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Financial Stability and the Trans-Pacific Partnership: Lessons from Chile and Malaysia

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Abstract

There is growing recognition that nations may need to deploy cross-border financial regulations to prevent and mitigate financial crises. Indeed, in December of 2012 the International Monetary Fund (IMF) agreed on a new 'institutional view' that notes how the IMF will begin to recommend that nations deploy cross-border financial regulations going forward. However, many nations have become party to global, regional, and bi-lateral trade and investment treaties that may restrict their ability to effectively deploy such regulations.

This paper examines the cases of two countries currently in negotiations for a Trans-Pacific Partnership Agreement (TPP): Chile and Malaysia. The paper examines the extent to which each nation has deployed cross-border financial regulations in the past, and the extent to which they have negotiated the policy space for such regulations in its previous trade and investment treaties. Finally, it analyzes the extent to which such measures would be permitted if the TPP's investment provisions looked like the model bi-lateral investment treaty of the United States.

We find that, with some important exceptions, both countries have successfully deployed cross-border financial regulations and have carved out the ability to do so under a sample of representative trading commitments. However, such policy space would be jeopardized if the TPP conformed to the US model rather than arrangements that each country has been able to broker in other arenas.

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I. Introduction

In the wake of the global financial crisis the regulation of cross-border finance has become justified now more than ever. New advances in econometrics has found that capital account liberalization is not strongly associated with growth in emerging markets and developing countries yet tends to be associated with financial crises. New theory sees financial markets as imperfect, thus requiring second-best Pigouvian taxes to correct those market failures. [2] Moreover, the bulk of econometric evidence also shows that taxes and other measures on capital flows tend to be effective in meeting their stated goals. Indeed, in the wake of the crisis the International Monetary Fund (IMF) found that those nations that regulated the inflow and outflow of capital were among the least hard hit from the crisis.[3] Perhaps even more notable is the fact that the IMF officially changed its view on capital account liberalization and the management of capital flows in 2012. Moving forward, the IMF will recommend that nations put in place capital account regulations under a number of circumstances.[4]

In the midst of this change, a number of countries are concerned that they may have taken on commitments in the trading regime that may not permit them to regulate cross-border finance. The legal and policy literature thus far confirms those concerns. Under the World Trade Organization (WTO) nations are not permitted to regulate cross-border finance if they have made commitments in financial services under the General Agreement in Trade in Services (GATS). However, there may be recourse under various WTO exceptions. For many Free Trade Agreements (FTAs) and Bi-lateral Investment Treaties (BITs) with the United States

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[2] Jeanne, Olivier, Arvind Subramanian John Williamson (2012), *Who Needs an Open Capital Account*? Washington: Peterson Institute for International Economics.
[3] Ostry et al, (2010), "Managing Capital Inflows-The Role of Controls" IMF Staff Position Note, Washington, IMF.
[4] International Monetary Fund (2012), Institutional View on Capital Account Liberalization and the Management of Capital Flows, Washington DC, International Monetary Fund.

however, all forms of capital must flow ‘freely and without delay’ among trading partners and such treaties have a generally more limited set of exceptions.

The paper is organized into four additional parts. Part II provides background on the relationship between trade treaties and capital account regulations (CARs). Part III provides our Chile analysis. Part IV is the analysis of Malaysia. Part V summarizes our findings and draws lessons for the TPP negotiations.

II. Background on CARs and the Trading System

Although the WTO requires a more limited opening of the capital account and may have a broader level of safeguards, there are a number of concerns about the ability of nation states to deploy CARs while maintaining their commitments under the GATS. Members liberalize each sector along four modes. Liberalization in mode one and three in financial services is the most relevant for capital flows because GATS members must liberalize financial flows that are connected to a service provided. [5] Mode one is cross-border supply, which stipulates the extent to which non-resident providers can supply services within the member's borders. Mode three refers to commercial presence, or the ability of foreign service providers to have a commercial presence in a member's territory, such as a branch, agency, or subsidiary.[6] Under the WTO, when nations choose to liberalize financial services--either through what is called ‘Mode 1’ trade in financial services or ‘Mode 3’ establishing a commercial presence (FDI) for financial service providers under the General Agreement on Trade in Services (GATS)—they do have to open their capital account in order for those services to contract. US FTAs and BITs, in contrast, require free transfers associated with all covered investments, which are defined broadly. This obligation

[5] Ibid., 216.

