-State Disputes: Bringing Back Diplomatic Protection?
Rodrigo Polanco

Industrial Policy and the World Trade Organization: Between Legal Constraints and Flexibilities
Sherzod Shadikhodjaev

The Public International Law of Trade in Legal Services
David Collins

The Prudential Carve-Out for Financial Services: Rationale and Practice in the GATS and Preferential Trade Agreements
Carlo Maria Cantore

Preferential Services Liberalization: The Case of the European Union and Federal States
Johanna Jacobsson

Judicial Acts and Investment Treaty Arbitration
Berk Demirkol

Distributive Justice and World Trade Law: A Political Theory of International Trade Regulation
Oisin Suttle

Freedom of Transit and Access to Gas Pipeline Networks under WTO Law
Vitalily Pogoretskyy

Reclaiming Development in the World Trading System, 2nd edition
Yong-Shik Lee

Developing Countries and Preferential Services Trade
Charlotte Sieber-Gasser

Establishing Judicial Authority in International Economic Law
Edited by Joanna Jemielniak, Laura Nielsen and Henrik Palmer Olsen

WTO Dispute Settlement and the TRIPS Agreement: Applying Intellectual Property Standards in a Trade Law Framework
Matthew Kennedy

Trade, Investment, Innovation and their Impact on Access to Medicines: An Asian Perspective
Locknie Hsu

The WTO and International Investment Law: Converging Systems
Jürgen Kurtz

The Law, Economics and Politics of International Standardisation
Edited by Panagiotis Delimatsis

Export Restrictions on Critical Minerals and Metals: Testing the Adequacy of WTO Disciplines
Ilaria Espa

Optimal Regulation and the Law of International Trade: The Interface between the Right to Regulate and WTO Law
Boris Rigod

The Social Foundations of World Trade: Norms, Community, and Constitution
Sungjoon Cho

Public Participation and Legitimacy in the WTO
Yves Bonzon

The Challenge of Safeguards in the WTO
Fernando Piérola

General Interests of Host States in International Investment Law
Edited by Giorgio Sacerdoti, with Pia Acconci, Mara Valenti and Anna De Luca

WTO Disciplines on Subsidies and Countervailing Measures: Balancing Policy Space and Legal Constraints
Dominic Coppens

The Law of Development Cooperation: A Comparative Analysis of the World Bank, the EU and Germany
Philipp Dann

Liberalizing International Trade after Doha: Multilateral, Plurilateral, Regional, and Unilateral Initiatives
David A. Gantz

Domestic Judicial Review of Trade Remedies: Experiences of the Most Active WTO Members
Edited by Müslüm Yilmaz

The Relevant Market in International Economic Law: A Comparative Antitrust and GATT Analysis
Christian A. Melischek

International Organizations in WTO Dispute Settlement: How Much Institutional Sensitivity?
Marina Foltea

Public Services and International Trade Liberalization: Human Rights and Gender Implications
Barnali Choudhury

The Law and Politics of WTO Waivers: Stability and Flexibility in Public International Law
Isabel Feichtner

African Regional Trade Agreements as Legal Regimes
James Thuo Gathii

Processes and Production Methods (PPMs) in WTO Law: Interfacing Trade and Social Goals
Christiane R. Conrad

Non-Discrimination in International Trade in Services: 'Likeness' in WTO/GATS
Nicolas F. Diebold

The Law, Economics and Politics of Retaliation in WTO Dispute Settlement
Edited by Chad P. Bown and Joost Pauwelyn

The Multilateralization of International Investment Law
Stephan W. Schill

Trade Policy Flexibility and Enforcement in the WTO: A Law and Economics Analysis
Simon A. B. Schropp

CAPITAL CONTROLS AND INTERNATIONAL ECONOMIC LAW

BRYAN MERCURIO
The Chinese University of Hong Kong

CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE
UNIVERSITY PRESS

Shaftesbury Road, Cambridge CB2 8EA, United Kingdom

One Liberty Plaza, 20th Floor, New York, NY 10006, USA

477 Williamstown Road, Port Melbourne, VIC 3207, Australia

314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre, New Delhi – 110025, India

103 Penang Road, #05–06/07, Visioncrest Commercial, Singapore 238467

Cambridge University Press is part of Cambridge University Press & Assessment,
a department of the University of Cambridge.

