STATEMENT OF
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BEFORE THE
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Thank you very much for your invitation to testify today. I am currently a professor at Georgetown University Law Center. Between 1993 and 1998 I held several economic policy positions in the United States Government, ending as Assistant to the President for International Economic Policy. I testify today purely in my individual capacity as an academic, with no client interests or representation.

Let me say at the outset that I support the negotiation of bilateral free trade agreements with Chile and Singapore. Both have bipartisan origins and bipartisan support. Let me also say at the outset that I do not come before the Subcommittee as an advocate of capital controls. I do come to criticize the inclusion in these two proposed trade agreement of rules penalizing emerging market countries for employing restrictions on capital flows, even in the most dire of circumstances. Our government's insistence on such provisions is bad financial policy, bad trade policy, and bad foreign policy.

It is ironic that the Administration would insist upon such measures in agreements with Chile and Singapore, among the most open and well-managed emerging market economies in the world. Indeed, it should give each member of this Subcommittee pause to realize that these two developing country governments – which declined to impose controls on capital outflows even in the midst of the global financial crisis of 1997-98 – believed it important to preserve the right to do so in exigent circumstances. They eventually compromised, but I doubt their views have changed. Of course, the Administration was attempting in these negotiations to create a "template" for future negotiations, importantly including the proposed regional trade agreements in this hemisphere. Thus I believe the Congress should send a strong message to the Administration: Such provisions are inappropriate in any agreement and may do substantial harm to both U.S. and emerging market interests in agreements with countries that are not as financially sophisticated as Singapore or Chile.

The Tenuous Case for International Financial Integration

The Administration has publicly defended its position in the Singapore and Chile negotiations by asserting the benefits of liberalized capital flows. It has invoked well-known theoretical arguments such as the increased mobilization of capital that occurs from the deepening of capital markets and the economic stabilization that comes from more efficient risk-spreading. These are appealing arguments and, in the context of a deep and well-regulated capital market such as the United States, convincing as well. The problem, though, is that in the context of developing countries, the evidence that these salutary effects occur is far from well-established.

Just a few weeks ago, the International Monetary Fund published an extensive review of the economic literature on the effects of financial globalization on developing countries. The study was nuanced, and its authors were careful not to jump to conclusions on the basis of their policy predispositions. On the central point, though, the study's conclusion was unequivocal: A fair-minded reviewer of the existing evidence simply cannot assert that global financial integration promotes significant economic growth in developing countries. The fact that the International Monetary Fund was the source of this paper makes this conclusion even more significant. It was not so long ago that the Fund was preaching the virtues of more or less complete capital account liberalization for everyone. The financial crises of the 1990s led many at the Fund to reexamine its policies and the premises on which those policies were based.

Note that this conclusion contrasts markedly with the overwhelming, though not unanimous, conclusion of empirical studies that trade integration *does* help to promote economic growth in developing countries. It is also important to note some potential explanations for why financial integration does not have a similar, demonstrable effect. Most of these explanations revolve around the relatively undeveloped character of legal and market institutions in emerging markets. That is, financial integration and increased capital flows may yield the hoped-for economic benefits only where the capital can be channeled efficiently within a developing country. Forcing capital in before the necessary institutions are in place may, the evidence suggests, have little positive effect on overall growth prospects.

We are, in other words, in that murky world of second best. The theoretical advantages of unregulated capital flows appear to be realized only where other important conditions obtain. Where they do not – as is often the case in most emerging markets – the benefits may simply not be forthcoming. Surely most countries will want to develop financial markets that will eventually allow them to realize the benefits of unimpeded capital flows more readily observed in highly developed financial markets. But the sequencing of steps that will most readily achieve this desirable end is far from clear.

As the recent IMF study and other reviews make clear, the ambiguity and inconclusiveness of the present evidence does not mean that the case will never be made for the growth-enhancing character of free capital flows. Indeed, there is already a much stronger body of evidence for the benefits of foreign direct investment (as opposed to portfolio investments such as stocks and bonds) for economic growth. And there have been a few studies purporting to find a positive correlation between financial integration and growth. But most do not. At this juncture, at least, an assertion that global financial integration promotes economic development for most emerging market countries must be attributed more to economic creed than to economic evidence.

