Trading away financial stability

The US needs stable trading partners - so why do its trade policies have the potential to harm emerging economies?

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guardian.co.uk
Tuesday 4 May 2010 18.00 BST

Pretend you are an investor that sees waning confidence in the eurozone and low interest rates in the United States on the one hand, and strong growth and rising interest rates in the developing world on the other. If you are like the rest of the herd you are putting your money in the developing world.

Now pretend you are a finance minister in an emerging market economy. In normal times you would more than welcome all the capital you could get. However, you have a fledgling financial system just showing signs of recovery from the global financial crisis. You are also just back from the annual International Monetary Fund meetings where you were warned that this "capital bonanza" may be causing currency, stock, real estate, and other asset bubbles in your economy. To stem those bubbles you raised interest rates – which only accentuated the incentive for foreign investors to pour speculative capital into your country.

Well, there may be another way out. In a February 2010 staff position note and (more cautiously) in the IMF's Global Financial Stability Report (GSFR) also released at those meetings you went to, the IMF said that capital controls are a legitimate part of the toolkit for the situation you are in.

That's right. There is a new consensus that controls like temporary taxes on speculative capital or policies that require a percentage of short-term investments to be reserved in the Central Bank for a minimum period of stay, may be of help. Indeed, the February IMF study argues that those countries who resorted to capital controls preceding the global financial crisis "were associated with avoiding some of the worst growth outcomes" of the current economic crisis.

So you are thinking about crafting such a policy when your trade minister tells you that deploying capital controls could be seen as a violation of your bilateral investment treaty or free trade agreement with the United States. And rather than going through a (drawn out) process whereby your government and the US government screen and debate the case in a relatively transparent panel, a US investor can directly file a claim against your government and sue you for millions of dollars in damages without even having to consult the US government.

As finance minister you remind the trade minister that you also have treaties with the European Union, Canada, and Japan. And in those treaties you have all the "policy space" you need to deploy capital controls, or you at least have a temporary safeguard provision for crises.

Those treaties only cover investment originating from those particular countries, says your trade minister. The minister cites a United Nations report (pdf) written by a senior lawyer at the IMF arguing that controlling capital with just those countries could create (local and global) distortions and an incentive for those countries to slip their inflows through the US and circumvent the whole effort and a host of other jurisdictional problems.

Unfortunately this story is not make-believe. As I show in my new study for the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development (G24), there are more than 50 developing countries that could find themselves in such a conversation.

Despite the fact that the US has now learned the hard way that the financial stability of its trading partners is in its interest, US trade and investment agreements require the free transfer of US capital without delay and without exception.

This can partially be rectified. The US is reworking its Bush-era trade deals with Colombia and South Korea – two countries with prior success with capital controls. Moreover, the Obama administration boasts that its newly launched negotiations for a "Transpacific Partnership Agreement (TPP)" will fix many of the flaws in past trade deals and forge a truly "21st century trade agreement". The TPP includes Chile, Peru, Singapore and other countries that are known for prudently using capital controls but have bad deals in this regard with the US. Finally, the US hopes to negotiate investment treaties with Brazil, China, and India under a new "model" as well.

In the wake of the financial crisis any 21st century trade or investment deal should ensure that nations have all possible tools at their disposal to prevent and mitigate financial crises. There is a model to follow: the treaties of virtually every other advanced capital exporting nation that allow their developing country partners to deploy capital controls at their own discretion – or at least do so in the midst of crisis.

Unfortunately the Obama administration's attempts at reform are on a slow track and facing stiff resistance from the same financial interests fighting financial regulatory reform. In the meantime, finance and trade ministries – and people with real livelihoods in their countries – are feeling the chilling effect of US trade policies as their economies heat up