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Recent Experiences with International Financial Markets

Lessons for the Free Trade Area of the Americas (FTAA)

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Executive Summary

Recent experience with international capital markets suggests that it is not an appropriate time to negotiate a new commercial agreement which would limit signatory countries' abilities to regulate the flow of capital across international boundaries.

But if the investment rules that emerge from negotiations on the Free Trade Area of the Americas (FTAA) are based on investment rules in the North American Free Trade Agreement (NAFTA) and the Multilateral Agreement on Investment (MAI) - as it now appears that they will be - the FTAA would do just that. Provisions in the NAFTA and the MAI on the definition of investment, transfers, and national treatment would severely restrain the ability of governments to regulate even short-term speculative capital flows, in order to prevent or manage a financial crisis.

The recent Asian crisis shows the effects which may result from sudden capital outflows. In East Asia, there was a net reversal of private international capital flows to the region of $105 billion-- from a net inflow of $92.8 billion in 1996 to a net outflow of $12.1 billion in 1997. This amounts to about 11 percent of the GDP, before the crisis, of the combined economies of South Korea, Indonesia, Malaysia, Thailand and the Philippines. This is a massive and highly destabilizing reversal of international capital flows, and it does not appear to be the result of changes in the real, underlying economies of the region.

Financial liberalization measures (often adopted under pressure from the OECD, IMF, or Washington) enacted by many Asian countries in the years prior to the 1997 crash bear much of the responsibility for the region's financial crisis. The result, made worse by IMF austerity measures, was a regional depression, increased unemployment and poverty, and increased political and social tensions that may persist for years to come.

In Mexico, most of the capital inflows in the four year period leading up to the peso crisis were comprised of so-called "hot money" - mainly short-term bank lending and portfolio investment. At the end of 1994 there was a shift in investors' sentiment, resulting in large scale capital flight. In 1995, Mexico experienced a net capital outflow of US $15 billion, as compared to a net *inflow* of $31 billion in 1993. The impacts of this reversal on the Mexican economy were severe: the economy contracted sharply, unemployment rose, and poverty rates soared.

Some countries have attempted to protect themselves from the harmful effects and instabilities inherent in a world of increasingly unrestricted capital flows. As recent experiences with capital controls in Chile, Colombia, Malaysia, Hong Kong, Taiwan, and China demonstrate, efforts to limit capital mobility are not inconsistent with orderly and robust economic growth and development. To the contrary, using capital controls can be a highly effective strategy in a country's efforts to return to economic growth after a financial crisis, or to prevent excessive short-term international borrowing, for example, from building up in the first place. However, if the deregulatory model (based on the NAFTA and the MAI) for international investment is followed, these and other types of controls would be mostly prohibited by the FTAA.

A number of leading economists have entered the debate over global capital flows and the need for more national controls. Along with Columbia's Jagdish Bhagwati, MIT's Paul Krugman and Harvard's Jeffrey Sachs, World Bank Chief Economist Joseph Stiglitz has repeatedly spoken out about the dangers of further capital account liberalization. Moreover, prominent Latin American economists Manuel Agosin and Ricardo Ffrench-Davis have conducted extensive research into the role of capital flows leading up to the Mexican crisis, and the effectiveness of Chile's capital controls. They argue that governments should adopt "speed bumps," reserve requirements, and other types of capital controls to shield their economies from the destabilizing effects of short-term capital flows.

In short, compelling evidence suggests that it is an inappropriate time to negotiate a treaty that makes it easier for capital to flow uninhibited across national boundaries. But the investment chapter of the proposed Free Trade Area of the Americas (FTAA), if based on the NAFTA/MAI investment model, would accelerate the pace of investment liberalization and capital mobility in the Western Hemisphere. It would restrict the ability of governments to shield themselves from the volatility of global financial markets. At a time when the control of international capital flows is the subject of heightened controversy and debate, the measures currently promoted for inclusion in the FTAA would prohibit most capital controls and similar regulatory measures. Before negotiating any such treaty, we should take stock of the impact of speculative capital flows as well as international capital mobility more generally. It would be unwise and counter-productive to negotiate a treaty that ignores recent experience with deregulated capital flows.

Introduction

The events of the last several years have highlighted the risks and complications of increasing international capital mobility. The role of highly volatile capital flows in precipitating the Mexican peso crisis (1995), and more dramatically the Asian, Russian, and Brazilian financial crises of the last two years, has caused a major shift in the thinking of economists. As recently as two years ago, the majority of the profession believed that increasing liberalization of capital flows, like the opening of economies to freer trade, was inherently beneficial. But today most economists would qualify any such statement considerably, and there has been a broad expansion in the number and types of capital controls that economists would be willing to consider in order to avoid or ameliorate the types of financial crises that we have recently witnessed.

However, policy makers have been slow to adapt to these changes in economic analysis and circumstances. They have continued, for the most part, to pursue through commercial agreements and other venues, measures that would increase the liberalization of capital flows.

The International Monetary Fund asked its executive board in September 1997 to complete an amendment to the IMF's Articles of Agreement that would make liberalization of capital movements one of the mandates of the Fund. The Multilateral Agreement on Investment (MAI), an investment liberalization treaty that was under negotiation at the OECD until December 1998, would have similarly mandated, through its broad definition of investment and language on transfers, liberalization of signatory countries' capital accounts.[1] The MAI, in turn, was modeled on Chapter 11 of the North American Free Trade Agreement (NAFTA), which contains a broad definition of investment, as well as language on financial transfers which effectively precludes most capital controls. The Free Trade Area of the Americas (FTAA) is the next venue where capital account liberalization will probably be mandated. If, as is anticipated, the investment rules in the FTAA are based on those in the NAFTA and the proposed MAI, the agreement could severely limit the ability of signatory governments to employ capital controls or otherwise protect themselves from the dangers of financial crises and destabilizing capital flows. It is therefore worth examining these investment rules in the light of recent economic events and analysis.