The Potential for Economic Disruption

If the positive economic case for requiring full capital liberalization cannot be established, perhaps the Administration's position can be justified on the ground that capital flows have at worst a neutral effect, and may sometimes have significant positive effects. Unfortunately for this possible justification, there is evidence that the liberalization of capital flows can make developing countries more vulnerable to financial crises. Again, the reason is not that capital flows are bad in principle. Sometimes, though, developing countries are not able to absorb increased flows in their relatively embryonic banking systems and capital markets in a manner consistent with sound credit standards. Moreover, sudden inflows of capital can be used to finance consumption. But – and this is the most important point – the spigot can be, and is, turned off as quickly as it is turned on.

Capital from the advanced industrial countries often flows into emerging markets in search of higher returns during periods of low interest rates at home, or following a sudden spurt in an emerging market's rate of growth. But it will cease flowing as soon as signs of a slowdown or banking problems emerge, or as investment opportunities at home become more attractive. Indeed, knowing that the markets of many developing countries are relatively illiquid, investors may quite understandably be quicker to withdraw their investments from a developing country market than they would disinvest from a developed financial market. Herd behavior is a very real phenomenon, and one that is not irrational from the standpoint of the investor.

As foreign short-term capital is withdrawn from the developing country, its currency can depreciate rapidly, leading in turn to more capital flight. Meanwhile, import prices soar, harming the country's economy. Once the crisis hits, the developing country has no good options. Raising interest rates dramatically may stem the outflow of funds, but at the cost of a serious recession. Borrowing money from the IMF can help reassure investors that they will be repaid. But IMF packages are rarely big enough to cover all obligations and, of course, they increase the debt of the affected country.

In such circumstances, the imposition of capital controls may be a viable tool to help stabilize a country's currency and give its government some breathing space for financial reform. This was the approach taken, with apparent success, by Malaysia during the 1997-98 global financial crisis. Alternatively, the country may design and implement a system of capital restrictions to forestall sudden inflows or outflows. This was the approach taken by Chile itself during the 1990s. There is disagreement among economists as to the relative importance and effectiveness of Chile's capital controls compared to its other economic policies. There can be little doubt, however, that Chilean officials believed they were taking prudent, limited steps within the context of very sound macroeconomic policies.

Capital controls can be – and often are – ill-conceived, poorly implemented, or both. Even effective capital controls would not be costless. Some useful investments would be prevented or discouraged. There may be opportunities for political favoritism and corruption in the administration of the controls. Perhaps even more serious in the longer run, capital controls may be used as a means to *avoid* reform, rather than to provide breathing space within which to implement reforms. Like all policy instruments, the costs of proceeding must be measured against the benefits and against alternative policy approaches. This calculus will, by definition, vary from case to case. Yet the Administration's negotiating position in the Chile and Singapore talks was that capital controls are *always* bad and should be prohibited by the rules of a bilateral trade agreement. Indeed, Administration officials have publicly stated this view in on-the-record comments.

The Administration is repeating the mistake which the IMF itself made a decade ago. At that time there was substantial enthusiasm within the Fund for making full capital account liberalization mandatory for all Fund members. This enthusiasm was based on the same theoretical advantages cited today by the Administration. Appropriately, perhaps, the financial crisis broke out in Asia just as the campaign for full capital account liberalization was being accelerated. Fund staff, developing country officials, academic economists and others all recognized fairly quickly that large, short-term capital flows can sometimes have deleterious effects in relatively undeveloped capital markets. They further recognized that these effects will be exacerbated in countries pursuing ill-advised macroeconomic policies. But requiring full capital liberalization would not then, and will not today, magically make developing country capital markets more liquid or bank regulation more effective or macroeconomic policies more sustainable.