[6] “Guide to Reading the GATS Schedules of Specific Commitments and the List of Aricle II (MFN) Exemptions, *World Trade Oranization,* accessed at http://www.wto.org/english/tratop_e/serv_e/guide1_e.htm 10 May 2012.

requires – in effect – a full opening of the capital account among parties to the agreement. Under the GATS if a nation makes commitments under Mode 1 they are required to open the capital account to allow those services to transact and are not permitted to regulate capital flows. Second, it is not clear that the GATS safeguards give ample room for nations to deploy CARs.

If a nation does not make any GATS commitments in Modes 1 or 3 of course they are free to regulate cross border finance as they see appropriate. If a nation does list Mode 1 or Mode 3 commitments, some degree of capital account liberalization is required. The IMF notes the following:

> WTO members must allow cross-border (inward and outward) movements of capital if these are an essential part of a service for which they have made liberalization commitments regarding its cross-border supply (without establishment). For example, international capital transactions are an integral part of accepting deposits from or making loans to nonresidents (mode 1). International capital transactions are also usually associated with financial services such as securities trading on behalf of a customer residing in another country. The establishment of a commercial presence (mode 3) in a host country by a foreign services supplier involves both trade in services and international capital transactions. In permitting the establishment of a commercial presence, WTO members must allow inward (but not outward) capital transfers related to the supply of the service committed.[7]

However, the GATS has three safeguard provisions that may allow nations to derogate from their commitments. The most relevant components of each safeguard are displayed in Box 1.

[7] International Monetary Fund (2010), Reference Note on Trade in Financial Services, Washington, International Monetary Fund.

BOX 1: Key Safeguards Relevant to CARS

GATS Article XII: Restrictions to Safeguard the Balance of Payments

1. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.

2. The restrictions referred to in paragraph 1:

   (a) shall not discriminate among Members;

   (b) shall be consistent with the Articles of Agreement of the International Monetary Fund;

   (c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member;

   (d) shall not exceed those necessary to deal with the circumstances described in paragraph 1;

   (e) shall be temporary and be phased out progressively as the situation specified in paragraph 1 improves.

3. In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programs. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.

Article 2(a) of the Financial Services Agreement

2. Domestic Regulation

(a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking 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 service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement.

There are many concerns in the legal literature about the balance-of-payments exception.[8] (see Viterbo, 2012). It may be that the GATs balance of payments safeguard does not adequately guarantee that nations can use measures to regulate both the inflow and outflow of capital because there is no reference to derogations to maintain 'financial stability'. Moreover, 2(c) in the balance of payments exception states that measures 'shall not exceed those necessary' to deal with the circumstances that a measure is trying to prevent or mitigate (see Box 1). This amounts to what is called in WTO law as a 'necessity test' and could give a dispute panel authority to rule that an alternative measure could have been used. Furthermore, there is concern over 2(e). Requiring that measures be 'temporary' may not give nations ample time to meet their stated goals.

The GATS also has a provision often referred to as the ¨prudential carve-out¨ (Article 2(a) of the Financial Services Agreement). This exception allows members to deviate from their commitments 'for prudential reasons' to ensure the protection of investors or to 'ensure the integrity of and stability of its financial system.' The GATS adds that if the prudential measures deviate from a nation´s GATS commitments "they shall not be used as a means of avoiding the Contracting Party´s commitments or obligations under the Agreement.¨ There are concerns in the legal literature that ´prudential reasons,' while not defined, may not cover CARs and that the sentence stating that prudential measures should not breach a party´s commitments could be seen as ´self-cancelling.'

