

# Financial Stability and the Trans-Pacific Partnership: Lessons from Chile and Malaysia

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## Abstract

There is growing recognition that nations may need to deploy cross-border financial regulations to prevent and mitigate financial crises. Indeed, in December 2012 the International Monetary Fund (IMF) agreed on a new 'institutional view' that notes how the IMF will begin to recommend that nations deploy cross-border financial regulations in the future. However, many nations have become party to global, regional and bilateral trade and investment treaties that may restrict their ability to deploy such regulations effectively. This article analyzes the cases of two countries currently in negotiation over a Trans-Pacific Partnership Agreement (TPP): Chile and Malaysia. This article examines the extent to which each nation has deployed cross-border financial regulations in the past, and the extent to which they have negotiated the policy space for such regulations in its trade and investment treaties. Finally, this article analyzes the degree to which such measures would be permitted if the TPP's investment provisions looked like the model bilateral investment treaty of the USA. We find that, with some important exceptions, both countries have successfully deployed cross-border financial regulations and have carved out the ability to do so under the World Trade Organization (WTO) and some regional commitments. However, such policy space would be jeopardized if the TPP conformed to the US model rather than arrangements that each country has been able to broker in other arenas.

## Policy Implications

- Policies for regulating global finance may be increasingly incompatible with global trade rules.
- The TPP is being negotiated in a region with a long history of financial instability and parties to the treaty should be sure that nations have the flexibility to regulate cross-border finance.
- Traditional trade negotiators and policy makers in central banks and finance ministries need to have more dialogue. 'Trade' is increasingly about financial services but is being negotiated by those with little expertise of financial matters.
- New institutions such as the Financial Stability Board should partner with trade institutions such as the WTO to ensure compatibility between the twin goals of boosting world trade and maintaining financial stability.

In the wake of the global financial crisis, the regulation of cross-border finance is justified now more than ever. New advances in econometrics have shown that capital

account liberalization is not strongly associated with growth in emerging markets and developing countries yet tends to be associated with financial crises. New

theory sees financial markets as imperfect, thus requiring second-best Pigouvian taxes to correct those market failures (Olivier and Williamson, 2012). Moreover, the bulk of econometric evidence also shows that taxes and other measures on capital flows tend to be effective in meeting their stated goals. Indeed, the International Monetary Fund (IMF) found that those nations that regulated the inflow and outflow of capital were among the least hard hit by the crisis (Ostry et al., 2010). Perhaps even more notable is the fact that the IMF officially changed its view on capital account liberalization and the management of capital flows in 2012. Moving forward, the IMF will recommend that nations put in place capital account regulations (CARs) under a number of circumstances (IMF, 2012).

In the midst of this change, a number of countries are concerned that they may have taken on commitments in the trading regime that may not permit them to regulate cross-border finance. The legal and policy literature thus far confirms those concerns. Under the World Trade Organization (WTO) nations are not permitted to regulate cross-border finance if they have made commitments in financial services under the General Agreement in Trade in Services (GATS). However, there may be recourse under various WTO exceptions. However, for many free trade agreements (FTAs) and bilateral investment treaties (BITs) with the USA all forms of capital must flow 'freely and without delay' among trading partners, and such treaties generally have a more limited set of exceptions. According to leaked text of the agreement and the model BIT that the USA uses as a first proposal in trade or investment negotiations, such is the case with the Trans-Pacific Partnership Agreement (TPP), a trade pact negotiated between Pacific Rim nations such as Canada, the USA, Mexico, Peru and Chile, in addition to Australia, New Zealand, Brunei, Vietnam, Malaysia, Singapore and Japan.

This article is organized into four additional parts. The next section provides background on the relationship between trade treaties and CARs – regulations on the inflow or outflow of short-term capital flows such as bonds, stocks, derivatives and beyond. Subsequent sections analyze Chile and Malaysia. The final section summarizes our findings and draws lessons for the TPP negotiations.<sup>1</sup>

### Background on CARs and the trading system

Although the WTO requires a more limited opening of the capital account and may have a broader level of safeguards, there are a number of concerns about the ability of nation states to deploy CARs while maintaining their commitments under the GATS. Members liberalize each sector along four modes. Liberalization in mode

one and three in financial services is the most relevant for capital flows because GATS members must liberalize financial flows that are connected to a service provided (TPP, 2012). Mode one is cross-border supply, which stipulates the extent to which nonresident providers can supply services within the member's borders. Mode three refers to commercial presence, or the ability of foreign service providers to have a commercial presence in a member's territory such as a branch, agency or subsidiary (WTO, 2012). Under the WTO, when nations choose to liberalize financial services – either through what is called 'mode 1' trade in financial services or 'mode 3' establishing a commercial presence (FDI) for financial service providers under the GATS – they do have to open their capital account in order for those services to contract. US FTAs and BITs, in contrast, require free transfers associated with all covered investments, which are defined broadly. In effect, this obligation requires a full opening of the capital account among parties to the agreement. Under the GATS if a nation makes commitments under mode 1 they are required to open the capital account to allow those services to transact and are not permitted to regulate capital flows. Second, the GATS may have ample safeguards for nations to deploy CARs.