We share the University's mission to contribute to society through the pursuit of
education, learning and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781009045452

DOI: 10.1017/9781009042215

First published 2023
First paperback edition 2024

A catalogue record for this publication is available from the British Library

Library of Congress Cataloging-in-Publication data
Names: Mercurio, Bryan, author.
Title: Capital controls and international economic law / Bryan Mercurio,
The Chinese University of Hong Kong.
Description: Cambridge, United Kingdom ; New York, NY : Cambridge
University Press, 2023. | Includes bibliographical references and index.
Identifiers: LCCN 2022057079 (print) | LCCN 2022057080 (ebook) |
ISBN 9781316517437 (hardback) | ISBN 9781009042215 (ebook)
Subjects: LCSH: Capital movements – Law and legislation.
Classification: LCC K4444 .M47 2023 (print) | LCC K4444 (ebook) |
DDC 343/.03–dc23/eng/20230403
LC record available at https://lccn.loc.gov/2022057079
LC ebook record available at https://lccn.loc.gov/2022057080

ISBN 978-1-316-51743-7 Hardback
ISBN 978-1-009-04545-2 Paperback

Cambridge University Press & Assessment
978-1-009-04545-2 — Capital Controls and International Economic Law
Bryan Mercurio
Frontmatter
More Information

CONTENTS

FOREWORD

Capital controls have for many decades been a source of controversy, disagreement and forceful policy debates. Previously thought of as simply part of the domestic policymakers' toolkit, this gradually changed as the world became more interconnected – and as global trade and finance blurred the once clear divide between the current and capital accounts. Capital controls fell out of fashion as countries of all kinds and for different reasons felt the need to walk away from them in the 1960s–1980s, and countries using them increasingly came under extreme pressure from other governments as well as international organisations. Economists continued engaging in a contentious policy debate over the value, role and effectiveness of capital controls, but for all intents and purposes by the 1990s the policy debate was all but settled – the dominant view becoming that capital controls should not be part of the policy toolkit to maintain stability and forestall crises.

But of course problems continued to exist all along, and equally policy debates, which I was part of, both in the formation and in the early years of the World Trade Organization (WTO) – where it fell on me to negotiate a *cooperation agreement* with the International Monetary Fund (IMF) to provide information flows to best inform decisions on trade-finance linkages – as well as at the IMF where I was involved in crisis management in the aftermath of the 1997 Asian Meltdown, when financial 'contagion' was born. This crisis led to many calls among outside experts and staff for sand to be placed in the wheels of capital movements in appropriate circumstances and form.

That string of financial crises hitting East and South-East Asia, then Russia, Brazil and Argentina, Turkey and many others in the late 1990s and early 2000s was a traumatic episode for developing and emerging markets, as dire for them if not worse than the subsequent Global Financial Crisis (GFC) of 2008 – even if on a global scale its sparing the major economies made it look relatively tame compared to the larger successor crisis. But a lot of thinking and reflection took place during and in the aftermath of those crises, and increasingly intellectuals and policymakers questioned the extreme liberal order with no place in it for capital account measures.

The IMF thus learned a lot from these crises and gradually underwent a shift in its thinking, as well as changes in how it approaches advice to countries needing support in times of crisis. Officially since 2012, and in practice since the Emerging Markets' crises at the turn of the century and then with the GFC, the IMF eschewed its former dogmatic position against the imposition of capital controls. This is reflected in its advice, which now includes advocating the imposition or maintenance of capital controls in certain circumstances.

Nevertheless, while economists and policymakers have focused their attention on public discussion and debates on the impact and effectiveness of financial liberalisation and capital controls, the legal framework to navigate these complex waters has been much understudied and underappreciated, as much in the academic literature as in practice. With no international framework governing capital movements, the 'rules of the game' can be unclear. While the right of a government to take action to prevent or forestall a crisis is paramount, this right is always tempered through the voluntary entrance into agreements with other governments, whether bilaterally, regionally or multilaterally. Such is the case with capital controls: governments enter agreements with one or more partners in free trade agreements (FTAs), in bilateral investment treaties (BITs) and in multilateral institutions such as the IMF and WTO. Such fragmentation in the results, or diverse incidence of legal commitments on the same issues, in differing and sometimes confusing structures and rules, as well as gaps in the rules, can contain contradictions and potential for conflicting rights and obligations. While governments and inter-governmental organisations attempt to fill the gaps with dialogue, this usually happens on an ad hoc basis, informal and unstructured, often yielding only marginal or partial results. And while numerous countries have negotiated a range of international agreements that liberalise capital movements, most seemingly fail to have macroeconomic stability at the core of the negotiation.

To most observers, the existence of exceptions to liberalisation commitments and other safeguards is confusing, and again, fully dependent on the relevant treaty at issue. The possibility of conflicting commitments grows with each new agreement, and of course the potential for conflict between these treaties and an IMF recommendation or commitment is also present. I therefore welcome wholeheartedly this valuable and penetrating monograph from Bryan Mercurio – the first study to expertly and systematically engage with and analyse such issues.