It should be stressed that there has not been a case where this language has been tested with respect to CARs. Some members gather that existing language will be sufficient. Indeed, Ecuador is leading an effort to clarify the extent to which nations looking to re-regulate their

[8] Viterbo, Anna Maria (2012), *International Economic Law And Monetary Measures, Limitations to States' Sovereignty and Dispute Settlement,* London: Edward Elgar.

financial systems can do so under the 'cover' of these safeguards. Their inquiry, for cautious reasons, was careful not to mention very specific measures or disciplines however. While a formal decision on this matter has thus far been blocked, Ecuador has received on-the-record assurances from many OECD countries, including the United States, that the GATS safeguards leave ample room to maneuver to prevent and mitigate financial crises.[9]

While reviews are mixed on the WTO, the literature is more unified that many FTAs and BITs may be significantly incompatible with the ability of nations to deploy CARs. Most FTAs and BITs are wider in scope than the WTO. Whereas the GATS only covers capital transfers related to trade in financial services, FTAs and BITs often cover all transfers between parties. In addition, transfers are often broadly defined as any investment, including stocks, bonds, currencies, derivatives, direct investment and beyond. Thus a much broader number of investments must be allowed to be transferred 'freely and without delay' among parties to an agreement.

What can often put a developing country at a disadvantage is that when negotiating an FTA or a BIT there is a 'negative list' approach whereby a nation is expected to liberalize all sectors except a handful where they still want to regulate. Thus if a nation wanted to regulate a new financial 'innovation' in the future such as a new form of derivative, that nation would not be permitted to regulate the related investments because it hadn't anticipated the innovation and reserved the right to regulate during the negotiation. Of course, such anticipation is impossible as financial 'innovation' has been at the heard of the globalization of financial volatility.

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[9] WTO, (2011). S/FIN/M/71, Committee on Trade in Financial Services, Report of the meeting held on 2 November 2011, Note by the Secretariat. Available at: http://docsonline.wto.org/DDFDocuments/t/S/FIN/M71.doc

What is astonishing is that many FTAs and BITs do not have a balance of payments safeguard and/or a prudential carve out. Those that do have a balance of payments safeguard are often modeled after the GATS Article XII and thus have the same concerns described above (lack of clear scope for inflows and outflows, a necessity test, and restrictions of temporariness). Among the few agreements that have a prudential carve out are those with the United States (which generally do not have balance of payments safeguards). However, most US treaties tie the definition of 'prudential' more closely to policies pertaining to 'individual financial institutions' and also include the potentially 'self-canceling' language found in the GATS. Moreover, US negotiators have repeatedly stressed that existing language does not pertain to the use of capital controls.[10] Indeed, a handful of US treaties have annexes that note how capital account regulations are deviations from commitments but require an extended 'cooling off' period before foreign investors may file claims for compensation. One treaty, the United States-South Korea FTA, allows South Korea to deploy regulations as specified under its law as long as such measures meet a number of limitations specified in the Annex.

The IMF has expressed concern that many FTAs and BITs lack the adequate safeguards to put in place CARs: "The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows" (IMF, 2012, 8). The IMF has developed an institutional view on the use of CARs that defines

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[10] See Saez, Raul (2006), *Trade in Financial Services: The Case of Chile,* Washington: World Bank; Geithner, Timothy (2011), Letter to 250 Economists Urging The US to Permit Capital Controls within US Trade and Investment Treaties. http://www.ase.tufts.edu/gdae/policy_research/CapCtrlsLetter.html; Taylor, John (2003), 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.
http://www.stanford.edu/~johntayl/taylorspeeches/Financial%20Services%20and%20Capital%20Transfer%20Provisions%20(1%20Apr%2003).doc

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CARS as “measures affecting cross-border financial activity that discriminate on the basis of residency.” Therefore forbidding nations to violate ‘national treatment’ in treaties may thus constrain the ability of nations to use CARS in general and even under IMF advice in particular. Some US treaties allow nations to deploy price-based taxation measures on capital flows, or have an annex that allows a nation to deploy CARs as long as they meet national treatment requirements. Such limitation may nullify the ability to use CARs by definition. Moreover, such incompatibility may make it more difficult for nations to accept the IMF policy advice based on its new institutional view.