We do not live in a textbook world, but in that complicated second-best world I mentioned earlier, where theoretically beneficial policies may at times do more harm than good. Remember, too, that the textbooks themselves must be rewritten after each major financial crisis, which results from a different set of proximate causes and unfolds in a different way. The prominence of privately held debt in precipitating the crisis that began in Asia in 1997 surprised nearly all government officials, market actors, and academics, who had become accustomed to focusing on the sovereign debt and balance of payments positions of developing countries. I suspect that the origins of the next widespread crisis will also surprise us, even though we will see in retrospect some of the same vulnerabilities. One can understand, in such a world, the nervousness of even the most orthodox developing country officials. One would also think that this is an occasion for modesty about our understanding of the effects of capital flows in particular circumstances.

The desirable aims of the United States related to developing country capital flows and policies are, in my view, fairly clear: We should continue to encourage official and academic research into the effects of capital flow and capital controls in developing countries, so that empirical work can provide a solid basis for policy. We should, though multilateral financial institutions such as the IMF, encourage the adoption of sound economic policies and assist the improvement of banking and capital market regulation in developing countries, so that they will be able to gain the benefits of liberalized capital flows without undue risk of financial crisis. We should, both directly and through our participation in the IMF, warn countries away from reliance on capital controls as a substitute for policy reform and the strengthening of market and regulatory institutions. But we should *not* attempt to impose a policy that penalizes an emerging market country beset by financial contagion that adopts temporary capital controls in accordance with the best judgment of its own financial officials following consultations with the IMF.

The Infirmities of the Negotiated Provisions

As has been well reported in the press, the governments of both Chile and Singapore resisted the Administration's demand for a rule in the trade agreements prohibiting the use of capital controls under any circumstances. Singaporean officials, for example, were quoted as saying that Singapore needed to "retain flexibility in extreme cases" to use controls. Again, we see this concern even on the part of an emerging market government that has followed orthodox macroeconomic policies and that did not institute controls during the turbulence of 1997-98. The Administration refused to agree to an exception even for the most extreme of crises. In the words of an Administration official, "The U.S. view is, we're not going to sign on to the notion that capital controls are justified in any circumstances."

The Administration accordingly shifted its strategy and sought the provisions that we have in the texts of the agreements. These provisions provide for direct, automatic compensation of U.S. investors by Chile or Singapore should one of those countries ever impose capital controls of any sort. This "solution" compounds the Administration's mistake on financial policy by distorting trade policy as well.

The agreements give any U.S. investor the right to obtain compensation for any "loss or damage" arising from the use of capital controls. If the control "substantially impedes" transfers, liability begins to accrue from the moment of imposition. If the controls do not substantially impede transfers, then damages begin to accrue after the controls have been in place for a year.

Thus, for example, an investor enjoying the higher yields that come from assuming the risk attendant to lending in an emerging market would presumably be able to claim damages for the imposition of capital controls if exchange rates moved unfavorably during the period of controls. This right exists even if the IMF approves the control. In a sense, then, the investor would be receiving a free insurance policy for its investment. Believers in the market-efficient internalization of costs by economic actors might think instead that a participant in a financial market should assume the cost of hedging against credit and market risk.

The investor would have a right to proceed under the so-called investor-state dispute settlement provisions of these agreements. This procedure in essence gives the investor a direct cause of action before an international arbitral tribunal, the decision of which can be enforced in directly in the domestic courts of the parties. Members of the Subcommittee may recognize this dispute settlement process from the controversies surrounding Chapter 11 of the North American Free Trade Agreement. The arbitral panels that decide such cases have generally been composed of people with the kinds of backgrounds one finds among traditional commercial arbitrators. They will not likely have macroeconomic expertise. Indeed, by the terms of the agreements, it does not matter how good a reason the country had for imposing controls in the first place.

Furthermore, the decision of the arbitral panel is final. It may not be appealed on its merits and is subject only to the loosest of constraints by domestic courts for exceeding its jurisdiction. The first decade of experience under Chapter 11 reveals that some arbitral panels have not hesitated to take a very broad view of the obligations of the government in question. Indeed, in response to some of these cases, Ambassador Zoellick and his subordinates have appropriately begun to narrow the language in some of the provisions which arbitral panels have expansively interpreted. But the fact remains that the arbitral panel continues to be, for all intents and purposes, the final decision-maker.