I met Bryan shortly after I arrived in Hong Kong fresh from the IMF in 2007. He was then the very active associate dean (research) of the Chinese

University of Hong Kong's (CUHK) Faculty of Law, and a major force on issues pertaining to WTO as much as international finance. He is a respected international economic law scholar with a distinct gift to see both the larger picture where countries engage and the intricacies of specific problems and issues, and to see and appreciate as much the trade and the financial dimensions.

Mercurio's acumen and penchant for precise legal analysis and insightful policy-based commentary is on full display throughout the eight chapters of this book. Importantly, he has done so in a way that can be read and digested by a non-expert. In this regard, the first two chapters introduce the key concepts, background information and historical developments that set the stage for the analysis to come. Part II of the book features a ground-breaking legal analysis of the IMF's oversight and control over capital movements. In so doing, Mercurio deftly explains how the IMF used legal means to slowly and steadily shift its mandate to cover the capital account through what he has termed a 'byroad' to avoid the historical distinction between 'capital movements' and 'current international transactions'. Thus, as the book makes clear, by the time the IMF issued its Institutional View in 2012, the result was not a massive change but more so an announcement of the direction that the Fund had pursued in the GFC. Another key component of the analysis is Mercurio's conclusion that the Fund's expansion in mandate is legally valid and legitimate. Referencing both hard and soft law, the conclusion may not be welcome by the Fund's critics, but it is well grounded, legally sound and persuasive. Often neglected in the literature, the addition of solid analysis on the legal authority of the Fund to expand its mandate is critical to its legitimacy to continue operating in this space.

Having set out the Fund's mandate and widening authority over capital movements, the book then shifts focus to analyse whether the Fund's emerging approach to capital controls could possibly conflict with obligations under international economic law: in particular whether a country imposing capital controls with the IMF's blessing would be inconsistent with the disciplines of trade and investment law. Mercurio's legal expertise and acute awareness of broader policy issues are on display when reviewing, analysing and balancing market commitments and exception clauses for such matters as balance of payment difficulties and prudential measures. Here again, the conclusions are carefully reasoned and technically sound. One of the most significant, and perhaps most surprising, findings is that it is larger, developed countries that now include the most exceptions and safeguards in their trade and investment agreements, whereas in agreements between developing countries such safeguards and exceptions can be entirely absent. This is an important finding for many reasons, and one would hope that at least developing countries will take note of it and act.

While Mercurio's analysis persuasively demonstrates that most trade and investment agreements offer sufficient flexibilities to prevent direct conflict with an IMF bailout package that includes the implementation or maintenance of capital controls, one has to understand the author's point that each agreement may be subtly different, and therefore the risk for each country varies by agreement. Governments should listen to Mercurio's advice and ensure future agreements allow for the imposition and maintenance of capital controls in order to prevent or forestall crises.

This book advances the literature on IMF governance of capital movements and the relationship between various strains of international economic law. It provides researchers and policymakers with detailed and informed analysis and clear policy advice. The book also provides confirmation that governments are on the correct path in balancing commitments and obligations with safeguards and exceptions, while also reminding us that work remains to be done and offering a pathway to proceed.

Jesús Seade
Founding WTO negotiator and deputy director-general;
former IMF senior advisor; and Mexico's USMCA chief negotiator

PREFACE

There may never again be a period so prosperous as the fifty years following the conclusion of the Second World War. The livelihoods of millions were improved, and the dream of a middle-class life with all its luxuries became the reality for much of the developed world. In the developing world, abject poverty remained but the growing middle class prospered and the elites became some of the richest humans on the planet. During this time, liberal and neo-liberal doctrines and ideologies dominated international policymaking and economic integration and cross-border trade in goods flourished. With the rise in trade came the need for cross-border payment methods, which correspondingly have also become easier and cheaper over the years. Trade in services also substantially increased in the past few decades, progressively transforming cross-border payments into cross-border brick and mortar investments and, more recently, financial investments. All in all, the world became more globalised than ever and some began to see the free movement of people, goods and capital as an ideal which for the first time seemed on the cusp of reality rather than mere fiction. The increased interdependence of countries combined with a free market ethos created opportunities and was making the world rich.

The past quarter-century, however, has stirred if not shaken the global order from an economic, policy and ideological perspective. Globalisation not only brought about peace and prosperity but also exacerbated economic crises, most notably the Asian financial crisis in the late 1990s, Argentina's financial crisis in 2001 and the Global Financial Crisis (GFC) of 2008. These crises have caused a variety of voices to question the validity of the liberal economic model, both from a financial governance perspective at the International Monetary Fund (IMF) and from a trade governance perspective at the World Trade Organization (WTO). At the same time, those same voices began questioning the financial stability of the liberal model at the domestic level.

