US-South Korea Free Trade Agreement: Out of Control

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South Korea will join the growing group of nations that have recently resorted to currency controls in the wake of the global financial crisis. As a rash of new research has shown, such controls are legitimate tools to prevent and mitigate financial crises.

Yet if the pending South Korea-US free trade agreement that the US just agreed to expedite at the G20 meetings had been ratified by now, South Korea's actions would be deemed illegal.

As the Obama administration works to put Bush-era trade policy behind and forge a "21st century trade policy" it should fix this flaw that could be fatal to South Korea's financial stability.

Like many other emerging markets, South Korea experienced highly volatile levels of capital both leading up to and in the wake of the global financial crisis. The most recent bout of capital inflows – that pushed up the value of the won – was largely due to the carry trade given the extremely low interest rates in the US and beyond. However, as the European debt crisis has caused a "flight to safety" where capital is again flocking to the US, the won has been pushed downward.

Starting today, South Korea will impose controls on capital to curtail on the amount of currency forward and derivatives trading that financial institutions can engage in. By putting caps on such leveraging, these measures should tame speculation on the currency and reduce volatility.

These policies are put in place after the nation already lowered interest rates to 2% so as to not attract speculative inflows. In addition to taming volatility then, the Economist adds that with "the foreign-exchange limits in place it may be easier for the Bank of Korea to raise interest rates to a more appropriate level given the economy's rapid growth".

South Korea joins Brazil, Taiwan, Indonesia, Russia, Brazil, and Venezuela on the list of nations that have deployed capital controls in the wake of the crisis. China has recently said that it may follow suit as well.

While such moves would have been seen as blasphemous only a decade ago, they have recently been endorsed by the mainstream. Indeed, these measures follow a mountain of economic evidence in academia and by the international financial institutions, most notably the National Bureau of Economic Research in the US, the International Monetary Fund, the United Nations, and the Asian Development Bank. The IMF study found that those nations that deployed capital controls were among the least hard hit by the crisis.

Under the Bush administration, the US began outlawing capital controls in the investment chapters of its trade and investment treaties. Beginning with its treaty with Chile – a nation that has almost unanimously been seen as using capital controls effectively, the US barred capital controls in trade deals with Singapore, Peru, Central America, and Morocco. Such moves were highly controversial –

then US trade representative Robert Zoellick had to go to Chile and personally grace the Chileans over this very issue in order to ink the deal.

The pending treaty with South Korea was also negotiated by the Bush administration and remains marred in controversy on both sides of the Pacific. Like the other Bush deals, the South Korean deal shuns capital controls. Though it does provide cover for some of South Korea's prudential regulations, recent legal analyses suggest that many of the provisions would still be deemed illegal under the US treaty.

The US treatment of capital controls is outdated, out of touch with contemporary economic analysis, and out of step with the treaties of its trading partners. Even Robert Zoellick (now president of the World Bank) has now cautiously lent support. On 16 June Zoellick had this to say about controls in Asia: "In a time of policy turmoil like this, people are going to be experimenting with different things", and "it's not a silver bullet but it doesn't surprise me that people are trying them and they may help at the margin".

In terms of being out of step with the treaties of other major capital exporters, in a recent report for the United Nations, I find that almost every other multilateral, regional, or bilateral treaty either fully grants nations to deploy capital controls or at least provides a safeguard mechanism for times like these.

The Obama administration has pledged to do better and create 21st century trade agreements that are more in touch with today's realities. If the new plan doesn't give nations the room to manoeuver to prevent and mitigate financial crises it will stay stuck in the Bush era.