How Might the FTAA Encourage Unregulated Capital Mobility?

The FTAA's Negotiating Group on Investment has as its mandate "to establish a fair and transparent legal framework to promote investment through the creation of a stable and predictable environment that protects the investor, his investment and related flows, without creating obstacles to investments from outside the hemisphere."[2] The negotiating group is in the process of drafting the FTAA's investment chapter primarily on the basis of the investment provisions the North American Free Trade Agreement (NAFTA), but it will likely also draw upon the MERCOSUR treaty and the MAI. The Group will also use the recommendations submitted by the Business Forum of the Americas, a coalition of multinational corporations from the United States and South America.

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[1] "The MAI Negotiating Text," April 24, 1998.

[2] "Joint Declaration of the Fourth Trade Ministerial," Annex II, 1998.

The relevant sections in each of the agreements cited above relating to a nation's ability to impose capital controls are the *definition of investment*, and provisions on *national treatment*, as well as *transfers*. The language in the FTAA on these issues will have the most impact on nations' abilities to regulate capital inflows and outflows.

Definition of Investment

Trade agreements and investment liberalization treaties have generally defined investment broadly in recent years. The NAFTA, in article 1139, defines investment to include enterprises, equity and debt securities, loans, income and profits, and real estate or other property, tangible or intangible. The draft MAI defines investment as "every kind of asset owned or controlled, directly or indirectly, by an investor..." This includes property, shares and stocks, claims to money, loans, and intellectual property rights.[3]

These definitions are very broad and include not only Foreign Direct Investment (FDI), but also portfolio investment and other forms of short-term lending. The most volatile kinds of flows included in these definitions are short-term financial credits to banks and large domestic firms, short-term deposits by non-residents in the domestic financial system and purchases of stocks and bonds by non-residents. These types of transactions are more likely to be for the purpose of taking advantage of interest rate differentials or to get quick capital gains. It is these types of short-term and especially speculative capital flows that are most likely to exacerbate a crisis when they are sharply reversed. *(See Chart 1, Appendix, for a depiction of trends in direct and portfolio investment in developing countries in the Western Hemisphere)*. On the other hand, foreign direct investment, which generally includes a controlling interest and often involves the creation of tangible assets such as the construction of factories, is more likely to remain invested for a longer time.[4] When economists argue for the benefits of investment liberalization, it is generally FDI that they rely on to make their case.

Because the definition of investment in the NAFTA and the MAI are broad enough to cover portfolio investment and other forms of short-term lending, the liberalizations and protections of Foreign Direct Investment (FDI) in these agreements will apply equally to speculative portfolio flows. Of particular concern are the provisions liberalizing the transfers of capital relating to investment and the national treatment protections of investment.

Transfers

The NAFTA mandates the unrestricted transfer of capital relating to investments including principal, profits, dividends, interest, and capital gains.[5] The investment chapter of the FTAA, based on other treaties and proposed language, may include a broadly worded section on transfers as well, without distinguishing between short-term flows and other forms of investment. If the Business Forum of the Americas' recommendations are adopted, the FTAA may go beyond even existing language on transfers to "design effective measures for free transfer and beyond-border transactions" to ensure that no controls are applied to investment entering or leaving the host country.[6]

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[3] "The MAI Negotiating Text," April 24, 1998, Section II.2.

[4] In a statistical survey based on flows to all developing countries, UNCTAD (1998, pp. 13-15) found that during the period 1992-1997, commercial bank loans and portfolio investment had, on average, higher rates of volatility than Foreign Direct Investment.

[5] See NAFTA Article 1109(1).

[6] "Final Recommendations by Workshops of Fourth Business Forum of the Americas," 1998, [on file with authors].

National Treatment

National treatment - the requirement that foreign investors be treated no less favorably than domestic investors, regardless of the circumstances - is another fundamental principle of investment liberalization treaties; it is a provision of the NAFTA and the proposed MAI. Because of the broad definition of investment, this provision could be used to protect highly mobile foreign capital from actions taken by national governments in the interest of protecting their economies. National treatment provisions would permit a foreign bank or other investor to argue that it has the same rights as domestic investors and banks under international law.[7]

The recommendations of the 1998 Business Forum of the Americas included broadening the definition of national treatment. The Forum advocated the extension of national treatment to taxation and suggested that the FTAA "extend uniform non-discriminatory national treatment to capital originating from countries *outside the FTAA*."[Emphasis Added][8] Under such an arrangement, investors from Europe and Asia, for example, would be entitled to the same treatment rights as investors from within the hemisphere. As will be shown in the examples below, national treatment provisions, as applied to portfolio and other short-term investments, risk increasing the vulnerability of national economies to financial turbulence and its harmful economic and social effects.

The provisions on the definition of investment, transfers, and national treatment that the FTAA is likely to include would almost certainly create major obstacles to any government seeking to regulate short-term speculative capital flows, even to prevent or manage a financial crisis.[9] At the same, the potential dangers of short-term capital inflows are well-documented in the recent economic literature on the subject. The crises in Asia and Mexico provide a useful introduction to the story of unchecked capital movements.

Capital Mobility and Financial Crises

The Role of Capitol Flows in the Asian Crisis

Prior to the onset of the Asian financial crisis, there were few mainstream challenges to the maxim that the deregulation of international capital flows was in the best interests of everyone. This principle seemed almost as well established as the theory of comparative advantage with regard to trade, and was able to benefit from a sort of "proof by association" with the latter. This is in spite of the fact that the reasoning of the trade theory does not apply to capital flows,[10] not to mention the very limited usefulness of the theory of comparative advantage itself to any kind of economic development strategy.

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[7] Such provisions would not prevent foreign investors from being granted greater rights than domestic firms.

[8] "Final Recommendations by Workshops of Fourth Business Forum of the Americas" 1998, op cit, [on file with authors].