If a nation does not make any GATS commitments in modes 1 or 3, of course they are free to regulate cross-border finance as they see appropriate. If a nation does list mode 1 or mode 3 commitments, some degree of capital account liberalization is required. The IMF notes the following:

WTO members must allow cross-border (inward and outward) movements of capital if these are an essential part of a service for which they have made liberalization commitments regarding its cross-border supply (without establishment). For example, international capital transactions are an integral part of accepting deposits from or making loans to nonresidents (mode 1). International capital transactions are also usually associated with financial services such as securities trading on behalf of a customer residing in another country. The establishment of a commercial presence (mode 3) in a host country by a foreign services supplier involves both trade in services and international capital transactions. In permitting the establishment of a commercial presence, WTO members must allow inward (but not outward) capital transfers related to the supply of the service committed (IMF, 2010, pp. 14–21).

However, the GATS has three safeguard provisions that may allow nations to derogate from their commitments.

The most relevant components of each safeguard are displayed in the following extract:

### GATS Article XII: Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.
2. The restrictions referred to in paragraph 1:
  - (a). shall not discriminate among Members;
  - (b). shall be consistent with the Articles of Agreement of the International Monetary Fund;
  - (c). shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;
  - (d). shall not exceed those necessary to deal with the circumstances described in paragraph 1;
  - (e). shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.
3. In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programs. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

### Article 2(a) of the Financial Services Agreement

2. Domestic Regulation
  - (a). Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

There are many concerns in the legal literature about the balance-of-payments exception (see Viterbo, 2012). It may be that the GATS balance of payments safeguard does not adequately guarantee that nations can use measures to regulate both the inflow and outflow of capital because there is no reference to derogations to

maintain 'financial stability'. Moreover, 2(c) in the balance-of-payments exception states that measures 'shall not exceed those necessary' to deal with the circumstances that a measure is trying to prevent or mitigate (see the previous extract). This amounts to what is called in WTO law a 'necessity test' and could give a dispute panel authority to rule that an alternative measure could have been used. Furthermore, there is concern over 2(e). Requiring that measures be 'temporary' may not give nations ample time to meet their stated goals.

The GATS also has a provision often referred to as the 'prudential carve-out' (Article 2(a) of the Financial Services Agreement). This exception allows members to deviate from their commitments 'for prudential reasons' to ensure the protection of investors or to 'ensure the integrity of and stability of its financial system'. The GATS adds that if the prudential measures deviate from a nation's GATS commitments, 'they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement'. There are concerns in the legal literature that 'prudential reasons', while not defined, may not cover CARs and that the sentence stating that prudential measures should not breach a party's commitments could be seen as 'self-cancelling'.

It should be stressed that there has not been a case where this language has been tested with respect to CARs. Some members gather that existing language will be sufficient. Indeed, Ecuador led an effort to clarify the extent to which nations looking to reregulate their financial systems can do so under the 'cover' of these safeguards. Their inquiry, for cautious reasons, was careful not to mention very specific measures or disciplines. Ecuador has received on-the-record assurances from many OECD countries, including the USA, that the GATS safeguards leave ample room to maneuver to prevent and mitigate financial crises (WTO, 2011).

While reviews are mixed on the WTO, the literature is more unified that many FTAs and BITs may be significantly incompatible with the ability of nations to deploy CARs. Most FTAs and BITs are wider in scope than the WTO. Whereas the GATS only covers capital transfers related to trade in financial services, FTAs and BITs often cover all transfers between parties. In addition, transfers are often broadly defined as any investment, including stocks, bonds, currencies, derivatives, direct investment and beyond. Thus a much broader number of investments must be allowed to be transferred 'freely and without delay' among parties to an agreement.

What can often put a developing country at a disadvantage is that when negotiating a FTA or a BIT there is a 'negative list' approach whereby a nation is expected to liberalize all sectors except a handful where they still want to regulate. Thus if a nation wanted to regulate a new financial 'innovation' in the future such as a new

form of derivative, that nation would not be permitted to regulate the related investments because it had not anticipated the innovation and reserved the right to regulate during the negotiation.

What is astonishing is that many FTAs and BITs do not have a balance of payments safeguard and/or a prudential carve-out. Those that do have a balance of payments safeguard are often modeled after the GATS Article XII and thus have the same concerns described earlier (lack of clear scope for inflows and outflows, a necessity test and restrictions of temporariness). Among the few agreements that have a prudential carve-out are those with the USA (which generally do not have balance of payments safeguards). However, most US treaties tie the definition of 'prudential' more closely to policies pertaining to 'individual financial institutions' and also include the potentially 'self-canceling' language found in the GATS. Moreover, US negotiators have repeatedly stressed that existing language does not pertain to the use of capital controls (Sáez et al., 2006; Taylor, 2003; Geithner, 2011). Indeed, a handful of US treaties have annexes that note how CARs are deviations from commitments but require an extended 'cooling off' period before foreign investors may file claims for compensation. One treaty, the US–South Korea FTA, allows South Korea to deploy regulations as specified under its law as long as such measures meet a number of limitations specified in the Annex.

The IMF has expressed concern that many FTAs and BITs lack the adequate safeguards to put in place CARs: 'the limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows' (IMF, 2012, p. 8). The IMF has developed an institutional view on the use of CARs that defines CARs as 'measures affecting cross-border financial activity that discriminate on the basis of residency'. Therefore, forbidding nations to violate 'national treatment' in treaties may thus constrain the ability of nations to use CARs in general and even under IMF advice in particular. Some US treaties allow nations to deploy price-based taxation measures on capital flows, or have an annex that allows a nation to deploy CARs as long as they meet national treatment requirements. Such limitation may nullify the ability to use CARs by definition. Moreover, such incompatibility may make it more difficult for nations to accept the IMF policy advice based on its new institutional view.