Finally, there is real concern about the use of ‘investor-state dispute resolution’ in cases pertaining to CARs in FTAs and BITs. WTO disputes are settled ‘state-to-state’ and therefore nation states can negotiate on behalf of the well-being of entire nations and financial systems—looking for situations where the benefits to the majority outweigh losses to a minority. However, that cost-benefit analysis is tipped on its head under investor-state disputes. Under investor-state private firms and investors may directly file claims against governments that regulate capital. Therefore, those sectors that may bear the cost have the power to externalize the costs of financial instability to the broader public while profiting from awards in private tribunals.

III. **Chile**

In 1990, just returned to democratic rule, Chile faced a greater relative supply of external finance than any other Latin American country, owing to its sharp economic recovery, smaller economic size and a smooth political transition out of the dictatorship. The new authorities considered that a large supply of inflows would be destabilizing for the domestic macroeconomy and its export strategy (particularly for the consistency of aggregate demand with potential GDP and of the exchange rate with a sustainable external balance). It was alive in the minds of the democratic government the recall of the huge crisis that Chile had suffered in the early 1980s due to large capital inflows in the late 1970s, leading to significant exchange rate appreciation, rising external deficit and climbing external liabilities.[11]

In response to the first signals of increasing inflows, it established an unremunerated reserve requirement (URR) of 20% on financial inflows, retained for one quarter. But, the reserve requirement rate, the duration for its retention at the Central Bank and its coverage became adjustable, according to the strength of the supply of external funds. The purpose was to make net flows consistent with the volumes that could be absorbed in productive investment (complementing domestic savings) while maintaining macroeconomic equilibrium (an aggregate demand consistent with potential output).[12] The flexibility with which the rate was managed and the extent of its coverage allowed it to posses the virtues of a control mechanism combining the use of relative prices and quantitative restrictions (see Table 1). There was a persistent monitoring of the market by the Central Bank in order to adjust policy and to close incoming loopholes. In parallel, there was implemented a comprehensive managed flexibility of the exchange rate in order to achieve a sustainable balance of the current account.[13]

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[11] Ffrench-Davis, Ricardo (2010) *Economic Reforms in Chile: From Dictatorship to Democracy,* Palgrave Macmillan, chapter III.

[12] In Ffrench-Davis (2010, chapter VIII) there is a detailed analysis of this experience and a discussion of the outcomes. See

Also Le Fort, G. and S. Lehmann (2003), " El encaje y la entrada neta de capitales: Chile en el decenio de 1990", *Revista de la CEPAL* No.81, December; Williamson, J. (2003), "Overview: An Agenda for Restarting Growth and Reform", in Kuczynski, P.P. and J. Williamson (2003), eds., *After the Washington Consensus: Restarting Growth and Reform in Latin America*, Institute for International Economics, Washington, DC.

[13] There was also a quite responsible fiscal policy: any new permanent expenditure was financed by corresponding tax changes; in 1990-98 there was a fiscal surplus averaging 2% of GDP. It must be stressed that a fiscal surplus is not enough to avoid crisis. In 1981 the Chilean Treasury hold a surplus over double that figure and Chile suffered the tougher crisis in all Latin America in 1982, with a 14% GDP drop. The huge macro imbalance was located in the private sector (See Marfán,

Both policies implied applying several mini adjustments in order to avoid the typical maxi adjustments that crisis generate.

During 1990-95, Latin America accepted large capital inflows and significant appreciation of the exchange rate with rising external deficits; in 1995 suffered the "Tequila crisis", and average GDP growth fell sharply in Mexico, Argentina and Uruguay.The situation in Chile was quite different; GDP growth exceeded 7%; exchange rate appreciation and the current account deficit (as a share of GDP) were much less than the average for the region. The comprehensive disincentives to destabilizing short-term capital inflows provided the room for actual counter-cyclical exchange rate and monetary policies along those years. Thus, Chile was able to gain control of the composition of inflows, significantly reducing short and liquid short-term inflows. This, together with interventions to sterilize the monetary and foreign exchange markets and prudential regulation of the domestic financial market, avoided a destabilizing appreciation of the exchange rate, maintaining, by the mid nineties, an aggregate demand consistent with potential GDP and the deficit in the current account within sustainable limits.

