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Trading Away Financial Stability in Colombia: Capital Controls and the US-Colombia Trade Agreement

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Trading Away Financial Stability in Colombia: Capital Controls and the US-Colombia Trade Agreement

Kevin P. Gallagher[1]

The United States-Colombia Trade Agreement between the United States and Colombia was signed before the global financial crisis. As Congress and the President convene to rework the agreement, it will be important to ensure that the agreement is designed so that it given both nations the flexibility to put in place macro-prudential regulations to prevent and mitigate financial crisis.

As the treaty now stands, a number of actions that Colombia has successfully deployed in the past to prevent and mitigate treaties in the past would be deemed actionable under the agreement's chapters on financial services and investment.

The global financial crisis has demonstrated that sound regulations are needed to stem the ability of speculative capital to create financial bubbles that burst and then leave ordinary Americans and Colombians worse off.

In this short note I outline how the negotiators fell short of recognizing this need. And, I provide specific remedies to amend the treaty in order for the treaty to better enable meeting its stated goals.

Specifically, this short essay discusses new evidence in the economics profession showing that capital controls are important macro-prudential measures that nations should have in their toolkit to prevent and mitigate financial crises. I then discuss the success that Colombia has had in using these prudential measures to prevent and mitigate financial crises. I will then show that the US-Colombia treaty does not reflect the emerging consensus on capital controls.

There is a unique opportunity to rectify this problem as the United States is considering amending the agreement in order for it to improve the economies of Colombia and the United States and the livelihoods of their citizens.

New Research on Capital Controls and Financial Stability

Capital flows—cross-border non-foreign direct investments—can help developing countries grow. Indeed, many developing countries may lack the savings or financial institutions that can help finance business activity. Capital from abroad can fill that gap. Therefore, under normal circumstances, the more capital flowing into a developing country, the more the country benefits. However, cross-border capital flows tend to be "pro-cyclical": too much money comes in when times are good, and too much money evaporates during a downturn.

A key characteristic of the global financial crisis has been the mass swings of capital flows across the globe. Indeed, international investment positions now surpass global output. Developing and emerging markets are no strangers to these flows. When the crisis hit, capital rapidly left the developing world in a flight to the "safety" of the United States market. In the attempt to recover, many industrialized nations, including the U.S., have resorted to loose monetary policy with characteristically low interest rates. Relatively higher interest rates and a stronger recovery have triggered yet another surge in capital flows to the developing world. The result has been an increasing concern over currency appreciation, asset bubbles, and even inflation.

Under these circumstances, capital controls can help smooth the inflows and outflows of capital and protect developing economies. Most controls target highly short-term capital flows, usually conducted for speculative purposes.

For example, Colombia's 2007 capital controls required foreign investors to park a percentage of their investment in the central bank, which helped that nation escape some of the damage from the global financial crisis[2]. Chile and Malaysia, two nations that form part of the TPP negotiations, successfully used capital controls in the 1990s to avoid the worst of the damages during crises in that decade.3

In the wake of the financial crisis, nations such as Brazil, Indonesia, South Korea, Taiwan and Thailand have all used capital controls to stem the massive inflows of speculative investment entering their economies and wreaking havoc on their exchange rates and asset markets. South Korea, where the won has appreciated by 30% since 2008, has direct limits on foreign exchange speculation, for example, and has also levied an outflows tax on capital gains of foreign purchases of government bonds.

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[2] Coelho, B.,Gallagher K.P, (2010, January). Capital Controls and 21st Century Financial Crises: Evidence from Colombia and Thailand. PERI Working Paper No. 213. Retrieved from http://www.ase.tufts.edu/gdae/policy_research/KGCapControlsPERIJan10.html

[3] Magud N., Reinhart, C. (2006, January) Capital Controls: An Evaluation. NBER Working Paper No. 11973. Retrieved from http://www.nber.org/papers/w11973

[4] Ostry,J., Ghosh, A., Habermeier,K., Chamon, M., Qureshi, M., Reinhardt D., (2010, February). Capital Inflows: The Role of Controls. International Monetary Fund. Retrieved from http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf

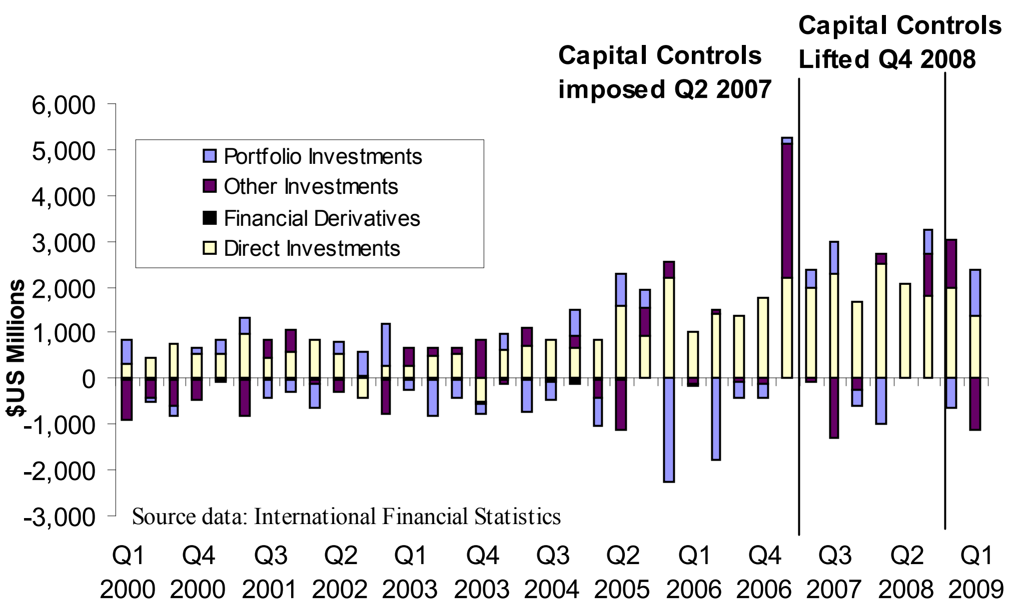
A pathbreaking IMF study finds that capital controls like these have helped developing nations stem currency appreciation and asset bubbles in the past[4]. Moreover, the IMF study found that capital controls helped buffer some of the worst effects of the financial crisis in some developing countries. In lieu of these findings, the IMF now endorses the use of capital controls as a part of the macroeconomic policy toolkit. The IMF permitted capital controls[5] on outflows in Iceland, Ukraine and Latvia as the crisis hit, and has recently recommended[6] that nations such as Brazil, Colombia, and India use controls on inflows to tame the mass influx of capital that herded to emerging markets in 2009-2010. In 2010 the IMF took a step further and recommended that a system of global coordination be put in place for capital controls, an initiative that the G-20 will take up in 2011.[7]

Colombia's Use of Capital Controls During the Crisis

Colombia has had a long experience with capital controls. It started the liberalization of its capital markets in 1991, but some controls remained in place until 2000, including an unremunerated reserve requirement (URR) that was effective between 1993 and 2000, with the goal of stemming the appreciation of the Colombian Peso[8]. The 1993 URR designated percentage of foreign loans with a maturity of less than a designated maximum be kept as a deposit in local currency, at zero interest for a certain percentage of the loan and a stated period of time (approx 47 percent for one year). Economists have shown that the URR during this period was effective in Colombia in reducing the volume of net capital inflows, improving the term structure of foreign borrowing, and granting more independence to monetary authorities. In some cases these effects were "speed bumps" however, rather than serving as full stops on inflows[9].

Like most developing countries, Colombia received large inflows of foreign capital between 2005 and 2007, with a particularly sharp increase in the first quarter of 2007 (see figure 1). In order to stem the appreciation of the Peso, the central bank (Banco de la República) intervened in the exchange market by buying foreign currency, resulting in a large accumulation of foreign reserves (see figure 2). The intervention did not prevent the Colombian Peso from appreciating further. Between June 28, 2006 and May 04, 2007, the Peso rose 28% against the dollar.

Figure 1 – Colombia's Net Capital Flows



On May 07, 2007, an URR was reintroduced on most type of external borrowings. 40% of the funds were to be kept in an unremunerated account in pesos or US dollars with the Banco de la República for six months. Other restrictions were also imposed, including a limit of 500% of the overall gross exposure of each participant in the foreign exchange derivatives market and lower URR for other current account related credit advances. On May 23 the 40% URR requirement was extended to include all portfolio inflows by foreign investors.