Finally, there is real concern about the use of 'investor-state dispute resolution' in cases pertaining to CARs in FTAs and BITs. WTO disputes are settled 'state to state' and therefore nation states can negotiate on behalf of the wellbeing of entire nations and financial systems – looking for situations where the benefits to the majority outweigh losses to a minority. However, that cost–benefit analysis is turned on its head under investor-state disputes. Under investor-state private firms and investors

may file claims directly against governments that regulate capital. Therefore, those sectors that may bear the cost have the power to externalize the costs of financial instability to the broader public while profiting from awards in private tribunals.

The leaked text of the TPP, along with the US model bilateral investment treaty, includes this broader definition of an investment, mandates that all capital be transferred freely and without delay, does not include a balance-of-payments exception, and does include the controversial investor-state dispute resolution system.

## Chile

In 1990, Chile returned to democratic rule. In general, there were no dramatic economic policy changes but a tax reform and comprehensive changes in macroeconomic management (Ffrench-Davis, 2010).

Chile faced a great supply of external finance. The new authorities considered that large inflows would be destabilizing for the macroeconomy and export strategy. Memories were fresh of the huge crisis that Chile had suffered in 1982 due to previous large financial inflows, which led to significant real exchange rate (RER) appreciation, and climbing external deficit and liabilities (Ffrench-Davis, 2010).

Reacting to the first signals of increasing inflows, it established an unremunerated reserve requirement (URR) of 20 per cent on financial inflows, retained for one quarter. The URR rate, the duration for its retention at the Central Bank and its coverage became adjustable, according to the strength of the supply of funds. The purpose was to affect the cost of inflows, making their volume consistent with what could be absorbed in productive investment (complementing domestic savings) while maintaining an aggregate demand consistent with potential output.<sup>2</sup> In parallel, comprehensive managed flexibility of the exchange rate was implemented in order to achieve a sustainable balance of the current account.<sup>3</sup> The Central Bank monitored the market persistently in order to adjust policy and close incoming loopholes.

Both policies implied applying several mini adjustments in order to avoid the typical maxi adjustments that crisis generate.

During 1990–95, in an opposite approach, Latin America accepted large capital inflows and significant RER appreciation with rising external deficits. In 1995, under the 'Tequila crisis', GDP fell sharply in Mexico, Argentina and Uruguay. In contrast, Chilean GDP growth exceeded 7 per cent; exchange rate appreciation and the relative current account deficit were much lower than the regional average. The regulation of destabilizing financial inflows had provided room for countercyclical exchange rate and monetary policies throughout those years. Thus, Chile was able to gain control of the composition of

inflows, significantly reducing liquid and short-term inflows. This, together with prudential regulation of domestic financial markets, avoided a destabilizing appreciation of the exchange rate and a credit boom, maintaining, by the mid-1990s, an aggregate demand consistent with potential GDP and the deficit in the current account within sustainable limits.

There is also a link with the future: an economy with a high rate of productive capacity utilization and long-term stable flows tends to exhibit higher investment ratios. In fact, even though the private sector was carrying a higher tax burden (a rise from 15 per cent to 18 per cent of GDP) and faced more progressive labor rights, the investment ratio (mostly private) increased from 16 per cent of GDP in 1982–89 to 23 per cent in 1990–98. Real macroeconomic stability was a key determinant of this improvement, associated to a level of domestic demand consistent with potential GDP and a 'stable and competitive' RER (a crucial macro-price) up to 1995. Even though exchange rate policy lost its coherence from 1996 (no monitoring of URR leakages and hesitating RER management), the economy continued to use potential GDP until 1998. Actually, Chile achieved a 7.1 per cent average GDP growth in 1990–98, and inequality was somewhat reduced (Ffrench-Davis, 2010, 2012).<sup>4</sup>

Paradoxically, since the mid-1990s, Chile (actually, the autonomous Central Bank) gradually moved toward the neoliberal or Washington Consensus approach of capital account and exchange rate liberalization. Because this move was gradual, part of the positive effects of the countercyclical approach remained at work. The economy remained close to potential GDP until 1998, but the deficit on current account duplicated and the RER appreciated significantly. Only in 1999 did it formally adopt the 'neoliberal' approach of a fully free exchange rate, followed in 2001 by a fully open capital account and inflation targeting as a dominant policy target, all of which have remained in place until 2015. Nonetheless, most of the policy tools remain available in case new authorities decide to apply capital account and exchange rate countercyclical policies.

As a result of the policy reversal, domestic demand and the exchange rate began to depend on financial flows, becoming 'victims' of the globalization of financial volatility. Inflation has been around a 3 per cent target, but at the expense of other underscored macroeconomic policy targets that had been taken into consideration systematically in 1990–95: primarily avoiding unstable aggregate demand and RER, and persistent output gaps.<sup>5</sup> Actually, with the subsequent liberalization, the exchange rate and domestic demand came to be led by cyclical short-term financial flows, reinforced by terms of trade instability. Their instability appears to be the main variable explaining why the Chilean economy moved downward from a 7.1 per cent average growth in 1990–

98 to a modest 3.9 per cent in 1999–2013 (Ffrench-Davis, 2015).

In all, evidence shows that countercyclical capital controls applied rather systematically between 1990 and 1995: (1) modified the maturity structure of capital inflows, reducing the unstable components; (2) allowed the maintenance of a differential between the domestic and international interest rates, providing room for active monetary policy (which ensured that the economy would ride around the production frontier); (3) allowed Chile to avoid a destabilizing exchange rate appreciation (Magud and Reinhart, 2007; Edwards and Rigobón, 2009; Lefort and Lehmann, 2003); and (4) contributed to a comprehensive real macroeconomic equilibrium that is friendly towards growth and equity. Since 1999, authorities have not used the specific policy space analyzed below.