While the world has not experienced much of a decline or reversal of trade liberalisation, the same cannot be said of finance. Over the past two decades – and undoubtedly as a result of the repeated economic crises – there has been a slow and steady reversal of the longstanding movement towards the free flow of capital. A diverse range of economies – including Brazil, Chile, China, Greece, Iceland, Malaysia, Taiwan and Thailand – have done so by effectively limiting the free flow of capital by putting in place capital controls (also commonly referred to as Capital Flow Management measures (CFMs) or Capital Account Regulations (CARs)) as a way to re-assert control over their economic systems and preserve their financial stability.

The trend towards preserving policy space to limit the flow of capital is worth emphasising for two reasons. First, it is an indication that unrestricted financial liberalisation is not a 'one size fits all' proposition, and that numerous countries will seek to maintain a form of independence against the excesses of the 'all-in' economic and financial ideal. Second, and perhaps more importantly, this development suggests that the rules of the game have somehow changed. Whilst economic and financial liberalism has always faced some criticism, they have remained the dominant doctrine. The repeated financial crises seen in the last two decades have led to a slow but sustained evolution in thinking and government policy. The first part of this book will explore and document the 'slow but sustained' shifts in the economic, doctrinal, ideological, policy and legal paradigm.

The idea of researching and writing a book that focuses on financial liberalisation and the constraints built into the international economic law system relating to capital controls seems an obvious extension of my work on regime fragmentation and overlap. Moreover, being based in Hong Kong at a time when Beijing is attempting to control outwards capital flows made the topic a natural fit for a research project. The decision to dedicate time to this project was cemented when reading an article published in the *Financial Times* in early 2016 which documented a conversation between Chinese president Xi Jinping, Japanese Central Bank governor Haruhiko Kuroda and managing director of the IMF, Christine Lagarde.[1] The article quotes the Japanese Central Bank's governor as saying that '[c]apital controls could be useful to manage [China's] exchange rate as well as domestic monetary policy in a constructive way', which contrasts sharply with the liberal doctrine historically promoted by Japan and more broadly the IMF. What is more, in a seemingly surprised tone the article observes that 'Kuroda's suggestion of temporary controls to help restore confidence was not rejected by Christine Lagarde … [who] dodged the question'.

[1] Chris Giles, 'Kuroda Calls for China to Tighten Capital Controls' (*Financial Times*, 23 January 2016) www.ft.com/content/03395bdc-c1c4-11e5-808f-8231cd71622e.

From my perspective, the most interesting aspect of the article was not Kuroda's suggestion or Lagarde's dodge, but the tone of surprise at the conversation. While liberalisation remains the dominant paradigm, by the time of the GFC the idea of controlling capital should not have been surprising. In fact, as early as the 1990s reasonable and qualified economists began discussing the usefulness (and drawbacks) of capital controls. For instance, in the midst of the Asian financial crisis the Nobel Laureate Paul Krugman briefly (but effectively) illustrated the complexity of implementing capital restrictions:

> Asia is stuck: Its economies are dead in the water, but trying to do anything major to get them moving risks provoking another wave of capital flight and a worse crisis. In effect, the region's economic policy has become hostage to skittish investors. Is there any way out? Yes, there is, but it is a solution so unfashionable, so stigmatised, that hardly anyone has dared suggest it. The unsayable words are 'exchange controls.' … If this sounds too easy to you, you're right. Exchange controls present lots of problems in practice.[2]

By the time of the conversation between Kuroda and Lagarde, regulators and policymakers increasingly considered restrictions on capital to be one of the components of the regulatory toolbox necessary to manage the economy. The IMF had even by that time seemingly shifted its longstanding position and endorsed, to a limited extent, the use of CFMs. More specifically, in 2012 the IMF published an 'Institutional View' which cautiously embraced CFMs as part of the policy 'toolkit', thereby allowing countries to regulate cross-border capital flows. For the first time, the IMF explicitly: (i) recognised that financial sector regulation/reform must be tailored to the socio-political components of each member; (ii) confirmed CFMs are part of the available regulatory toolkit; (iii) signalled that CFMs may be included in IMF programmes as part of more comprehensive efforts to provide stability; and (iv) did not preclude the long-term maintenance of such measures.[3] To some onlookers, the Institutional View represented a radical shift from its traditional position towards open capital accounts. To those who believe the IMF has no mandate over capital movements,

2 Paul Krugman, 'Saving Asia: It's Time to Get Radical. The IMF Plan Not Only Has Failed to Revive Asia's Troubled Economies but Has Worsened the Situation; It's Now Time for Some Painful Medicine.' (*Fortune Magazine*, 7 September 1998) https://archive.fortune.com/magazines/fortune/fortune_archive/1998/09/07/247884/index.htm.