[5] The Strategy, Policy and Review Department (2009, September). Review of Recent Crisis Programs. International Monetary Fund. Retreived from http://www.imf.org/external/np/pp/eng/2009/091409.pdf

[6] IMF backs capital controls in Brazil, India. Agence-France Presse (2011, January 6). Retrieved from http://www.deccanherald.com/content/127011/imf-backs-capital-controls-brazil.html

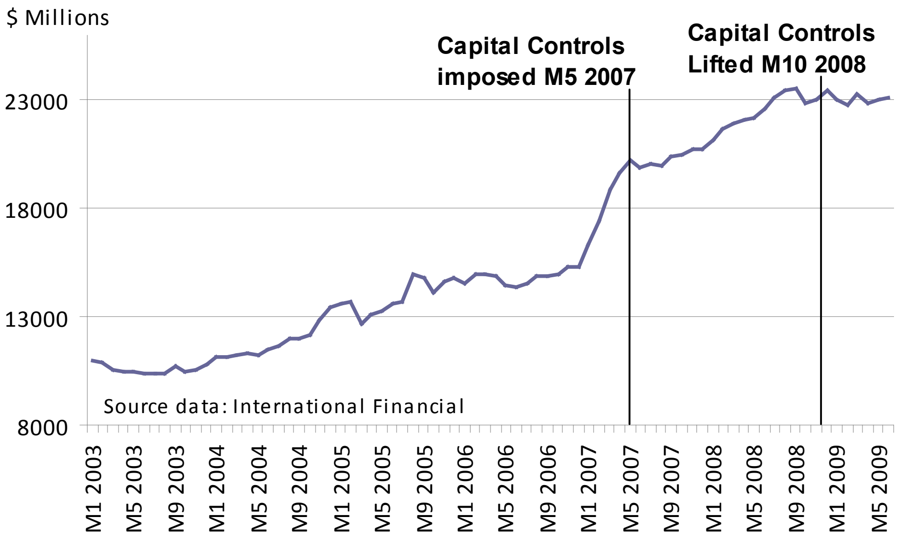
[7] G-20 to Address Hot Money. The Wall Street Journal (2011, February 12). Retrieved from http://online.wsj.com/article/SB10001424052748704629004576136080912756002.html

[8] Concha, Alvaro, and Arturo José Galindo. 2009. An Assessment of Another Decade of Capital Controls In Colombia: 1998-2008: Inter-American Development Bank.

[9] Ocampo, José Antonio and Camilo Tovar 2003. Colombia's Experience with Reserve Requirements on Capital Inflows. CEPAL Review 81 (December):7-31.

In addition to a URR, Colombia also deployed three other measures: limits on maturity mismatches; limits on open positions of foreign exchange of financial intermediaries; and limits on the amount of foreign currency pensions funds are able to hedge. These measures were seen to have a stabilizing role during the current crisis.[10]

Figure 2 – Colombia's Foreign Reserves



Clements and Kamil point out that excluding Colombian institutional funds from the capital controls is of particular importance, since they are highly active in the trading of the foreign exchange market. They also remark that Colombian residents and firms, also exempted from the URR requirements, accounted for three-fourths of the of portfolio inflows in the pre-controls era. In June 2007, an exemption was granted for equities issued abroad, which allowed the issuance of stock through American Depository Receipts (ADRs) controls-free.[11]

The capital controls underwent several modifications in late 2007 and in 2008, including further exemptions for initial public offerings of equities in December 2007, an increase of the URR on portfolio inflows from 40% to 50% and a minimum stay requirement of two-years on FDI in May 2008.

The collapse of Lehman Brothers on September 15, 2008 and the subsequent aggravation of the financial crisis in the United States reversed the trend of capital as investors rushed to safer assets in the developed world. Between mid-June and early October 2008, the Colombian Peso fell almost 30% against the U.S. dollar. On October 09, 2008 the Colombian government announced that the URR as well as the two-year minimum stay requirement on FDI were being lifted.

Capital Controls in the US-Colombia Trade Treaty

In contrast with the treaties of many other industrialized nations, the US-Colombia treaty does not leave adequate flexibility for nations to use capital controls to prevent and mitigate financial crises[12]. The US-Colombia treaty sees restrictions on the movement of speculative capital as a violation of their terms. The safeguards in the treaty were not intended to cover capital controls. A special annex on capital controls that appears in the treaty is inadequate.