There is a further dynamic dimension, which links the present with the future; an economy with a high rate of productive capacity utilization and long term stable flows, tends to exhibit higher productive investment ratios. In fact, even though the private sector was carrying a somewhat higher tax burden (a rise from 15% to 18% of GDP) and was now obliged to respect more progressive labor rights, the investment ratio increased from 16% of GDP in 1982-89 to 23% in 1990-98. Real macroeconomic stability was a key determinant of this improvement, associated to a level of domestic demand consistent with potential GDP and a "stable and competitive" real exchange rate (RER, a crucial macro-price) up to 1995; even though the

M. (2005), "La eficacia de la política fiscal y los déficit privados: un enfoque macroeconómico", in J.A. Ocampo (ed.), *Más allá de las reformas: dinámica estructural y vulnerabilidad macroeconómica*, CEPAL/Alfaomega, Bogotá.; Ffrench-Davis, *Economic Reforms in Chile*, pp. 30-31, table I.4).

exchange rate policy lost it coherence since 1996, the economy remained using potential GDP until 1998.This contributed in Chile to the increasing rate of productive investment during the 1990s. Actually, Chile achieved a 7% average GDP growth and inequality was somewhat reduced, while the average growth of the region was less than half that figure and inequality worsened. Instability generated by volatile capital flows is depressive for GDP and regressive for its distribution.[14]

Paradoxically, since the mid-1990s, Chile (actually, the autonomous Central Bank) gradually moved toward the neo-liberal or Washington Consensus approach of capital account and exchange rate liberalization. Since it was quite gradual, part of the positive effects of the counter-cyclical approach continued to be at work. The economy remained close to potential GDP until 1998, but the deficit on current account started to rise, the exchange rate to appreciate significantly and speculative inflows to increase (though moderately, since the URR remained in place but weakened due to lack of monitoring to fight emerging leakages). Only in 1999 it was formally adopted the so-called "neo-liberal" approach of a fully free exchange rate, followed in 2001 by a fully open capital account and inflation targeting as a dominant policy target. The authorities of the Bank had changed and the staff was receiving new PHDs well trained in the belief of the macroeconomic approach led by the flows in an open capital account. Nonetheless, with the partial exception of Chile's treaty with the US, most part of the policy tools remains available for the future in case new authorities would decide to apply capital account or exchange rate counter-cyclical policies.

As a result of the policy reversal, domestic demand and the exchange rate began to depend on financial flows, becoming 'victims' of the globalization of financial volatility. Inflation has been particularly low, but at the expense of the other complementary macroeconomic policy targets that had been taken systematically into consideration in the early 1990s: primarily,

[14] Ffrench-Davis, *Economic Reforms in Chile,* Chapter VIII.

avoiding unstable aggregate demand and real exchange rate, and persistent output gaps (that is unemployment of labor and capital goods) and external imbalances. Actually, the exchange rate and domestic demand came to be led by shortermish financial flows, reinforced by terms of trade instability, and fell victim to their volatile cycles. Both sustained growth and equity suffered.

As a consequence, persistently in 1999-2012, the Chilean economy has mostly been out of real macroeconomic equilibrium, with significant output gaps, with average actual GDP remaining quite below average potential output. As well, an outlier exchange rate has worsened trade performance. Since the start of the sharp improvement of the terms of trade in 2004 and the parallel surge of financial inflows, a significant exchange rate appreciation has implied that the volume of imports, in 2004-12, has risen at a speed more than doubling that of exports. The gap was covered by an evidently abnormally high price of copper.

In all, the evidence overwhelmingly shows that capital controls applied rather systematically between 1990 and 1995 (i) modified the maturity structure of capital inflows, reducing the unstable component; (ii) it allowed the maintenance of a differential between the domestic and international interest rates, providing room for an active monetary policy which ensured that the economy would ride around the production frontier; (iii) it allowed avoiding a destabilizing exchange rate appreciation.[15] Above all, (iv) it contributed to a comprehensive and sustained real macroeconomic equilibrium that is friendly with growth and equity. Thus, the counter-cyclical regulation of the capital account is crucial for building a real macroeconomic environment conducive to development.