### Chile's WTO commitments

As a WTO member Chile has included numerous horizontal and specific limitations on the GATS that allow policy space to use CARs. Concerned as it was with financial volatility, Chile was very cautious in its GATS negotiations, with limited commitments to capital account liberalization. Chile places horizontal limitations on market access and national treatment across all of its service obligations. Measures taken by the Central Bank regarding capital inflows and outflows as well as exchange rate policy are reserved in order to maintain financial stability (Sáez, 2006). The bulk of Chile's commitments were adopted under commercial presence, while limited commitments on cross-border supply of services were undertaken (Sáez, 2006).

Chile's general market access and national treatment limitations specify that for reasons of macroeconomic stability and maintenance of the functioning of the payments system, the Central Bank can adopt measures according to its Banking Act. This includes limitations on payments and transfers in and out of Chile, such as reserve requirements. Market access limitations state that authorization for commercial presence may take into account the effect of the commercial presence on economic activity (including employment and the use of parts, products or services produced domestically), productivity, industrial efficiency, technological development and product innovation, competition in any sector, consumer protection, the functioning, integrity and stability of the market, national interest and Chile's integration into world markets. These limitations apply to: corporations (open or closed), private limited companies and subsidiaries.<sup>6</sup> These very broad limitations to market access across all services, including financial services, allow considerable leeway for Chilean authorities to limit market access for foreign companies. Chile also maintains significant horizontal limitations for national treatment



for its liberalization of services. Its national treatment limitations state that foreign investors may transfer capital abroad once two years have elapsed since the date of entry.

Chile has signed onto GATS financial services; however, it remains unbound and maintains multiple limitations beyond those horizontal limitations already discussed. Cross-border trade and consumption abroad (modes 1 and 2) are completely unbound except for reinsurance and retrocession and brokerage of reinsurance. Commitments were generally made under mode 3 (commercial presence) in insurance services. However, auxiliary insurance services, such as consultancy, actuarial, risk and claim services, are not included. Banking regulations essentially follow the guidelines of Chile's Banking Act. However, not all services in the Banking Act are listed in the GATS – for instance, some core banking services (Sáez, 2006).

In general, Chile made use of the GATS balance-of-payments exception while negotiating its GATS obligation in the 1990s (Viterbo, 2012). Chile clearly took steps to ensure that it could use CARs, including the use of a URR in due time rather than in the midst of a crisis. Chile remained unbound in several key areas, thus retaining policy space in the commitments adopted on financial services in 1997. In negotiations with Canada, the USA and the EU, Chile faced pressure to liberalize financial services and/or take on more commitments.

### Canada–Chile FTA

The Canada–Chile FTA came into force in 1997 (Sáez, 2006). Canada offered Chile the option of negotiating an agreement modeled after NAFTA. The FTA contains chapters on investment as well as on cross-border trade in services. The financial services chapter was not negotiated then because Chile felt that it needed to maintain financial services as a bargaining chip for later negotiations with the USA; however, there were protections in the investments chapter intended for investors in foreign financial institutions. Dispute settlement is carried out through investor-state dispute resolution. Later, in 2012, the financial services chapter was incorporated, following the model of NAFTA; the protections to investors in financial institutions were placed in this chapter.

Canada expected a strong obligation regarding transfers that would prevent the use of an URR. However, Chile wanted to retain full policy space for a URR. The compromise reached was an annex to the investment chapter that provided an exception for transfers. Annex G-09.1 retains Chile's ability to apply a reserve requirement, but with two limitations. First, the maximum URR is 30 per cent for no more than two years. Second, there is a requirement that authorization of certain transactions that are carried out in the formal foreign exchange market be granted without delay.

The Canada FTA has a balance-of-payments exception that states that 'nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures that restrict transfers when the Party experiences serious balance of payments difficulties, or the threat thereof, and such restrictions are consistent with this Article.'<sup>7</sup> This exception is modeled after GATS.

Annex G.09.1 and the balance of payments gives Chile the space to implement CARs if it needs to.

### US–Chile FTA

The US–Chile FTA entered into force in January 2004. The agreement includes separate chapters on investment, cross-border trade in services and financial services, all of which are relevant for capital flows. The financial services agreement is largely based on the NAFTA financial services agreement. Negotiations with the USA took place at the same time as with the EU, and this was the first time that Chile had negotiated regarding financial services (Sáez, 2006).

Financial services are covered specifically in their own chapter, and are only partially subject to the requirements of the other services or investment chapters. The financial services chapter includes: financial institutions, investors and investments of such investors in financial institutions, and cross-border trade of financial services. A separate team was designated to negotiate issues of CAR and balance-of-payment measures. While the *encaje* was not in force at the time of the negotiation, Chile was committed to preserving the right to use a URR as well as a balance-of-payments exception.