It is important to correct some misimpressions concerning the provisions we are discussing today. A number of people with whom I have spoken recently, including some from the financial services industry, have agreed that an absolute prohibition on capital controls is ill-advised. But they are consoled by what they believe to be mitigating features of the agreements as negotiated. Undoubtedly, any qualification on an absolute prohibition is an improvement on the Administration's negotiating position. But I fear that some observers read too much into the qualifications we find in these agreements.

One mitigating feature mentioned is a letter from Under Secretary Taylor to Singaporean monetary officials which is appended to the text of the investment chapter of the U.S.-Singapore trade agreement. This letter provides, among other things, a gloss upon the meaning of the "substantially impede" language explained earlier. It would be a mistake for those favoring retention of sensible discretion by emerging market finance officials to take much comfort from this letter. As a law professor, I must say that it is not a model of clear drafting. It leaves ample room for investors' lawyers to argue for damages in almost any imaginable case. Moreover, even were the language more clear, it is not necessarily a practical limitation on the discretion of an arbitral panel to award damages. To say in the abstract, as the letter does, that damages must be proven and not speculative is not to assure that a decision-maker will take a suitably skeptical view of damage claims. The Subcommittee should be very clear that, once these agreements are approved, the arbitral process is largely autonomous from the governments themselves. Overreaching in a particular case cannot easily be corrected.

A second key misimpression is that the agreements do not give investors a right to collect damages for capital controls that have been in effect for less than a year. Those who believe that there is a role for capital controls, but only controls applied for a relatively short period, would be reassured by such a limitation on damages. Unfortunately, this is not what the agreements say. The agreements do require an investor to *wait* one year before filing an arbitral claim. However, this is *not* an exclusion for losses arguably incurred during that year. The damages begin to accrue from the moment controls are imposed. It is only the collection of those damages that is delayed. Because the agreements provide for interest to be paid on awards to investors, the only relief this provision gives the developing country is that it need not pay the compensation immediately.

It is true that the agreements exclude recovery of losses resulting controls that do not "substantially impede" transfers. But this provision just returns us to the uncertainty surrounding the meaning of "substantially impede." The glosses in Under Secretary Taylor's letter and press comments by an Administration official suggest that any measures of sufficient robustness to help an emerging market though a financial crisis would, in the Administration's view, "substantially impede" transfers and thus be subject to compensation claims.

Foreign Policy Consequences

Not only is the Administration's approach to capital controls bad financial policy and bad trade policy. It is also bad foreign policy. I would certainly favor a provision that guaranteed U.S. investors no less favorable treatment than that granted investors from the country imposing the capital controls or from third countries. American investors should not be singled out for adverse treatment by host countries. But the provisions in the agreements require what will likely be *more* favorable treatment for U.S. investors than for other investors, domestic or third country. If a country party to one of these agreements imposes capital controls, it will have to compensate American investors but not others.

Let us play out the consequences. A developing country is faced with a severe financial crisis. It seeks IMF assistance, raises interest rates, and imposes temporary controls on portfolio capital flows. While the IMF assistance and the controls help to stabilize the country's external financial position, they do not prevent a serious recession, the usual outcome of emerging market financial crises. The country's gross domestic product declines significantly. Unemployment and poverty rise. Unless the country is very lucky, these consequences will be felt for years rather than months.

Then, as the country struggles to emerge from its recession and to repay its debts (many of which will have been deferred or rescheduled), U.S. investors file their claims for compensation. And, of course, under the bilateral trade agreement they are entitled to that compensation. Thus the still-suffering citizens of the country are treated to the prospect of U.S. investors being made whole while everyone else bears losses from an economic catastrophe that has afflicted the entire nation. Regardless of what one thinks on the merits of capital controls, one would have to be naïve not to think that an anti-American backlash would result. Instead of the United States being perceived as providing leadership to help the country back on its feet, we will be perceived as grabbing everything we can while the country is flat on its back.