This shortcoming in U.S. trade treaties has recently been the subject of significant controversy. In January of 2011, 250 economists from the United States and across the globe, including a Nobel Laureate, former IMF officials, two former ministers of finance, and members of pro-trade think tanks such as the Peterson Institute for International Economics sent a letter to the U.S. government calling on the U.S. to address this imbalance in U.S. trade treaties[13]. That letter was followed by a rebuttal letter signed by many of the major corporate lobby organization in the United States and has since become elevated as an important issue in pending treaties and negotiations.[14]

[10] Villar, Leonardo. 2010. Latin America: Comments on Financial Regulation and International Capital Flows in Latin America. Journal of Globalization and Development 1 (1):1-9.
[11] Clements, Benedict, and Herman Kamil. 2009. Are Capital Controls Effective in the 21st Century? The Recent Experience of Colombia: IMF
[12] Gallagher, K.P, (2010, May). Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Treaties. Discussion Paper, United Nations. Retrieved from http://www.ase.tufts.edu/gdae/policy_research/CapControlsG24.html
[13] Economists Issue Statement on Capital Controls and Trade Treaties (2011 January 11). Retrieved from http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.html
[14] USCIB Pushes Back Against Efforts to Permit Capital Controls Under FTAs (2011, 8 February). United States Council for International Business. http://www.uscib.org/index.asp?DocumentID=4052A

Under the treaty with Colombia and in other treaties, the use of capital controls to prevent and mitigate financial crises is actionable under the treaty. This means that private investors my file arbitral claims against nations that deploy controls. The Transfers provisions Chapter 10 (investment) of the treaty requires that capital be allowed to flow between trading partners "freely and without delay". This is reinforced in Chapter 12 on financial services that states that nations are not permitted to pose "limitations on the total value of transactions or assets in the form of numerical quotas" across borders.

Article 12:10 of the treaty discusses "exceptions" that pertain to that chapter and Chapter 10's transfers provisions. Informally referred to as the "prudential exception," it reads:

Financial Services chapter: Article 12.10: Exceptions
1. Notwithstanding any other provision of this Chapter or Chapter Ten (Investment), Fourteen (Telecommunications), or Fifteen (Electronic Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, a Party shall not be prevented from adopting or maintaining 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 institution or cross-border financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Agreement referred to in this paragraph, they shall not be used as a means of avoiding the Party's commitments or obligations under such provisions.

2. Nothing in this Chapter or Chapter Ten (Investment), Fourteen (Telecommunications), or Fifteen (Electronic-Commerce), including specifically Articles 14.16 (Relationship to Other Chapters) and 11.1 (Scope and Coverage) with respect to the supply of financial services in the territory of a Party by a covered investment, applies to non-discriminatory measures of general application taken by any public entity in pursuit of monetary and related credit or exchange rate policies. **This paragraph shall not affect a Party's obligations under Article 10.9 (Performance Requirements) with respect to measures covered by Chapter Ten (Investment) or under Article 10.8 (Transfers) or 11.10 (Transfers and Payments).**

Capital controls are not seen as permissible under this exception. This has been communicated by the United States Trade Representative and in 2003 testimony by the Under Secretary of Treasury for International Affairs to the U.S. Congress[15]. In general this is because the term "prudential reasons" usually interpreted in a much narrower fashion, pertaining to individual financial institutions. Concern has also been expressed that the last sentence is "self-canceling," making many measures not permissible.

The prudential exception in services chapters or BITs is usually followed by an exception for monetary policy that often reads like (again to use the US-Peru Trade treaty):

This second exception could be seen as granting nations the flexibility to pursue necessary monetary and exchange rate policy (of which capital controls are a part). Yet the last sentence in that paragraph specifically excludes transfers.

These provisions were very controversial with the US-Chile and US-Singapore trade treaties in the early 2000s. U.S. trading partners repeatedly asked for a safeguard that would include capital controls but the United States has denied that request. In a few instances, U.S. negotiators granted special annexes that allowed U.S. trading partners to receive an extended grace period before investor-state claims can be filed with respect to capital controls, as well as limits on damages related to certain types of controls.