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[15] Magud, R. and C. Reinhart (2007), "Capital controls: an evaluation", in S. Edwards (ed.), *Capital controls and capital flows in emerging economies: policies, practices and consequences*, University of Chicago Press, Chicago; Edwards, S. and R. Rigobon (2009), "Capital controls on inflows, exchange rate volatility and external vulnerability", *Journal of International Economics*, 78.

Table 1: Capital Account Management in Chile in the 1990s

Foreign Direct Investment	Investments were required to remain in Chile for one year and could not be financed with more than 30 percent debt (70 percent equity). This was reduced from 50 percent in 1997.
Portfolio Investment Flows	In 1994, the minimum ADR issue was reduced from \$50 million to \$25 million. Non-financial firms were required to have a rating of BBB and banking firms were required to have a minimum rating of BBB+. Beginning in July 1995, there was a 30 percent reserve requirement for secondary ADRs.
Other financial and portfolio inflows	Thirty percent reserve requirement on trade credits, foreign currency deposits, loans associated with FDI, and bond issues. Bond issuers also faced the same restrictions as ADR issuers.
Foreign Investments of Chilean Institutional Investors	There were limits on the amounts and types of foreign assets that could be held by pension funds, mutual funds, and life insurance companies. Pension funds could hold just 12 percent of their total assets in foreign assets, and only half of foreign holdings could be stocks.
Foreign Investments by Banks	Foreign financial investments by commercial banks were required to be fixed income securities that are issued or guaranteed by foreign governments or central banks. These investments were limited to 25 percent of bank capital and reserves. Banks could use foreign deposits to finance trade among countries within the Latin American Association for Integration (ALADI). Commercial banks with a capital/asset ratio of at least 10 percent could hold equity in foreign banks.

Source: Ffrench-Davis, Ricardo (2010) ibid, chapter VIII, Box VIII.1.

Chile's WTO Commitments

Chile has signed onto the GATS but has included numerous horizontal and specific limitations that allow it to continue to have policy space to use capital account regulation even with its WTO commitments. It was very conservative in its GATS negotiations.[16] The limited commitments to capital account liberalization was due in large part to the timing of negotiations. Chile's banking act was being reformed just as negotiations were taking place, so regulators in large part were uncertain about the outcome of the legislative process, which prevented them from making larger commitments.[17] Chile places horizontal limitations on market access and national treatment across all of its services obligations. Measures taken by the Central Bank regarding capital inflows and outflows as well as exchange rate policy to maintain financial stability are reserved.[18]

Chile's general market access and national treatment limitations specify that for reasons of macroeconomic stability and for maintenance of the functioning of the payments system, the Chilean Central Bank can adopt measures according to its Banking Act. This includes limitations on payments and transfers in and out of Chile, such as reserve requirements.[19] Market access limitations state that authorization for commercial presence may take into account the effect of the commercial presence on economic activity (including employment and the use of parts, products, or services produced within Chile), productivity, industrial efficiency, technological development and product innovation in Chile, competition in any sector, consumer protection, functioning, integrity, and stability of the market, national interest, and Chile's integration into world markets. These limitations apply to: corporations, open or closed, private-limited companies, and subsidiaries (which under Chilean legislation are the equivalent of agencies of

[16] Saez, Raul E. (2006), "Trade in Financial Services: The Case of Chile," *Free Trade Agreements and Financial Services in Latin America and the Caribbean LCR Study,* December, p. 13.
[17] Saez, "Trade in Financial Services," p. 16.
[18] Ibid.
[19] Ibid., Annex 1, p. 49.

corporations).[20] These very broad limitations to market access across all services, including financial services, allow for considerable leeway for Chilean authorities to limit market access for foreign companies. Chile also maintains significant horizontal limitations for national treatment for its liberalization of services. Its national treatment limitations state that foreign investors may transfer capital abroad after the elapse of two years from the date of entry.