[9] The draft text of the MAI (24 April 1998) contains exceptions to the MAI's "Transfers" sections, so that a country may "delay or prevent a transfer through equitable, non-discriminatory and good faith application of measures" in order to "protect the rights of creditors," ensure compliance with laws and regulations on trading and dealing in securities, futures, and derivatives, and on recording and reporting transfers, and in connection with criminal offences. The exception concludes with the caveat that "such measures and their application shall not be used as a means of avoiding the Contracting Party's commitments or obligations under the Agreement." (Chapter IV, 4.1-4.6) These exceptions, therefore, would not permit a country to regulate short-term capital inflows, or enact capital controls in a time of crisis. (See also Sforza 1998).

[10] See Bhagwati 1998.

The debate over the effects of deregulated international investment intensified when the economies of South Korea, Indonesia, Malaysia, Thailand, and the Philippines, and others in the region were hit by a financial crisis that subsequently developed into a regional depression. Although the policies of the IMF helped transform the financial crisis into a crisis of the underlying real economy, even pro-globalization economists have noted that the financial liberalization of these countries was a major proximate cause, if not the major cause, of the onset of the crisis. Jagdish Bhagwati, one of the world's leading international economists and the Economic Policy Adviser to the Director-General of the GATT (1991-93) has noted that "the Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as Asian economies loosened up their capital account controls and enabled their banks and firms to borrow abroad. . . it has become apparent that crises attendant on capital mobility cannot be ignored."[11]

What was so striking about this case is that it was truly "the intrinsic instability in international lending"[12] that pushed these countries to the abyss. Most important was a net reversal of private international capital flows to the region of $105 billion-- from a net inflow of $92.8 billion in 1996 to a net outflow of $12.1 billion in 1997. This amounts to about 11 percent of the GDP, before the crisis, of the combined economies of South Korea, Indonesia, Malaysia, Thailand and the Philippines.[13] This is a massive and highly destabilizing reversal of international capital flows, and it does not appear to be related to the workings of the real, underlying economies of the region.[14]

Financial liberalization measures enacted by many Asian countries in the years prior to the 1997 crash bear much of the responsibility for the inability of governments to control the massive net reversal of capital flows out of the region in 1997. For example, the Korean government began to relax its control over financial flows in the early 1990s. In order for South Korea to join the OECD in 1996, it had to liberalize its financial sector even further.[15] The deregulation of financial transfers provided for in NAFTA and the proposed MAI would, most importantly, 1) increase the ability of affected economies to rapidly acquire accumulations of short-term debt and 2) remove from national authorities the ability to enact capital controls when the resulting panic sets in.

Other explanations of the onset of the Asian crisis, especially the media sound bites about "crony capitalism" or "inefficient" industrial organization do not have much evidence to back them up. Indeed, when people, including some economists, refer to the Korean economic system as "inefficient" it is not clear what they mean. The most obvious economic meaning would be that resources were allocated inefficiently, so that the economy (and therefore living standards) did not grow in accordance with its full potential. The South Korean economy grew at a *per capita* rate of 7.2% over the last thirty years, one of the highest rates of economic growth in the history of the world. It is certainly possible that it could have grown even faster, but no one has presented an economic argument as to how this might have been accomplished.

All this is not to say that there were no problems accumulating in these five Asian countries. There was a build up in domestic bank lending in all of the countries except Indonesia, where firms increased their borrowing directly from foreign banks. Real exchange rates did appreciate noticeably - about 12% for

[11] Ibid, p. 8.

[12] Radelet and Sachs 1998, p. 4.

[13] Ibid.

[14] See Mark Weisbrot 1999, for a more extensive discussion of this point.

[15] See Ha-Joon Chang, 1998.

South Korea and 25% for the other four countries - as large international capital flows poured in. But other countries have had much larger real appreciations without the kind of currency collapse that these countries underwent. And it should be stressed that these weaknesses as well as the current account deficits were very much tied to the liberalization of capital flows that took place in the preceding years.

Radelet and Sachs[16] have also examined the effect of international shocks, such as the devaluation of the Chinese yuan in 1994, the increased competition from Mexico, and the overcapacity in particular industries such as semiconductors. The combined effect of these influences does not appear to account for what happened.

It is therefore difficult to escape the conclusion that the instability caused by recent international financial liberalization bears the primary responsibility for the onset of the crisis. The reversal of capital flows amounting to eleven percent of the regional GDP was a result of "herd" behavior, with foreign and domestic investors alike stampeding for the exits for fear of being caught with greatly depreciated local currency and assets.

The logic of such panics is fairly straightforward. In the Asian crisis, it began with the fall of the Thai currency, then soon spread to other countries. With a high level of short-term international debt, a depreciation of the domestic currency increases the cost of debt service. Everyone needs more domestic currency to get the same amount of dollars for debt service, and the selling of domestic currency to get those dollars or other "hard" currencies drives the domestic currency down further. It does not take much to set off a panic, especially if the central bank does not have a high level of foreign currency reserves relative to the short term debt. These reserves shrink further as more and more investors convert their domestic currency and domestic assets into dollars. Foreign lenders refuse to renew their short-term loans (or, as in South Korea, are able to even call them in early), and the downward spiral continues.

Other economists have found that the inherent instability of international financial markets was a major cause of previous financial crises, including Mexico's in 1994.[17] And Radelet and Sachs' statistical analysis of recent crises in emerging markets found that the most important predictor of crisis was the ratio of short-term international debt to the country's foreign exchange reserves.[18] In other words, these countries became vulnerable to panic-induced capital outflows, as well as runs on their currency, because of a build-up of short-term international borrowing.