The financial services chapter has national treatment requirements that apply to both Chile and the USA for all financial services covered in the chapter. Article 12.3 also has most favored nation (MFN) requirements. Regarding market access, neither party may impose limitations on the number of financial institutions, the total value of financial service transactions, the total number of financial service operations, or the total number of natural persons that may be employed in a particular financial service.<sup>8</sup>

Throughout the two years of negotiations, the USA and Chile were unable to come to agreement about capital controls and a balance-of payments exception. Chile was determined to retain the right to use a URR. The solution was an annex that allowed Chile to adopt measures if needed. However, US investors can file claims but no sooner than one year after the measures are implemented. The damages resulting from the measures are also limited to the actual reduction in value of transfers, and exclude other damages such as loss of profits. There are circumstances under which claims can be submitted immediately, including transfers related to direct foreign investment and payments pursuant to a loan or

bond issued in a foreign market. The exception of these investments is intended to distinguish volatile capital flows from other forms of capital flows. The agreement includes no balance-of-payments safeguard provisions.

The compromise reached between the USA and Chile leaves somewhat vague the possible interpretations of what is permitted under the agreement. While Chile reserves the right to impose CARs to avoid building a crisis (and more so during an emergency), foreign investors also retain the right to seek compensation after one year. The compromise was the first of its kind in a US FTA, and served as a model for future US FTAs such as the US–Singapore agreement (Sáez, 2006).

### Chile–EU FTA

In 2002, the EU and Chile concluded an association agreement that included an FTA. The agreement seeks to establish transparent rules for exporters, importers and investors, create a free trade area in goods, services and government procurement, liberalize investment and capital flows, and strengthen the protection of intellectual property rights.<sup>9</sup>

EU-style agreements follow a GATS framework where financial services are included as an annex to the regular services chapter. The GATS text was incorporated into the financial services chapter without any changes so as to minimize uncertainties associated with legal interpretation, which means that market access and national treatment provisions are the same as the GATS. There is also a prudential carve-out that is taken from NAFTA and the GATS Annex on Financial Services (Sáez, 2006). Chile's commitment to liberalizing financial services under the agreement remains 'intermediate' according to an EU analysis of the agreement.<sup>10</sup> No MFN clause is included. There is a schedule of horizontal and specific service commitments made by Chile and also by each EU member.

The EU agreement contains a chapter on current payments and capital movements. Chile commits to allow payments and transfers in convertible currency in accordance with the Articles of Agreement of the IMF. Chile is obligated to allow the free movement of capital relating to investments made in accordance with domestic laws and to allow the repatriation of any profit. However, the chapter contains an article that provides an exception to these obligations. The article states that measures can be taken under 'exceptional circumstances, payments and capital movements between the Parties cause or threaten to cause serious difficulties for the operation of monetary policy or exchange rate policy of either Party'. In these cases, parties can apply safeguard measures for up to one year (and that time period can be extended) (Sáez, 2006).

Beyond its prudential carve-out, the agreement includes Annex XIV, which enables the Foreign Investment Committee or the government to employ special investment regimes that could include minimum periods for the repatriation of capital. The provision is very similar to that in the Canada–Chile FTA, with a condition that measures be applied on a nondiscriminatory basis. There is also a maximum URR of 30 per cent and a maximum holding period of two years (Sáez, 2006).

The prudential carve-out and Annex XIV give a similar degree of freedom to use CARs as the GATS and the Canada agreement. During emergency situations there is a greater degree of flexibility to impose CARs, and Chile has retained its ability to use a URR if necessary. Chile was highly successful in most of the 1990s in using a set of effective countercyclical macroeconomic policies, including the regulation of capital inflows. Nonetheless, since 1999 it has decided to keep an open capital account and a free exchange rate. The fact is that it has experienced high real macroeconomic instability, including of the RER; as a consequence, it has underutilized the trade preferences received in the FTA. Excessive financial volatility has deterred productive development.

### Malaysia

Throughout most of the past 30 years Malaysia has pursued a relatively open capital account with few regulations on capital flows. On two occasions Malaysia decided to experiment with capital regulations: once in 1994 and most famously again in 1998. The first was to control the inflow of capital and the second to control its outflow.

The surge in short-term capital inflows prior to 1994 caused an overheating of Malaysia's economy and stock market; it also put upward pressure on its exchange rate. In early 1994, the government enacted monetary and administrative controls to mitigate capital inflows. These measures included stepwise increase in statutory reserve requirements for commercial banks, imposing a ceiling on the net external liabilities of banks, prohibition of selling short-term monetary instruments to nonresidents, prohibition of commercial banks' forward and nontrade-related swap transactions with foreign customers, and the requirement for commercial banks to place their ringgit funds of foreign institutions with the central bank. These policies reversed capital inflow, drained excess liquidity by RM10 to 12 billion and dampened the economy without pushing it into recession. Some economists, like Kuroyanagi and Hayakawa (1997), believed the measures to be on the whole successful; others (e.g. Economic Forum, 1998) questioned the long-term effectiveness of the sterilization. Many of these policies had been repealed by August 1994.

In 1998 Malaysia used capital controls again, this time to stem the outflow of capital precipitated by the Asian financial crisis. The purpose was to gain monetary independence and to mitigate against deteriorating global financial markets. The regulations implemented during the 1998 crisis were designed to limit foreign currency outflows and speculation on the ringgit. Malaysia shut down the offshore ringgit market in Singapore and limited the trade of ringgit to within Malaysia. Transfer of funds into the country from external ringgit accounts was prohibited except for investment or the purchase of goods in Malaysia. On 2 September 1998 the ringgit was pegged at RM3.80 to the US dollar. This allowed the adoption of expansionary monetary and fiscal policies.

There was a one-year ban on the repatriation of shares or proceeds from the sale of shares and later a system of graduated exit levies to the profit of foreign portfolio investment. However, the selected exchange controls did not apply to trade and foreign direct investment transactions. These capital control measures were severely criticized at that time but are now seen as having helped stabilize and resuscitate the economy.