This approach is not only at odds with a sensible strategy to maintain the goodwill of developing countries towards the United States. It is also at odds with efforts to develop a set of fair and efficient procedures for the resolution of sovereign debt problems. The U.S. Government would have no authority to defer or reject the claims of investors. Our government would thus be unable to deflect the foreign policy problem of U.S. investors suing in international arbitration while other investors are being asked to forbear while an approach to a country's debt problems is fashioned.

There is a great irony here: Under the version of sovereign debt restructuring procedures currently being advocated by the International Monetary Fund, sovereign payments could be suspended for a time while debts are rescheduled or written down. Many people – myself included – have some questions about these proposals. But a number of people who favor a less top heavy, more "market friendly" mechanism for sovereign debt restructuring rely upon the possibility of a developing country being able to impose temporary capital controls in truly extreme circumstances as part of their justification for opposing a world bankruptcy court. That is, they believe that most of the time a market-based restructuring negotiation would be adequate, but that on some occasions the imposition of capital controls by the developing country might be necessary to allow the process to work smoothly. The Administration position on capital controls would, if realized in other agreements, undermine the reserved authority of a developing country that could allow a generally less intrusive framework for debt restructuring. It might, thereby, build support for a more activist sovereign debt restructuring mechanism that would override U.S. and other domestic legal processes.

Finally, there is another possible foreign policy consequence. As investors from other countries realize that U.S. investors are given preferential treatment and insulated from losses if capital controls are imposed, they will have an incentive to channel their investments through a U.S. intermediary which qualifies as a U.S. investor under the agreements. After a time, the United States may, for these purposes, resemble an offshore financial center that helps investors from other countries evade taxes or money laundering regulations or regulatory requirements. A moment's thought as to how we in the United States have traditionally regarded such offshore centers will reinforce one's foreign policy uneasiness at the prospect of these provisions being exercised.

The Problems with Templates

As earlier noted, the Administration intends the provisions of the Chile and Singapore agreements to be a "template" for future bilateral and regional trade agreements. This expectation raises two serious concerns beyond the uncertainties and disadvantages I have mentioned in the context of Chile and Singapore.

First, does this intention mean that the Administration will seek to force removal of *existing* restrictions on capital flows as it negotiates more trade agreements? That is, will it seek to obtain the right for U.S. investors to obtain damages for effects from existing restrictions. The stated, absolutist view of the Administration would suggest an answer in the affirmative. As we know, Chile and Singapore do not currently impose controls and have no apparent present plans to do so. But not all of our potential trade agreement partners are similarly situated. To remove controls rapidly, and without proper cultivation of financial and regulatory systems, would be to fly in the face of something we should have by now learned – that capital account liberalization, desirable as it may be as an end point, needs to be carefully sequenced with the development of appropriate legal, economic, and market institutions to handle the resulting capital flows without undue risk of financial crisis.

Second, if the United States continues to insist on similar provisions in its bilateral and regional trade agreements, it will be affecting not just bilateral relations but international financial policy as a whole. We will be subverting the authority and influence of the International Monetary Fund in an area in which it shows appropriate nuance. We will be imposing unilaterally our doctrinaire view of financial policy. And, as illustrated by my comments concerning debt restructuring proposals, we will have undermined cooperative efforts to fashion a sensible set of crisis prevention and crisis response measures.

Conclusion

In closing, I want to reiterate that I am not offering a brief for capital controls in general or, indeed, in any particular circumstances. I share with others the concern that this tool often causes more problems than it solves. But existing empirical work does not allow us to say in sweeping terms that free capital flows are always good for development, or that restrictions on capital are always a mistake for a developing country. Current knowledge does not permit a broadbrush rule. Even when we learn more, it is possible that an inflexible rule will never be justified. Instead, presumptions and standards may be the most we can with confidence derive from experience.

The Chile and Singapore agreements do not take account of these subtleties. The implications of the Administration's absolutist position for international financial policy and U.S. foreign policy interests seem not to have been considered. The potential for negative effects upon the interests of both the developing world and our own country will only grow if such provisions proliferate. The Congress should serve notice to the Administration that this is not a template which it wants to see adopted in future agreements.

Thank you very much for your attention. I would be pleased to answer any questions you might have.