The United States-Colombia treaty has one such annex, Annex 10-E . This annexes is inadequate in the wake of the financial crisis for at least four reasons. First, the annexes still allow for investor-state claims related to capital controls—they just require investors to delay the claims for compensation. An investor has to wait one year to file a claim related to capital controls to prevent and mitigate crises, but that claim can be for a measure taken during the cooling off year. The prospect of such investor-state cases could discourage the use of controls that may be beneficial to financial stability. Second, many other nations' treaties allow for capital controls. Indeed, the Canada-Chile FTA, the EU-Korea FTA, the Japan-Peru BIT, and the Japan-Korea BIT (just to name a few) all grant greater flexibility for capital controls. This gives incentives for nations to apply controls in a discriminatory manner (applying controls on EU investors but not on US investors). Third, the IMF has expressed concerns that restrictions on capital controls in U.S. agreements, even those with the special annexes, may conflict with the IMF's authority to

[15] Financial Services and Capital Transfer Provisions in Recent Free Trade Agreements (2003, April 1). John B. Taylor, Under Secretary of Treasury for International Affairs Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology Committee on Financial Services U.S. House of Representatives. Retrieved from http://www.stanford.edu/~johntayl/taylorspeeches/Financial%20Services%20and%20Capital%20Transfer%20Provisions%20(1%20Apr%2003).doc

recommend capital controls in certain country programs, as they have done in Iceland and several other countries. Finally, the special dispute settlement procedure included in the US-Chile and Singapore FTAs did not become a standard feature of U.S. agreements. It is not in CAFTA, any U.S. BIT, or the pending US-Korea FTA.

Reforming U.S. Treaties for Financial Stability

This problem should be rectified. It is in the interests of the U.S. and its trading partners to have adequate policy space to prevent and mitigate financial crises. A number of (non-exclusive) options are possible. First, some IMF officials have gone so far as to recommend that speculative capitals in the form of derivatives and other financial "innovations" be omitted from the definition of investment in treaties.[16] Such an option was also recommended in the International Institute for Sustainable Development's Model Investment Treaty. Another option, more recently advocated by the IMF, is to come up with a uniform safeguard language that can be used by all nations.[17] Finally, and more specific to U.S. treaties, the "exceptions" language in U.S. treaties could be broadened to explicitly allow for the flexibility to deploy controls and other measures now recognized as prudential to prevent or mitigate a crisis.

The prudential exception paragraph could have a footnote with an explicitly non-exhaustive list that clarifies that prudential measures include capital controls, among other measures. The last sentence in that paragraph could be deleted (as it is in the North American Free Trade Agreement), as could the omission of "transfers" from last sentence in the "monetary policy" exception also quoted above.

Finally, resorting to "state-to-state" dispute settlement for matters as serious as financial crises may be more appropriate. Nation states seeks to weigh the benefits of financial stability versus the costs to individual firms. However, in the treaty, this equation is tipped upside down. Even in situations where the benefits of stability through capital regulations may far outweigh the costs to individual investors, individual investors may have the ability to file claims and dismantle regulation.

This issue should be rectified in the pending trade deals with South Korea, Colombia, and Panama. Moreover, it should be corrected in the soon to be completed review of US model BIT and taken forward in negotiations for a TPP, and elsewhere.

The global financial crisis has made it all to obvious that granting our trading partners the flexibility to use legitimate policies to prevent and mitigate financial crises is also good for the United States. When its trading partners fall into financial crisis, the United States loses export markets and subsequently jobs in the export sector. Capital controls can help stabilize exchange rates, which is good for long-term investors and for exporters and importers from the United States. When countries abroad cannot control financial bubbles that drive up currency values, American consumers may be hurt by rising prices on imported goods. As we have learned all too well, financial instability in a globalized world can be contagious, and quickly come back to the United States.

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[16] Transfer of funds (2000) United Nations Conference on Trade and Development. Retrieved from UNCTAD/ITE/IIT/20. http://www.unctad.org/en/docs/psiteiitd20.en.pdf
[17] The Funds Role Regarding Cross-border Capital Flows (2010, November 15).Prepared by the Strategy, Policy, and Review Department and the Legal Department. International Monetary Fund. Retrieved from http://www.imf.org/external/np/pp/eng/2010/111510.pdf

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