Chile has signed onto GATS financial services; however, it remains unbound and maintains multiple limitations beyond those horizontal limitations already discussed. Cross border trade and consumption abroad (modes 1 and 2) are completely unbound except for reinsurance and retrocession and brokerage of reinsurance. Commitments were generally made under mode 3, commercial presence, in insurance services. However, auxiliary insurance services, such as consultancy, actuarial, risk, and claim services are not included. Banking regulations essentially follow the guidelines of Chile's Banking Act; however, not all services in the Banking Act are listed in the GATS, for instance, some core banking services.[21]

As with Malaysia (and all members of the WTO for that matter), the GATS includes a balance of payments exception. Article XV of the GATT stipulates that nothing within the WTO can preclude the use of exchange limitations or exchange regulations that are in accordance with the Articles of Agreement of the IMF. GATS Article XII also specifies that prudential measures can be taken to address a balance of payment problem and ensure the stability of a member's economy. However, it is not specified whether capital account regulations, particularly regulations on outflows, are considered a measure taken for prudential reasons.[22]

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[20] Chile WTO Schedule for Services, accessed at http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm, 6 May 2013.
[21] Saez, "Trade in Financial Services," p. 14.
[22] Viterbo, Annamaria (2012) *International Economic Law and Monetary Measures: Limits to States' Sovereignty and Dispute Settlement,* Cheltenham,UK: Elgar International Economic Law, p. 217.

While negotiating its GATS obligation in the 1990s, Chile clearly took steps to ensure that it could use capital account regulation, including the use of a URR in due time rather than already going into a crisis. Chile chose to take a conservative approach to the GATS and remained unbound in several key areas, which allows it to retain this policy space. In negotiations with Canada, the US, and the EU, Chile faced more pressure to liberalize financial services and/or take on more commitments.

Canada-Chile FTA

The Canada-Chile FTA came into force in July 1997. Canada offered Chile the option of negotiating an agreement modeled after NAFTA.[23] The FTA contains a chapter on investment as well as a chapter on cross-border trade in services. The financial services chapter was not negotiated because Chile felt that it needed to maintain financial services as a bargaining chip for later negotiations with the US.[24] It was agreed that a financial services chapter between Chile and Canada would begin to be negotiated no later than April 1999; however, this deadline was never met.[25] Even though the financial services chapter was not included, there were protections in the investments chapter intended for investors in foreign financial institutions.[26] The investment chapter contains both national treatment and most favored nation clauses. Dispute settlement is done through investor-state dispute resolution.

Canada expected a strong obligation regarding transfers in and out of the country that would prevent the use of an unremunerated reserve requirement (URR). However, Chile was negotiating its agreement with Canada at the same time that the Uruguay round was taking place

[23] Saez, "Trade in Financial Services," pp. 12-13.
[24] Ibid.
[25] Ibid.
[26] Ibid., p. 17.

and it was also creating its banking act, and it did not want to prohibit the use of a URR. The compromise reached was an annex to the investment chapter that provided an exception for transfers. Annex G-09.1 retains Chile's ability to apply a reserve requirement, but with two limitations. First, the maximum URR is 30% for no more than two years. Second, there is a requirement that authorization of certain transactions that are carried out in the Formal Exchange Market be granted without delay. Additionally, there is a non-discriminatory clause for Canadian investors and non-Canadian investors.[27]

The Canada FTA has a balance of payments exception that states that "Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining measures that restrict transfers where the Party experiences serious balance of payments difficulties, or the threat thereof, and such restrictions are consistent with this Article."[28] This exception is modeled after GATS.

Annex G.09.1 and the balance of payments gives Chile the space to implement capital account regulation if it needs to. Chile chose not to negotiate financial services in this FTA which allowed it to maintain those negotiations when bargaining directly with the US.

US-Chile Free Trade Agreement

The US-Chile FTA entered into force in January 2004. The agreement includes separate chapters on investment, cross-border trade in services, and financial services, all of which are relevant for cross-border flows of capital. The financial services agreement is in large part based

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[27] Ibid.