Beginning in 2000, regulations were gradually scaled back after the economy stabilized; by 2007 the regulations were loosened to a level that was more liberal than prior to the Asian financial crisis. There are no more controls over the inflow and outflow of capital. Nonresidents can now borrow any amount in ringgit for use in the real estate sector within Malaysia. However, limitations are still placed on the use of ringgit for speculative purposes. Foreign currency borrowings by Malaysian-resident companies and individuals have been raised substantially to the equivalent of RM100 million for corporate groups and RM10 million for individuals. The ringgit has been partially internationalized wherein imports and exports can be invoiced in ringgit and international trade can be settled in ringgit onshore (Lim, 2013). Nevertheless, some regulations on exchanging ringgit and limiting access to

the ringgit for nonresidents are still in place in order to prevent the growth of another offshore ringgit market (Lim, 2013).

### WTO commitments

Malaysia has clearly reserved its right to regulate its capital account, as demonstrated by the CARs that it continues to use. It has chosen to include some liberalization of financial services under the GATS, which comes with certain obligations for the movement of capital (Viterbo, 2012).

Malaysia places horizontal limitations only on mode 3 (commercial presence) and mode 4 (movement of natural persons), which limit the GATS's national treatment and market access requirements (see Table 1). In its general horizontal limitations for mode 3, Malaysia specifies it can impose limitations on foreign ownership of companies and businesses. Malaysia also specifies that approval may be denied if dealings in land, property and real estate are for speculative purposes. Other horizontal limitations indicate that incentives can be used for Malaysia-owned firms. Measures taken for national economic or development purposes remain unbound to mode 3.<sup>11</sup> These limitations to national treatment and market access allow Malaysia greater control over the ability of foreign service providers to set up branches in Malaysia.

In its financial services sector, Malaysia includes even more limitations on national treatment and market access. Some of the biggest limitations include mode 3 provisions that allow Malaysia to confine offshore banks, investment banks, insurance companies and other companies to the island of Labuan. These banks are permitted to accept foreign currency deposits only. As of 2011, there are 27 foreign banks (commercial and Islamic banks) from 14 countries with a presence in Malaysia.<sup>12</sup> Aggregate foreign shareholding in a commercial bank cannot exceed 30 per cent.<sup>13</sup> (This has been liberalized: a

**Table 1.** Malaysia's horizontal General Agreement in Trade in Services (GATS) exceptions to mode 3 in 2012

Market access	National treatment
<p>Approval is required when:</p> <ul style="list-style-type: none"> <li>• a single foreign interest or group gains more than 15 per cent voting rights in a Malaysian business;</li> <li>• the aggregate foreign interest is 30 per cent or more (or exceeding 5 million ringgit);</li> <li>• when the transaction results in foreign ownership or control of a Malaysian corporation.</li> </ul>	<p>Malaysia maintains the right to deny approval for:</p> <ul style="list-style-type: none"> <li>• dealings on land, property or real estate for speculative purposes;</li> <li>• measures to assist the development of any Malaysian financial institution to achieve the objectives of the national development policy;</li> <li>• corporations in which the government has an interest will give first consideration to service providers in which the government also has an interest.</li> </ul>

Source: 'Horizontal commitments of Malaysia', World Trade Organization Services Database, <http://tsdb.wto.org/simplesearch.aspx> [Accessed 10 May 2012].



2009 Bank Negara press release states that 'in terms of foreign shareholding, the new commercial bank may have a foreign equity interest of up to 100 per cent' and 70 per cent foreign equity interests for Islamic and investment banks.) Lending of more than RM25 million must be undertaken jointly with a Malaysian commercial or merchant bank.

Malaysia's commitments essentially bind it to the level of foreign access that it provided to foreign service providers at the time of the Uruguay WTO negotiations, which is less liberalized than Malaysia's current level (Ranjane, 2012). By binding its commitments below its actual level of liberalization, Malaysia has some flexibility to implement certain CARs. Exceptions and limitations allow greater control of the offshore ringgit market and speculation on real estate. They also allow for the violation of national treatment in order to implement domestic development policies. They also allow Malaysia to retain the ability to limit foreign market access and require joint ventures under certain circumstances. The GATS limitations allow Malaysia to implement many regulations on the lending, borrowing and trading of domestic and foreign currency (Ranjane, 2012).

Malaysia's commitments under GATS do, however, preclude it from implementing measures such as the ban and tax on outflows during the 1998 crisis. Malaysia must allow transfers and payments for financial services that it has chosen to liberalize, and a ban or tax on inflows or outflows would impede transfers and payments. Measures taken in 1998 were specifically targeted at foreign investors, and they would violate the national treatment discipline of the GATS. Malaysia would likely only implement these measures during a crisis, so it may be able to use the GATS balance-of-payments exception in order to enact temporary CARs. However, it is not clear if limitations on outflows are allowed under the balance-of-payments clause. Furthermore, the ban and tax on outflows in 1998 was not short-term and therefore would likely not be permissible under the balance-of-payments clause. Were a crisis such as the 1998 one to arise again, Malaysia may face less flexibility in its policy options than it did in the 1990s.

### Association of Southeast Asian Nations (ASEAN)

The ASEAN Economic Community (AEC) was created in 2002 with a view to creating 'free movement of goods, services, investment, skilled labor, and freer flow of capital' in the ASEAN region and with a goal of regional economic integration by 2015.