This build-up of short-term international borrowing was thus a direct result of the financial liberalization that took place in the years preceding the crisis. In South Korea, for example, this included the removal of a number of restrictions on foreign ownership of domestic stocks and bonds, residents' ownership of foreign assets, and overseas borrowing by domestic financial and non-financial institutions.[19] Korea's foreign debt nearly tripled from $44 billion in 1993 to $120 billion in September 1997. This was not a very large debt burden for an economy of Korea's size, but the short-term percentage was dangerously high at 67.9% by mid-1997.[20] For comparison, the average ratio of short-

[16] Radelet and Sachs 1998, op cit.

[17] See, e.g., Guillermo Calvo and Enrique Mendoza, 1995, page 235.

[18] The authors used a probit model based on data for 22 emerging markets, during the years 1994-97.

[19] Chang, Park, Gyue 1998.

[20] Radelet and Sachs 1998, op cit.

term to total debt for non-OPEC less developed countries at the time of the 1980s debt crisis (1980-82) was twenty percent.[21]

Financial liberalizations in the other countries led to similar vulnerabilities. Thailand created the Bangkok International Banking Facility in 1992, which greatly expanded both the number and scope of financial institutions that could borrow and lend in international markets. Indonesian non-financial corporations borrowed directly from foreign capital markets, piling up $39.7 billion of short-term debt by mid 1997, eighty-seven percent of which was short-term.[22] On the eve of the crisis the five countries had a combined debt to foreign banks of $274 billion, with about sixty-four percent in short-term obligations.

In sum, it is clear that international financial liberalization played a significant role in bringing about the Asian financial crisis, from which the region has yet to recover. We now turn to the Mexican peso crisis, and recent experience with international capital flows in the Americas.

The Mexican Peso Crisis and Latin America's Experience with Liberalized Capital Flows

Latin American nations have become accustomed - for better or for worse - to the boom-and bust cycles that have come to exist in a world of growing transnational capital flows. In the 1970s and early 1980s, many countries in the region received large inflows of foreign capital. At the same time, countries in the region undertook liberalization of their financial sectors and relaxed or eliminated foreign exchange regulations. The inflows dried up in the 1980s as the debt crisis discouraged lending to the region. After the debt crisis subsided, however, Latin America again received large capital inflows beginning in 1991. In the 1990s, foreign capital inflows have reached between 5 and 10 percent of GDP in Argentina, Brazil, Chile, and Mexico.

During the periods when capital inflows were plentiful (from 1976-1981 and 1991-94), macroeconomic imbalances emerged towards the ends of the cycles. Throughout both periods, currencies appreciated and current account deficits grew in many countries. As a result, some of these countries became very vulnerable to the actions of external creditors. The creditors in turn became sensitive to even the slightest bit of "bad news."[23]

This was the case in the lead-up to Mexico's financial crisis in December 1994. Access to external capital grew very quickly in the early 1990s - in 1991, 1992, and 1993 annual net capital inflows represented more than 8% of Mexico's GDP.[24] These large capital inflows supported an overvalued peso as well as chronic current account deficits. These factors combined to make the economy very vulnerable to external shocks.

Most of the capital inflows to Mexico in the four year period leading up to the crisis were comprised of so-called "hot money" - mainly short-term bank lending and portfolio investment. In 1993, portfolio inflows alone amounted to 7.7% of GDP, with FDI inflows amounting to just 1.4% of GDP (See

[21] Chang, Park, Gyue 1998, op cit.

[22] Bank for International Settlements data cited in Radelet and Sachs 1998, op cit.

[23] See Ricardo Ffrench-Davis 1998, p.17-18.

[24] Agosin and Ffrench-Davis 1996, op cit, p. 5.

Table 1). In the four-year period leading up to the crisis, Mexico's net external debt grew by US $92 billion, of which only US $24 billion was Foreign Direct Investment (FDI).[25]

Mexico was especially hard hit by the inflow of short-term capital in the 1990s because of its *laissez-faire* approach to capital inflows. Beginning in the mid-1980s, Mexico's capital account was dramatically liberalized. Before 1988, foreign portfolio investment had been strictly regulated.[26] After 1988, due to the lifting of capital account restrictions, there was a surge in foreign portfolio investment. The liberalization was part of a larger effort to liberalize the economy (including trade liberalization, privatization of state-owned enterprises, and removal of restrictions on foreign ownership). Many of these policy changes were required in order for Mexico to accede to the GATT, become a member of the OECD, and join the NAFTA, all of which Mexico did in the early 1990s.[27]

The crisis was precipitated in 1994 largely as a result of the U.S. Federal Reserve's doubling of short-term interest rates in the U.S. from February 1994 to February 1995, which caused Mexico's bond market to become relatively less attractive to investors. Investors grew even more wary when the Zapatista uprising in Chiapas and the assassination of leading presidential candidate Luis Donaldo Colosio suggested political instability. The result: market sentiment changed, and both foreign and domestic financial capital stampeded for the exits.

The reversal of capital flows was drastic. In 1995, Mexico experienced a net capital outflow of US $15 billion, as compared to a net inflow of $31 billion in 1993. In just the fourth quarter of 1994, there was a net outflow of $5.5 billion of portfolio investment, and Mexico was facing a $17.7 billion (4.2% of GDP) balance of payments deficit at the end of the year. Foreign exchange reserves fell from $24.9 to $6.1 billion, and the Mexican peso collapsed, losing a third of its value in the last 10 days of 1994, and half of its value by the end of 1995.[28]

The impacts on the Mexican economy were drastic, although they were certainly exacerbated by the IMF austerity policies - including enormous interest rate hikes and budget cuts - that followed. The economy contracted by 6.6% in 1995 and investment dropped 30%. As interest rates soared, companies (especially small businesses) failed, debt burdens became unpayable and layoffs ensued.

By mid-1995 official unemployment had doubled as compared to two years earlier. From 1994 to 1995, there was a 20% increase in the proportion of people living in extreme poverty.[29]

Economic growth resumed in 1996, but much of the crisis-induced decline in living standards persisted or worsened for the bulk of the population. By 1997 poverty levels had barely come down. Real wages for manufacturing workers plummeted by 39% from 1994-1997,[30] even as manufacturing employment grew.