3 IMF, 'The Liberalization and Management of Capital Flows: An Institutional View' (International Monetary Fund 2012) www.imf.org/external/np/pp/eng/2012/111412.pdf.

the Institutional View was a usurpation of authority and undue limitation on members' ability to regulate capital movements.

Economists and political scientists have discussed and debated the worthiness of CFMs and the IMF positional shift, but analysis of the legal dimension to CFMs and the IMF position remains scarce. This insight led to the conclusion that more research was necessary to (i) clarify whether CFMs ought to be considered as legitimate regulatory tools to maintain financial stability and forestall economic crises; (ii) determine the extent to which the IMF supports reliance on such tools, and whether it has the authority to even weigh in on the issue; and (iii) understand whether governments have the legal and policy space to take such measures or whether the existing international economic law landscape might prevent such measures from being utilised.

The research conducted for this book has provided the opportunity to widen the scope of the debate on CFMs. To date, academic and policy research has focused on two questions. First, commentators have considered but not fully decided whether capital account liberalisation leads to economic growth, as the empirical literature on capital account liberalisation and growth is both voluminous and contradictory. Even research papers produced by the IMF fail to come to a consensus; some are supportive of the traditional liberalisation approach,[4] while others find no evidence of direct or indirect benefits on growth.[5] Second, commentators have explored whether and how host governments could rely on CFMs to preserve economic stability. The related literature is essentially economic in nature, but again largely equivocal. At best, CFMs seem effective in countries with existing restrictions on capital flows but ineffective in countries where the capital account has been more fully liberalised.[6] Moreover, the evidence generally finds that CFMs are more successful in changing the composition of capital flows rather than in reducing aggregate volume. More surprisingly, however, economists remain divided

[4] See i.e. Giovanni Dell'Ariccia and others, *Reaping the Benefits of Financial Globalization* (International Monetary Fund 2008); M. Ayhan Kose and others, 'Financial Globalization: A Reappraisal' (2009) 56 (1) IMF Staff Papers 8; IEO IMF, 'IMF's Approach to Capital Account Liberalization 2005' (International Monetary Fund) 24–29 www.imf.org/en/Publications/Independent-Evaluation-Office-Reports/Issues/2016/12/31/IEO-Evaluation-Report-on-the-IMF-s-Approach-to-Capital-Account-Liberalization-2005-18289.

[5] See Olivier Jeanne, Arvind Subramanian and John Williamson, *Who Needs to Open the Capital Account* (Peterson Institute 2012) 56–58.

[6] IEO IMF, *IMF Response to the Financial and Economic Crisis* (International Monetary Fund 2015) www.imf.org/en/Publications/Independent-Evaluation-Office-Reports/Issues/2016/12/31/The-IMF-and-the-Crises-in-Greece-Ireland-and-Portugal-An-IEO-Assessment-42404.

on the main objectives of the measures – that is, just what capital controls measures are designed to accomplish.[7] Simply stated – the impact of CFMs 'in crisis and non-crisis periods' remains unestablished.[8] The GFC may have brought about a major rethink among the economic elite, but economists remain 'widely divided about the interpretation of the crisis and especially their interpretation of capital controls and the governance of the international financial system'.[9]

Thus while it is clear that the crisis 'shattered' the consensus which had built around financial openness and governments resurrected and legitimatised CFMs during and after the crisis subsided, it is less clear which CFMs were prudent and justifiable in the circumstances and which did little or nothing to bring stability to the ailing host nation. For instance, Otto Hieronymi wrote that the subprime bubble burst was only the 'detonator' of the GFC but the root 'was the profound metamorphosis' of the global financial and monetary landscape over the years leading to the 'gradual elimination of systemic checks and balances [caused by] … the absence of a common international monetary order' following the collapse of the Bretton Woods system and the replacement of 'external discipline' with 'monetary nationalism'.[10] Similarly, Brummer opined that international financial regulation has mainly come from the ability of a select few domestic financial authorities to impose and export their regulatory preferences, not in relation to financial stability but in relation to their own expectations, thus making international financial regulation (*lex financiaria*) a 'fragmented' system.[11] Referring to what he calls 'productive incoherence', Grabel is more blunt in questioning the 'proliferation of responses to the crisis by national governments, multi-lateral institutions, rating agencies and the economics profession that have not yet congealed into a consistent approach to capital controls'.[12]

Indeed, in the absence of precise policy objectives, governments are faced with an innumerate range of potential policy actions to maintain financial