There are two major documents providing the guiding principles for economic and financial integration: the ASEAN Economic Blueprint (the 'Blueprint') and the ASEAN Capital Market Development and Integration Plan (the

'Plan'). Both these documents aim at creating a single market with free trade of goods, services, investments, capital and skilled labor. The Plan in particular seeks to allow for more cross-border capital flows and services. However, after the Asian financial crisis, many Asian countries recognized the risks associated with capital flows and the potential for destabilization. Thus, while AEC commits members to greater liberalization, it also recognized CAR as an important tool for developing countries.

Within the Blueprint<sup>14</sup> and the Plan, there are special clauses that recognize the use of capital regulations. Financial-services liberalization also contains flexibilities for certain subsectors. The Plan also lists several guiding principles in liberalizing capital movements: consistency with each country's national agenda; readiness of the economy; adequate safeguards against potential macroeconomic instability; and countries should maintain the right to adopt necessary measures to ensure macroeconomic stability.<sup>15</sup> Also there are no binding agreements or steps that members must take toward full capital account liberalization.

### Japan–Malaysia Free Trade Agreement (JMFTA)

Malaysia signed an FTA with Japan in 2006 that covers capital flows in both a financial service section and a separate investment chapter. The services agreement contains a commercial presence mode similar to mode 3 of the GATS and uses a GATS-style positive-list approach. The JMFTA differs from the GATS in that members are required to make binding commitments at the current level of liberalization that is in force. Furthermore, there is a 'ratcheting up' policy whereby any liberalizations that are made in the future become binding (Fink and Molinuevo, 2008). The dispute-settlement mechanism is through ad hoc arbitration and parties can block disputes by failing to appoint arbitrators. Investor-state disputes are allowed specifically for disputes concerning the investment chapter (Fink and Molinuevo, 2008).

Malaysia's commitments to Japan in financial services and investment go only slightly beyond what it offers through the GATS. Foreign equity participation limitations in some institutions were raised by 5 per cent. The agreement's rules on subsidies and domestic regulation for financial services are lenient. The agreement contains disciplines on national treatment, market access and MFN. The MFN clause demands that trade privileges extended to other countries also be extended to Japan and Malaysia. However, there is a carve-out clause and emergency safeguard measures that allow a country to take measures for prudential reasons to protect investors and depositors or to safeguard the stability of the financial system during a crisis.

The agreement has special rules of origin for services that allow Malaysia flexibility to deny service providers if

they are not fully Japanese and vice versa (Fink and Molineo, 2008).

The most significant difference between the GATS commitments and the JMFTA agreement is the binding rules and 'ratcheting up' policy. This difference in implementation reduces Malaysia's flexibility and ability to experiment with regulations. If Malaysia were to experiment with more liberalization, its commitments are then automatically bound to the greater level of openness due to the 'ratcheting up' policy in the JMFTA. This policy most likely deters Malaysia from experimenting with different levels of liberalization or capital regulations.

### ASEAN-Australia-New Zealand Free Trade Area (AANZFTA)

ASEAN signed an FTA with Australia and New Zealand in 2010, two years after the global financial crisis. This agreement follows a 'WTO plus' framework for regulation. The AANZFTA binds members to existing levels of market openness.<sup>16</sup> However, there is no automatic 'ratcheting up' policy. In the investment chapter, dispute resolution includes investor-state dispute settlement. If the country agrees to market access in mode 1 and mode 3, the country is then committed to allow free capital movement. The financial services sector also includes an annex with a prudential exception clause that allows for measures to be taken to ensure the stability of the economy.<sup>17</sup>

Article 19 of trade in the services chapter recognizes safeguard measures; however, it requires that any measures taken be mutually agreed upon.<sup>18</sup>

Members of AANZFTA each develop their own commitments for the investment chapter to be submitted by 2015. The commitments will follow a negative-list approach.<sup>19</sup> The investment chapter also includes a national treatment clause that allows each party to accord to investors of another party treatment no less favorable than it accords to its own investors and their investments.<sup>20</sup>

Table 2 provides a summary of the main elements of each of the FTA and bilateral investment agreement between Malaysia and the other parties.

### Conclusions and recommendations

This article pinpoints the commitments made by two TPP countries, Chile and Malaysia, under the WTO and various FTAs and BITs. Table 3 summarizes our findings, and reveals that both countries have taken steps to preserve their policy space for CAR. However, the agreements they have entered into have to varying extents limited this space. For Malaysia, the agreement that most infringes on its policy space is that with Japan. The 'ratcheting up' policy of the Japan agreement automatically binds Malaysia to the existing state of openness and limits Malaysia's ability to experiment with various degrees of

**Table 2.** Summary of the main elements of Malaysia's agreements

	WTO/ GATS	ASEAN	Japan FTA	ASEAN- AANZFTA
Positive list	Yes	N/A	Yes	No
Negative list	No	N/A	No	Yes
Investor-state dispute	No	No	Yes	Yes
Binding commitment at existing level	No	N/A	Yes	Yes
Binding commitment below existing level	Yes	N/A	No	No
Most favored nation	No	No	Yes	Yes
Carve-out of financial service	Yes	N/A	Yes	Yes
Emergency safeguard measures	Yes	Yes	Yes	Yes
Ratcheting clause	No	No	Yes	No
Prudential measure	Yes	N/A	Yes	Yes
Balance of payment exception	Yes	N/A	Yes	Yes
Nonbinding commitment to liberalization	No	Yes	No	No

*ASEAN, Association of Southeast Asian Nations; ASEAN-AANZFTA, ASEAN-Australia-New Zealand free trade area; FTA, free trade agreement; GATS, General Agreement in Trade in Services; WTO, World Trade Organization.*

openness. However, this agreement still contains a balance-of-payments exception for emergency measures.