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[25] Ffrench-Davis 1998, op cit, p. 24.

[26] Agosin and Ffrench-Davis 1996, p. 23.

[27] See Nora Lustig 1998, for a discussion of trade and investment liberalization undertaken by Mexico in the 1980s and 1990s.

[28] Blecker (1996); IMF International Financial Statistics.

[29] Lustig and Szekely 1999.

[30] Ibid.

As in the Asian economic crisis, it is difficult to separate the effects of the financial liberalization, the ensuing crisis and currency collapse, and the IMF austerity policies.[31]

Some observers have laid the blame on major policy errors, in particular the maintaining of an over-valued currency for the years prior to the crisis.[32] Others, such as Robert Blecker have made a strong case that there are fundamental contradictions in the whole growth and development model pursued by Mexican governments since the early 1980s, not only in their exchange rate policies, but in macroeconomic and other policies which thwarted its attempt to harness foreign trade and investment as the engine of economic growth (Blecker 1996).

Nonetheless it is clear that the Mexico's financial liberalization played a key role in enabling not only the reversal of capital flows that precipitated the crisis, but the imbalances that were involved (e.g. the overvalued currency and swelling trade deficit-- $28.8 billion in 1994, from a $4.2 billion surplus in 1987).

The Mexican crisis also had an impact on the rest of the region. Annual GDP growth was zero for Latin America in 1995 and unemployment rates rose that year in Argentina, Costa Rica, Paraguay, Uruguay, and Venezuela. The crisis had a particularly large impact in Argentina and Uruguay, where GDP fell 5.0% and 2.3%, respectively, in 1995. Argentina also opened up its capital account in the early 1990s and pursued a *laissez-faire* approach like Mexico, which at least partially explains that country's heightened sensitivity to the Mexican crisis, in comparison with other economies in the region.[33]

Not all Latin American economies were affected as severely as Argentina by the Mexican crisis. Chile and Colombia, for example had different policies towards large inflows of foreign capital. Rather than adopting complete financial and capital-account liberalization, these countries maintained various kinds of controls and restrictions on short-term inflows. In 1995, for example, the Chilean economy grew by 10.6% and Colombia by 5.8%; it is possible that their capital controls helped insulate them from the fallout of the Mexican peso crisis.

The Need for Capital Controls and "Speed Bumps"

In light of the experience with recent financial crises, which ensued largely because of sudden reversals of international capital flows, a growing number of economists have begun to consider the need for capital controls. In fact, some countries in Asia and Latin America already have such controls in place, despite the general opposition to such measures by the United States, the IMF, and private financial institutions. As recent country experiences with capital controls demonstrate, these measures are not inconsistent with orderly and robust economic growth and development. To the contrary, capital controls can be a highly effective tool in a country's efforts to return to economic growth after a financial crisis, or to prevent excessive and volatile capital inflows from building up in the first place. If the deregulatory model (i.e., based on the NAFTA and the MAI) for international investment is followed, however, these controls would be prohibited by the FTAA's investment provisions.

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[31] Ironically, the IMF policies in Asia were so much more destructive (e.g. a 15.5% annual decline in GDP in Indonesia), as well as more clearly unnecessary (and therefore widely criticized by prominent economists), that the Fund's handling of the Mexican peso crisis subsequently came to be viewed as a success story.

[32] See Blecker 1996, for a review of some of the mainstream economists' explanations of the crisis.

[33] Ffrench-Davis 1998, op cit, p. 30.

Some Country Experiences with Capital Controls

Chile

In Latin America, Chile is the most frequently cited example of a country whose application of capital controls protected its economy from speculative capital inflows. In the early 1990s, as large amounts of capital entered the country, authorities adopted a range of policies to regulate the inflow of capital. In June 1991, a non-interest bearing reserve requirement of 20% was established on external credits. This meant that foreign investors had to place sums equal to 20% of their investment into a zero-interest account with the Central Bank, with the requirement that these reserves be maintained at the Bank for a minimum of 90 days. A stamp tax (at an annual rate of 1.2% on operations of up to one year) that had formerly only applied to domestic loans was applied to external credits as well. As upward pressures on the currency grew in May 1992 (mainly due to growing capital inflows), authorities raised the reserve requirement to 30%. In October, the central bank increased the length of the reserve requirement to one year regardless of the loan's maturity.[34]

With these measures, Chile sought to protect itself from the destabilizing effects (e.g., excessive currency appreciation) of capital inflows by discriminating against the least desirable and volatile inflows. Discrimination against short-term flows is inherent in the reserve requirement. Because the requirement is fixed regardless of the term of the credit, the cost of the requirement decreases with the duration of the investment. For example, with the reserve requirement at 30% and an international interest rate (LIBOR) at 5%, the cost of the reserve requirement to an investor who borrows abroad to invest in Chile for a one-month period is 29%; for a two-month period, the cost falls to 13.5%. At the same rate, the cost of borrowing falls to 2.1% for a year-long investment term and to .2% for a ten-year term.[35]

Another important feature of Chile's policy is its flexibility. As seen, the requirements were phased in - but they were also designed to move up or down, depending upon the amount of funds coming in at a given time. An example of this flexibility was demonstrated as the current account deficit grew in 1998 and investors became less interested in Chile (due to a steep drop in the price of copper, its chief export, and the effects of decreased demand in Asia). As a result, Chilean authorities reduced the reserve requirement from 30 to 10 percent. Even with the decline in the reserve requirement, the policy still served as a barrier to the most speculative and volatile forms of foreign capital inflows.[36] Since September 1998, Chile has temporarily dropped the reserve requirement to 0% - based on the fact that there are currently no speculative, short-inflows. But the authorities have reserved the right to re-establish the reserve requirement when necessary.