7 Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (Princeton University Press 2002) 31–32.
8 Adrian Blundell-Wignall and Caroline Roulet, 'Macro-Prudential Policy, Bank Systemic Risk and Capital Controls' (2014) 2013 *OECD Journal: Financial Market Trends* 7.
9 Tirole (n 7) x.
10 Otto Hieronymi, 'From "Global Finance" to the Crisis of Globalization', *Globalization and the Reform of the International Banking and Monetary System* (Palgrave Macmillan 2009) 11–16.
11 Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge University Press 2015) 22.
12 Ilene Grabel, 'The Rebranding of Capital Controls in an Era of Productive Incoherence' (2015) 22 *Review of International Political Economy* 7.

stability and often apply a myriad of inadequate and incongruent measures in their attempt to prevent financial crisis. The inconsistent policy recommendations over capital controls turned almost comical, since, depending on whom one was listening to, CFMs were either critically necessary to forestall crisis or a misguided tool that would hasten and deepen financial crisis. There is not even a consistent opinion or approach as to whether CFMs should be employed as temporary stopgap measures or necessary efficiency tools and/or safeguards to be applied on a long-term basis. Hence, critics view CFMs as nothing more than a red herring, with Hieronymi even facetiously describing CFMs as 'a self-propelling phenomenon [and] the only major activity that could create value out of thin air'.[13]

The economic discussion remains ongoing and contentious, but what seems clear is that the majority of economists believe that in some cases, particularly those involving developing countries with weak regulatory structures and immature markets, regulation of cross-border finance can be essential for maintaining financial stability. The underexplored aspect of regulation is the legal perspective. Other than a document compiled by a group made up predominantly of economists and political scientists who argued that the current web of investment and trade agreements embed liberalism and prevent regulators from restricting capital flows,[14] there is very little sustained discussion on the legal aspects of CFMs in the literature. The second part of this book seeks to add a legal voice to the debate and focuses on the international regulatory framework.

The financial framework applicable to global capital flows – or the lack thereof – is vitally important to study and understand, if only because the lack of oversight in global finance constitutes a veritable source of legal and political uncertainty. The prevailing view of most commentators is that the world lacks a forum for governing global capital flows, and that the Bretton Woods conference did not create such a framework.[15] Thus, the world community has tended to 'allow capital controls as long as they do not have large negative externalities on other countries, [an idea] anchored on the principle that a country's sovereign right to implement policies that they deem best for national welfare should

[13] Hieronymi (n 10).
[14] Kevin P Gallagher and others, 'Capital Account Regulations and the Trading System: A Compatibility Review' (2013) Pardee Center Task Force Report, Frederick S. Pardee Centre for the Study of the Longer-Range Future, Boston University.
[15] Kevin P Gallagher, *Ruling Capital: Emerging Markets and the Reregulation of Cross-Border Finance* (Cornell University Press 2015) 30.

be respected as long as there are no substantial negative externalities on other countries'.[16]

What is missing, however, is a single legal framework designed specifically to regulate or coordinate capital movements and restrictions. In practice, capital movements are in fact regulated, but in a piecemeal manner in accordance with the various international economic law regimes developed over the past several decades. First and foremost, of course, is the IMF, which has tirelessly worked for decades to liberalise the cross-border flow of capital and ensure that the financing of trade is not only possible but also stable and secure. Another important source of law is the WTO and free trade agreements (FTAs), which regulate and aim to progressively liberalise trade in goods and services between members and signatories, respectively. The final source of legal obligations are bilateral investment agreements (BITs) and investment chapters contained in FTAs – collectively referred to as International Investment Agreements (IIAs) – which can also contain legal obligations regarding the financial services sector and capital flows. Among other things, IIAs aim to protect foreign investors from political pressure and regulatory uncertainty by placing them under the protection of international standards of treatment – which typically guarantee the absence of restrictions on investment capital repatriation – while facilitating the free exchange of capital from one treaty partner to another.[17]

An IMF working paper published in 2010 lamented the absence of a formal framework for capital flow management, describing the applicable framework for financial regulation as a 'patchwork' of bilateral, regional and other arrangements with contradictory, differing and discriminatory provisions.[18] The working paper also noted that '[m]any Fund members have assumed legal obligations to liberalise capital movements under a broad range of international agreements with varying objectives and

16 Maria Socorro Gochoco-Bautista and Changyong Rhee, 'Capital Controls: A Pragmatic Proposal' (2013) No. 337 ADB Economics Working Paper Series.

17 As Broomfield notes, those agreements 'typically do not allow for the imposition of restrictions on capital outflows associated with foreign investments for balance-of-payments reasons'. See Elizabeth Broomfield, 'Reconciling IMF Rules and International Investment Agreements: An Innovative Derogation for Capital Controls' (2012) Columbia FDI Perspectives. See also Kevin P. Gallagher, 'Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements', *G-24 Discussion Paper Series Research papers for the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development* (United Nations Conference on Trade and Development 2010).