Chile's agreement with the USA is its most limiting agreement for adopting countercyclical regulation of cross-border finance. Chile can implement a URR; however, foreign investors can claim damages as a result of the measures that Chile implements (after a one-year 'cooling-off' period). Furthermore, there is no balance-of-payments exception. This is the only agreement examined in this article that does not include a balance-of-payments exception. This means that even in a crisis situation, Chile could face litigation from investors. Both Malaysia and Chile have made compromises to their policy space in negotiating FTAs; however, they have so far in large part retained the ability to implement measures in times leading to (or of) financial crisis. There may be consequences to implementing such measures, particularly for Chile due to the lack of balance-of-payments exception.

As the leaked text indicates, in the TPP the USA has proposed provisions that offer even less than what Chile received in the US–Chile FTA – a wide definition of investment with no balance-of-payments provisions and no change in the prudential exception. In fact, Chile is trying to get what it was unable to get in the negotiations of the US–Chile FTA. However, according to leaked

**Table 3.** Comparison of policy space for capital account regulation

	Malaysia	Chile	
WTO	Limitations on national treatment and market access in financial services essentially bind Malaysia to the level of openness that it had during the Uruguay negotiations. Balance-of-payments exception.	Largely unbound in modes 1, 2, and 4. Balance-of-payments exception.	WTO
Japan	Automatic 'ratcheting up' that binds Malaysia to its current level of current account openness. Emergency safeguard measure provisions allowed during crisis.	Annex that allows for measures to be implemented without foreign investors being allowed to litigate for one year. No balance-of-payments exception.	USA
Australia	Limited financial service liberalization commitments, yet to submit investment chapter. Remains unbound for many subsectors. Agreement contains a binding policy that requires a minimum degree of openness for any bound sectors. GATS-style balance-of-payments exception	GATS-style balance-of-payments exception. Annex G.09.1 allows a maximum URR of 30 per cent for up to two years	Canada
ASEAN	No binding commitments. All members commit to move toward greater liberalization. Goal of full economic integration among members by 2015. Advocates that countries retain their right for emergency safeguard measures.	Capital account regulation measures can be taken 'under exceptional circumstances' according to one article of the chapter on the free movement of capital. Annex XIV allows a maximum URR of 30 per cent for up to two years.	EU

ASEAN, Association of Southeast Asian Nations; GATS, General Agreement in Trade in Services; URR, unremunerated reserve requirement; WTO, World Trade Organization.

text of the investment chapter, TPP negotiating partners have introduced two additions. Analogously to what it negotiated with Canada and the EU, Chile has proposed an annex to the agreement that would give deference to Chile's *encaje*. One other nation has proposed a balance-of-payments exception quite similar to the one in the GATS. This pair of reforms would be more consistent with current thinking on these issues but would not go far enough for Malaysia and other parties to the TPP.

For Chile, deference to its law and a balance-of-payments provision would grant it the ability to regulate both the inflow and outflow of capital to prevent and mitigate financial instability. Malaysia would have the policy space to regulate outflows of capital in the middle of a crisis under a balance-of-payments exception. However, Malaysia and other TPP nations do not have an *encaje* on their books and thus would not benefit from the special annex for Chile. In order for TPP nations to have ample space to regulate the inflow of capital, there would have to be a deletion of the footnote that constrains the definition of 'prudential'. It could be replaced with a footnote that has an illustrative but not exhaustive list of measures, such as CARs. Only then can TPP nations rest assured that they have all the countercyclical tools necessary to regulate capital flows for development.

## Notes

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1. See the leaked text in TPP (2012).
2. See the detailed analysis of this experience and a discussion of outcomes in Ffrench-Davis (2010); Le Fort and Lehmann (2003); Williamson (2003).
3. There was also a quite responsible fiscal policy: in 1990–98, the fiscal surplus averaged 2 per cent of GDP. However, a fiscal surplus is not enough to avoid crises. In 1981 Chile held a larger surplus and suffered the deepest GDP drop of all Latin American countries in 1982; a huge macroeconomic imbalance was located in the private sector.
4. Notice that GDP growth during the 16 years of dictatorship had averaged 2.9 per cent (Ffrench-Davis, 2010)
5. While in 1991–98 the economy was working close to potential GDP, since 1999 it has only come close to this level in 2007, 2012 and 2013 (Ffrench-Davis, 2015).
6. 'Chile WTO Schedule for Services', [www.wto.org/english/tra-top\\_e/serv\\_e/serv\\_commitments\\_e.htm](http://www.wto.org/english/tra-top_e/serv_e/serv_commitments_e.htm), [Accessed 6 May 2013].
7. 'Canada–Chile Free Trade Agreement, Part Five, Other Provisions, Chapter O, Exceptions', [www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/chile-chili/chap-o26.aspx?lang=en&view=d](http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/chile-chili/chap-o26.aspx?lang=en&view=d), [Accessed 6 May 2013].
8. 'US–Chile Free Trade Agreement', Chapter 12, Financial Services, [www.ustr.gov/sites/default/files/uploads/agreements/fta/chile/asset\\_upload\\_file306\\_4006.pdf](http://www.ustr.gov/sites/default/files/uploads/agreements/fta/chile/asset_upload_file306_4006.pdf) [Accessed 6 May 2013].
9. 'Trade: Chile', <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/chile/>, [Accessed 6 May 2013].

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