While Mexico experienced tremendous increases in portfolio inflows in the lead-up to the peso crisis as a percentage of GDP, Chile was able to keep portfolio flows under relative control and avoided the balance of payments crisis that occurred in Mexico. Recall that in Mexico in 1993, portfolio flows were 7.7% of GDP and FDI inflows amounted to 1.4% of GDP. In Chile in 1993, FDI and medium and long-term credits represented 4.6% of GDP, while portfolio flows and short-term credits represented 4% of GDP. In 1994, FDI and medium and long-term credits were 6.5% of GDP and portfolio flows and short-term credits were 3% of GDP.[37]

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[34] Agosin and Ffrench-Davis 1996, op cit, p. 14-16.

[35] Cowan and De Gregorio 1998, p. 467-68.

[36] Andrea Mandel-Campbell, October 2, 1998, p. 30.

[37] Agosin and Ffrench-Davis 1996, p. 9 (data from the Central Bank of Chile).

TABLE 1
Net inflows of foreign capital to Chile, Colombia and Mexico, 1991-1994, as a percentage of GDP

	Chile				*Colombia*				*Mexico*			
	1991	1992	1993	1994	1991	1992	1993	1994	1991	1992	1993	1994
Foreign Direct Invest.	3.1	1.8	3.2	4.2	1.0	1.7	1.6	2.6	1.7	1.6	1.4	NA
Medium / Long-Term Credits	0.7	1.2	1.4	2.3	NA	-0.1	1.2	3.7	2.7	1.9	NA	NA
Portfolio Flows	0.8	1.1	2.3	2.0	NA	0.1	0.4	0.7	3.2	4.3	7.7	NA
Short-term Credits	1.9	2.4	1.7	1.0	-1.3	1.4	2.9	0.6	1.2	1.8	0.2	NA
Other	-3.4	-1.0	-3.0	-1.9	0.7	2.3	1.5	2.5	-0.3	-1.5	-0.3	NA
Total	**3.0**	**5.4**	**5.6**	**7.6**	**-1.0**	**0.8**	**4.6**	**5.1**	**8.5**	**8.0**	**8.9**	**5.1**

Source: Agosin and Ffrench-Davis 1996. Data from Central Bank of Chile, Banco de la Republica (Colombia) and CEPAL.

As Cowan and De Gregorio conclude: "The reserve requirement...has imposed a relatively higher cost on short-term inflows. As the evidence partially shows, this has tilted the composition of capital flows toward longer maturities." The authors also point out that reserve requirements have permitted Chile's government to maintain a degree of control over monetary policy that would not be possible without them.[38]

Chile's mixture of capital controls would violate the national treatment and financial transfers requirements of the NAFTA and the MAI. Since Chile's reserve requirement is directed specifically at foreign investors but it is not required of domestic investors, the policy, however effective, is "discriminatory" according to the NAFTA definition of the term. Similarly, the transfers sections mandates the free flow of capital relating to investments - and reserve requirements impede such capital flows. Chile's controls would have to be abolished under the NAFTA model. In fact, the U.S. Treasury Department reportedly demanded that in order for Chile to join in a free trade agreement with the United States, its capital controls would "have to go."[39]

Colombia

Reserve requirements and taxes on short-term capital inflows were also used in Colombia. In April 1991, Colombian authorities began to charge a commission of 5% on foreign exchange sold to the Central Bank - along with a retention fee of 3% (later raised to 10%) on non-export foreign exchange receipts. In September 1993, this system was replaced with a reserve requirement of 47% on all credits of less than 18 months. By August 1994, this requirement had been extended to all loans of up to 60 months' maturity.[40]

There has not been as much analysis of the impact of the Colombian measures as in the Chilean case. In Table 1, data on the composition of inflows in Colombia shows that, between 1993 and 1994, inflows shifted from short-term credits (2.9% of GDP in 1993; .6% of GDP in 1994) to FDI and medium and long-term bank credits (2.8% in 1993 and 6.3% in 1994).[41] Agosin and Ffrench-Davis offer a tentative conclusion: "Although there is no hard evidence on the effects of the reserve

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[38] Cowan and De Gregorio 1998, op cit, p. 486.

[39] See Kristof and Sanger, February 16, 1999, p. A10.

[40] Agosin and Ffrench-Davis 1996, op cit, p. 20.

[41] Ibid, p. 9, citing data from Banco de la Republica de Colombia.

requirement mechanism used in Colombia, perhaps one of its results has been the lengthening of maturities on foreign borrowing and the near disappearance of short-term borrowing since late 1993."[42] As in the case of Chile, Colombia's capital controls would be found illegal under the national treatment and the financial transfers sections of the NAFTA and the MAI.

The Use of Capital Controls in Response to the Asian Crisis

Realizing the role played by financial liberalization and volatile capital flows in the Asian crisis, some Asian countries have undertaken measures to look for ways to insulate themselves from further damage and protect themselves in the future. As Robert Wade explains, "The crisis has taught Asian governments just how risky it can be to open their economies to inflows and outflows of short-term finance."[43]

Malaysia

In this vein, Malaysia surprised the world on September 1, 1998 by instituting strong controls to protect its economy from currency speculators and to regain control of its monetary and fiscal policy. The measures included fixing the value of the Malaysian currency, the ringgit, at 3.8 to the dollar; the closure of secondary currency markets so that trading can only be done on the Kuala Lumpur Stock Exchange; setting a September 30, 1998 deadline for ringgit held abroad to re-enter Malaysia (after which they would no longer have value); locking in portfolio investment for one year before allowing it to leave the country; and other measures imposing conditions on the operations and transfers of funds in external accounts.[44] The specific objective of Malaysia's policy was to contain speculative capital and the actions of speculators betting on the value of the ringgit. Another important objective was to "regain monetary independence and insulate the Malaysian economy from the prospects of further deterioration in the world economic and financial environment."[45]

The controls have largely stopped overseas speculation in the ringgit, which had previously been carried out mostly by hedge funds based in Singapore.[46] The controls have also allowed the Malaysian government to undertake measures to stimulate the economy - including deficit spending on infrastructure projects and tax cuts without facing the capital flight and currency collapse that such policies might otherwise meet. Interest rates have also been allowed to fall: by January1999, the real short-term interest rate was just under 1%,[47] as compared to 4.2% in August 1998, before the implementation of currency controls. The government has also encouraged banks to increase their domestic lending. The government projects 1% GDP growth in 1999; private analysts have predicted up to 2-3% growth.[48]

Hong Kong, Taiwan, China and India

Malaysia was not the only Asian country to respond to the crisis by increasing its intervention in capital markets. Hong Kong also took measures to protect itself from hedge funds when its currency and stock

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[42] Ibid, p. 21.