18 IMF, 'The Fund's Role Regarding Cross-Border Capital Flows' (International Monetary Fund 2010) 22 www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/The-Fund-s-Role-Regarding-Cross-Border-Capital-Flows-PP4516.

scope … [but] most of them do not approach capital account issues from the perspective of macroeconomic stability, or consider the effects their provisions may have on global stability'.[19] A document produced in 2015 by the Fund's Independent Evaluation Office (IEO) similarly noted that international policy coordination relating to capital flows 'is an ongoing challenge … There is currently a patchwork of bilateral, regional, and international agreements regulating cross-border capital flows among different groups of countries, but there are no universally agreed "rules of the game"'.[20]

Overall, there is a shared feeling among most commentators that the current system is incoherent as cross-border financial flows are regulated by the independent policymaking priorities and needs of countries that seek to develop and preserve their own markets,[21] yet these efforts are constrained by a variable assortment of international legal standards. In this regard, international bodies and inter-governmental dialogues ranging from the United Nations, United Nations Conference on Trade and Development (UNCTAD) and G20 have expressed concern regarding the extent to which constraints on capital controls can limit policy choices.[22]

What is somewhat surprising, however, is that governments and scholars have generally overlooked or treated in a cursory manner the key issue of to what extent the various rules and sources of international economic law permit or prevent CFMs. The IMF's Institutional View essentially acknowledged the void in legal analysis – and the potential problems unleashed by its new embrace of CFMs – by stating that 'liberalization obligations [in FTAs and IIAs] may create challenges for the management of capital flows … institutions and members should take [the Fund's] view into account' when drafting new agreements.[23] The IMF thus identifies that its position and recommendation to members in loan/stabilisation

[19] Ibid 17.
[20] IMF, *IMF Response to the Financial and Economic Crisis* (n 6).
[21] For a similar argument, see for instance Adam Feibelman, 'The IMF and Regulation of Cross-Border Capital Flows' (2015) 15 *Chicago Journal of International Law* 409; Broomfield (n 17); Annamaria Viterbo, *International Economic Law and Monetary Measures: Limitations to States' Sovereignty and Dispute Settlement* (Edward Elgar Publishing 2012).
[22] See United Nations Report on Reform of International Monetary and Financial System (2009), at 104; UNCTAD, Trade and Development Report (2011), at 100; Macro prudential policy tools and frameworks – Update to G20 Finance Ministers and Central Bank Governors (FSB, IMF, BIS, February 2011), at 13.
[23] IMF, 'The Liberalization and Management of Capital Flows: An Institutional View' (n 3).

programmes could perhaps lead to violations of other international agreements yet does nothing to resolve the coming clash.[24]

The framework for the legal regulation of cross-border capital flows is critically important yet remains vastly unexplored and undeveloped. This book aims to fill the void and contribute detailed legal analysis to the ongoing discussion and debate. In contrast with existing literature, this book does not focus on the utility of CFMs but on legal issues of fragmentation and associated problems. As mentioned, only a handful of political scientists have studied this issue[25] and the existing literature starts with the premise that members should have an absolute right to maintain CFMs – as a result, over-reading and misinterpreting provisions is rife. My approach to the issue came with no pre-conceived ideological viewpoint but instead sought to provide solid analysis on the consistency of CFMs with the trade and investment regimes and to develop a framework to manage and avoid regime conflict in existing and future treaties.

The book is structured in three parts: Part I sets out and defines the key concepts and debates concerning capital account liberalisation and capital controls. More specifically, Chapter 1 provides a general overview of the global financial landscape by introducing the IMF and other key components of the traditional approach to capital flows and demonstrating how and why this traditional approach to free capital flows has shifted over time. Chapter 2 then defines and explores the role, impact and legitimacy of capital controls/CFMs.

Part II focuses on the IMF's oversight and control over the use and legitimacy of capital controls. Chapter 3 explores the legal foundation for the IMF's mandate over capital controls, finding that while the Fund grounded its mandate shift and expansion on the text and wording of the

[24] Former IMF legal counsel Deborah Siegel bluntly states that FTA/IIAs 'are potentially on a collision course with the [IMF] because of how [they] deal with capital transactions'. See Deborah E Siegel, 'Using Free Trade Agreements to Control Capital Account Restrictions: Summary of Remarks on the Relationship to the Mandate of the IMF' (2003) 10 *ILSA Journal of International and Comparative Law* 297.