[43] Wade 1998-99, p. 48.

[44] Keenan, September 10, 1998, p. 12.

[45] Statement from Bank Negara Malaysia, 1 September 1998.

[46] Landler, February 14, 1999, p.10.

[47] Official Statistics cited in Far Eastern Economic Review, Economic Indicators, January 21, 1999.

[48] FT Asia Wire, "...Malaysia in on Track Toward Recovery," January 24, 1999.

market came under attack in the summer of 1998. The Hong Kong Monetary Authority (HKMA) discovered that speculators, including international hedge funds were making a deliberate effort to topple the stock market in order to bring down the Hong Kong dollar. In Hong Kong's quasi-currency board system, where the Hong Kong dollar is pegged to the US dollar, the speculators were happy to profit by betting against the Hong Kong dollar and breaking the peg. In August and September 1998, Hong Kong's government introduced restrictions on certain kinds of speculative trading against the Hong Kong dollar and in the Hong Kong stock market. The HKMA also bought up 6 percent of the stock market to keep the price of stocks high, "to show them [speculators and hedge funds] that selling stocks short was not a one-way bet."[49] The HKMA intervened primarily to wipe out those speculators' "short" positions taken in equities. Their effort was a success: the hedge funds took losses and stopped their attack.[50]

At about the same time, the government of Taiwan temporarily curbed capital flows in and out of the country in order to ward off excessive speculation. The central bank was given the authority to regulate the inflow of funds to the stock market. The Taiwanese central bank also decided to essentially isolate the New Taiwanese dollar from the region's currency decline by virtually shutting down trade in futures instruments and by closing the offshore market in the New Taiwanese dollar.[51] The central bank also issued public notice that foreign currency speculators would find 'no quarter' to operate in the domestic currency market.[52]

China and India have maintained restrictions on capital flows throughout the crisis. China's currency is not freely convertible and therefore cannot be subject to speculative trading. The fact that China's economy continued to grow (at annual rate of 7.8% for 1998) while the rest of East Asia has suffered through recession or depression, has prompted a re-consideration of currency controls.

The policies adopted by China, India, Malaysia, Hong Kong, and Taiwan to shield themselves from turmoil in international capital markets would not be permitted under the provisions on national treatment and financial transfers in Chapter 11 of the NAFTA and the MAI. At a time when financial instability is an important concern, should such provisions be included in new international agreements? Economists from across the spectrum have begun to address this very question in recent months.

The Changing Economic Debate: Will New Commercial Agreements Heed the Warnings?

The Asian and Mexican crises are by no means anomalous in the history of international finance. As Harvard economist Dani Rodrik, citing the Mexican crisis of 1994-1995 and the Latin American debt crisis of 1982 has noted, "Boom and bust cycles are hardly a sideshow or minor blemish in international capital flows; they are the main story."[53]

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[49] See Wade and Veneroso 1998, p. 23-25.
[50] Ibid.
[51] Ibid, p. 25
[52] Ibid, citing Kynge and Lewis, September 1, 1998.
[53] Rodrik 1998, p. 56.

Rodrik is not alone among the prominent economists who have entered the debate over global capital flows and the need for national controls. Along with Columbia's Jagdish Bhagwati and Harvard's Jeffrey Sachs, World Bank Chief Economist Joseph Stiglitz has repeatedly spoken out against further capital account liberalization. In an October 1998 speech, Stiglitz concluded: "Capital account liberalization has the potential of imposing greater risk and greater inequality. At the same time...studies show there is no systematic relationship between capital account liberalization and economic growth and investment."[54]

Rodrik recently conducted one such study -- to find out if countries with no restrictions on capital-account transactions performed better than those with restrictions. The sample covered nearly 100 countries and looked at the correlation between economic growth, investment as a share of GDP, and inflation and capital-account liberalization from 1975-1989. Rodrik found no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation.[55] The study also tested the hypothesis often cited by proponents of further capital account liberalization that it works better in countries with "strong financial systems." This claim was also found to be unsupported by the evidence.

Paul Krugman of MIT has also noted the role of unregulated capital flows in causing the Asian crisis. He has endorsed the use of capital controls, including restrictions on currency convertibility, in Malaysia, and has recently advocated the same for Brazil.[56] "As long as capital flows freely," writes Krugman, "nations will be vulnerable to self-fulfilling attacks, and policymakers will be forced to play the confidence game. And so we come to the question of whether capital should really be allowed to flow so freely."[57]

Despite the powerful critique emerging from the world's most prominent economists, as well as the growing willingness of some developing country governments to challenge the "Washington Consensus," the United States government and the IMF have continued to promote the liberalization of capital flows. This is undoubtedly driven at least partly by domestic political interests: politically powerful banking and financial interests in the United States have an interest in maintaining and expanding the free worldwide movement of capital. But these policies, as we have seen, can have a significant impact on the economies of Latin America. The FTAA investment negotiations may play an important role in determining what that impact will be.

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[54] Rebello, October 5, 1998.

[55] Rodrik 1998, op cit, p. 60-64. Rodrik notes in his study that countries are more likely to remove their capital controls when their economies are doing well. Because of this bias, this study probably overstates the case in favor of capital account liberalization. If there was some way to remove this bias, Rodrik postulates, "we might even find a negative relationship between open capital accounts and performance."

[56] See Krugman, September 7, 1998. On Brazil see, "Alas Brazil," [http://web.mit.edu/krugman/www/brazil.htm].

[57] Krugman, October 5, 1998.

Recommendations for FTAA Investment Negotiators

1. No provision should be adopted which restricts a signatory government's ability to impose limits on currency convertibility, during time of financial crisis, or under other circumstances in which the government determines that such action is in the national interest.

2. No provision should be adopted which restricts a signatory government's ability to impose so-called "speed bumps," in order to promote long-term investments over short-term inflows. No provision should be adopted which restricts a signatory government's ability to impose reserve requirements on portfolio investment.

3. No provision should be adopted which limits a signatory government's ability to impose a ceiling, or other restrictions, on foreign borrowing by domestic banks. Such measures may violate national treatment provisions under the NAFTA or the draft MAI.

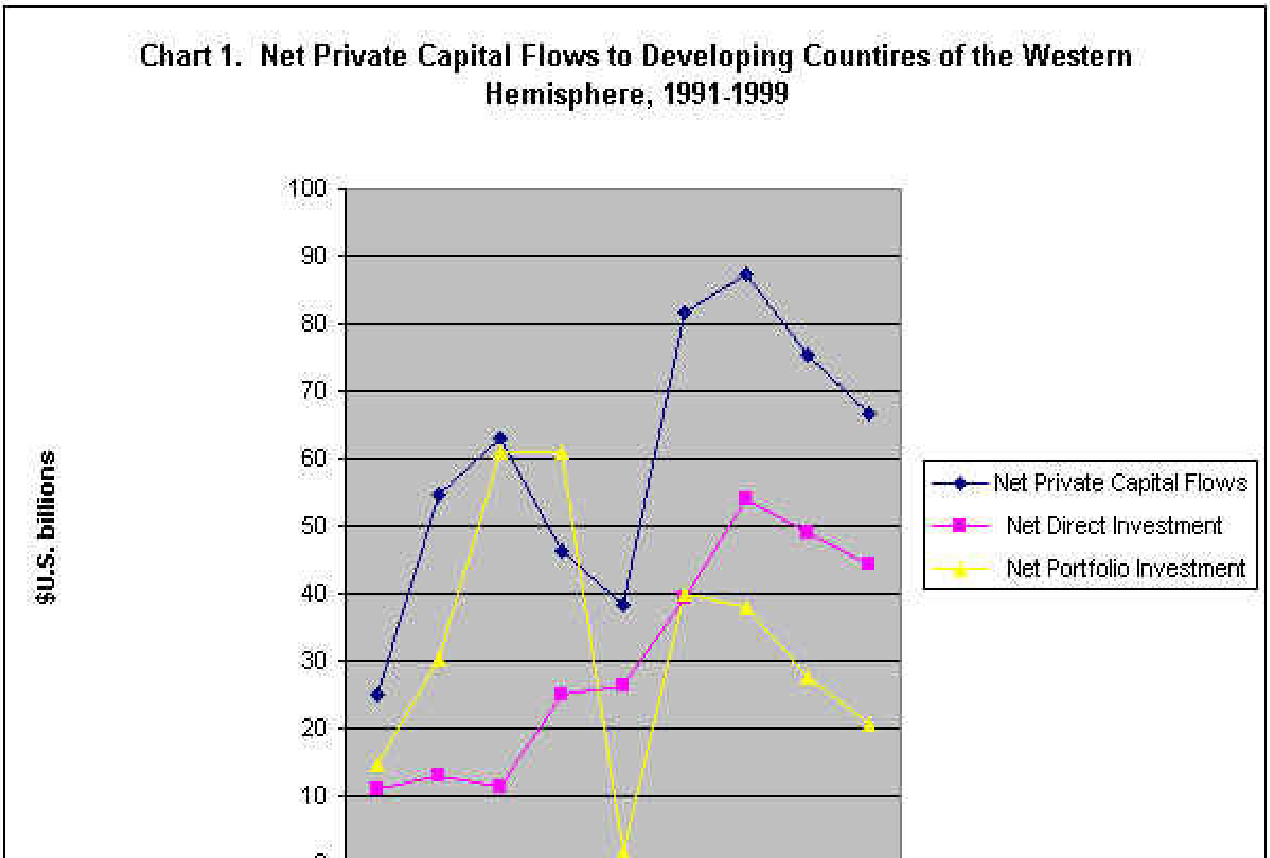
4. No provision should be adopted which restricts a signatory government's ability to withhold government-subsidized insurance for the bank deposits of foreign investors.

5. No provision should be adopted which restricts a signatory government's ability to require administrative permission for a foreign bond issue and or impose minimum maturity periods for foreign bond issues

6. A signatory government's power to control the inflow and outflow of capital from its borders, even if such controls have the effect of "discriminating" against foreign investors, must be affirmed and strengthened by any pan-hemispheric commercial agreement.

Appendix

CHART 1
Net Private Capital Flows to Developing Countries of the Western Hemisphere, 1991-1999



	1991	1992	1993	1994	1995	1996	1997	1998	1999
Net Private Capital Flows	25	54.8	62.9	46.5	38.2	81.8	87.5	75.2	66.6
Net Direct Investment	10.9	12.9	11.2	25	26.2	39.2	54.1	49	44.3
Net Portfolio Investment	14.7	30.4	61.1	60.9	1.7	40	38	27.8	20.7

Source: International Monetary Fund, World Economic Outlook, October 1997, October 1998. Data for 1998 and 1999 are IMF projections. (Note: Private projections and recent press reports suggest that net private capital flows for 1998 and 1999 will be markedly lower than the projections indicated above.)

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