[25] See Jeffrey M Chwieroth, 'Normative Change from Within: The International Monetary Fund's Approach to Capital Account Liberalization' (2008) 52 *International Studies Quarterly* 129; Jeffrey M Chwieroth, *Capital Ideas: The IMF and the Rise of Financial Liberalization* (Princeton University Press 2009); Jeffrey M. Chwieroth, 'Controlling Capital: The International Monetary Fund and Transformative Incremental Change from within International Organisations' (2014) 19 *New Political Economy* 445; Jeffrey M Chwieroth, 'Managing and Transforming Policy Stigmas in International Finance: Emerging Markets and Controlling Capital Inflows after the Crisis' (2015) 22 *Review of International Political Economy* 44; Gallagher and others (n 14); Gallagher (n 15).

Articles of Agreement, it did so by using a 'byroad' which allowed the Fund to interpret its constitutive instrument and creatively use its legal instruments to escape the historical distinction between 'capital movements' and 'current international transactions'. The chapter also makes clear that while the Fund's Institutional View of 2012 was important, it does not represent a radical break from tradition but merely a formalisation and crystallisation of the ideas and direction it has pursued since 2008, and did not create any new rights; nor did it change the Fund's legal mandate. Chapter 4 then explores whether the Fund's expansion in mandate is legally valid and legitimate. By looking at hard and soft law, the chapter concludes that the mandate expansion was in line with the standards of international law applicable to international organisations and thus the Fund can legally monitor and discipline capital movements.

Part III seeks to determine whether the Fund's approach to capital controls conflicts with international economic law, namely the disciplines of trade and investment law. Through the negotiation of trade and investment agreements, countries agree to certain obligations and make specific market access commitments. While such agreements contain safeguards and exception clauses, the scope and depth of such clauses vary between agreements. For this reason, the Fund's approach to capital controls may very well run afoul of the obligations and commitments undertaken in certain agreements. Chapter 5 assesses the issue under the multilateral trade regime, most notably the WTO's General Agreement on Trade in Services (GATS), while Chapter 6 focuses on bilateral and regional trade agreements. Chapter 7 analyses the situation with regards to investment treaties. Chapter 8 ties together the analysis of the preceding three chapters and offers concluding analysis.

ACKNOWLEDGEMENTS

This book is the product of over six years of studying, examining and questioning the linkages between finance, trade and investment law. It took me out of my comfort zone and led me down paths I never expected to travel. It has been frustrating at times, and if I had realised the depths to which I would have to go to understand exactly how and why the International Monetary Fund operates as it does, I am unsure if I would have ever started on this journey. But now that it is over, I look back fondly and am proud to have contributed to the literature.

Along the way, I have benefitted from numerous conversations with friends and colleagues. I am grateful to those that generously agreed to be interviewed and to those that read draft chapters of the manuscript. All errors and omissions, of course, remain my own. I would also like to thank emeritus professor and former dean of the Faculty of Law at the Chinese University of Hong Kong, Christopher Gane, for his years of support, friendship and leadership. As with my previous book, this book benefitted tremendously as our many social meetings at the Tin Tin Bar inevitably turned into casual but productive work-related meetings. I miss you, boss!

As always, I thank my former dean at the Faculty of Law at the University of New South Wales, Leon Trakman, and George Williams, for their unwavering belief and support since day one. Without them, I would not be in academia. I owe them both a debt of gratitude. I also thank Cambridge University Press, with whom I have cultivated a deep relationship for well over a decade. Finola O'Sullivan and Kim Hughes have been supportive, good-natured and professional throughout our many projects, and Joe Ng has again been incredibly helpful and encouraging in the production of this book. Happy retirement, Finola! I look forward to working with Kim and Joe again in the not too distant future, and hopefully meeting all again before too long. I would also like this thank Ruth Martin for compiling the index with accuracy and in a compressed period of time.

A debt of gratitude goes to those research associates and students who worked on the book during this journey. A huge thank you goes to Antoine P. Martin, who was by my side for several years as a senior research associate. We had a productive few years, and Antoine has been instrumental in helping me understand the technicalities and peculiarities of finance law. Antoine played a significant role in this project, keeping it on track and contributing to the final product. It is not an exaggeration to say that its shape and direction would have been very different but for his astute understanding of key concepts, issues and concerns. Academia suffers from your decision to go in a different direction, but I am glad to see you so happy. See you at Scarlett soon! I would also like to thank Maggie YuanYuan Zhang, my former research assistant and recent PhD graduate from the Chinese University of Hong Kong, for her research and help in coding international investment agreements.

Finally, while the idea to write such a book came long ago, it would not have been possible if not for the support of the Hong Kong University Grants Committee. I gratefully acknowledge the financial support received by Hong Kong General Research Fund (GRF) for Project No. 14613717, entitled ‘When Regimes Clash on Capital Controls: Managing the Conflicting Norms and Standards of the IMF, WTO and International Investment Agreements’. Thank you for providing funds to make this book possible.