[28] "Canada-Chile Free Trade Agreement, Part Five, Other Provisions, Chapter O, Exceptions," accessed at http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/chile-chili/chap-o26.aspx?lang=en&view=d, 6 May 2013.

on the NAFTA financial services agreement.[29] Negotiations with the US took place at the same time as those with the EU and it was the first time that Chile negotiated about financial services.[30]

Financial services are covered specifically in their own chapter, and are only partially subject to the requirements of the other services or investment chapters. The financial services chapter includes: financial institutions, investors and investments of such investors in financial institutions, and cross-border trade of financial services. A separate negotiating team was designated to negotiate issues of capital account regulation and balance-of-payment measures.[31] While the *encaje* was not in force at the time of negotiation, the Central Bank Act still allowed for the imposition of a URR, and the negotiating committee was committed to preserving the right to use a URR as well as a balance-of-payments exception.[32]

The financial services chapter has national treatment requirements that apply to both Chile and the US for all financial services covered in the chapter. Article 12.3 of the chapter also has most favored nation requirements. Regarding market access, neither party may impose limitations on the number of financial institutions, the total value of financial service transactions, the total number of financial service operations, or the total number of natural persons that may be employed in a particular financial service.[33]

Throughout the two years of negotiations, the US and Chile were unable to come to agreement about capital controls and a balance-of payments exception. Chile was determined to retain the right to use a URR. The solution that was come to was an annex that allowed Chile to adopt measures if needed, but those measures could be subject to dispute settlement by US

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[29] Saez, "Trade in Financial Services," p. 33.
[30] Ibid., p. 18
[31] Ibid., 21.
[32] Ibid.
33 "US-Chile Free Trade Agreement," Chapter 12, Financial Services, accessed at http://www.ustr.gov/sites/default/files/uploads/agreements/fta/chile/asset_upload_file306_4006.pdf, 6 May 2013.

investors. However, US investors can file claims no sooner than one year after the measures are implemented. The damages resulting from the measures are also limited to the actual reduction in value of transfers, and exclude other damages such as loss of profits. There are circumstances under which claims can immediately be submitted, including transfers related to direct foreign investment and payments pursuant to a loan or bond issued in a foreign market. The exception of these investments is intended to distinguish volatile capital flows from other forms of capital flows. The agreement includes no balance-of-payments safeguard provisions.[34]

The compromise reached between the US and Chile leaves somewhat vague the possible interpretations of what is permitted under the agreement. While Chile reserves the right to impose capital account regulations to avoid building a crisis and more so during an emergency, foreign investors also retain the right to seek compensation after one year. The compromise was the first of its kind in a US FTA, and served as a model for future US FTAs, such as the US-Singapore agreement.[35]

Chile-EU Free Trade Agreement

In 2002, the EU and Chile concluded an Association Agreement that included a free trade agreement. The stated goal of the agreement is to establish transparent rules for exporters, importers, and investors, create a free trade area in goods, services, and government procurement, liberalize investment and capital flows, and strengthen the protection of intellectual property rights.[36]

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[34] Saez, "Trade in Financial Services," pp. 39-40.
[35] Ibid.
[36] European Commission, "Trade: Chile," accessed at http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/chile/, 6 May 2013.

EU-style agreements follow a GATS framework where financial services are included as an annex to the regular services chapter. Chile, as with the US agreement, was able to negotiate a separate financial services chapter; however, the chapter still follows a GATS approach with key provisions and listing of commitments.[37] GATS text was incorporated into the financial services chapter without any changes so as to minimize uncertainties associated with legal interpretation, which means that market access and national treatment provisions are the same as the GATS. There is also a prudential carve-out that is taken from NAFTA and the GATS Annex on Financial Services.[38] Chile's commitment to liberalizing financial services under the agreement remains "intermediate" according to an EU analysis of the agreement.[39] No MFN clause is included. There is a schedule of horizontal and specific service commitments made by Chile and also by each EU member.

The EU agreement contains a chapter on Current Payments and Capital Movements. Chile commits to allow payments and transfers in convertible currency in accordance with the Articles of Agreement of the IMF. Chile is obligated to allow the free movement of capital relating to investments made in accordance with domestic laws and to allow the repatriation of any profit. However, the chapter contains an article which provides an exception to these obligations. The article states that measures can be taken under "exceptional circumstances, payments and capital movements between the Parties cause or threaten to cause serious difficulties for the operation of monetary policy or exchange rate policy of either Party." In these cases, parties can apply safeguard measures for up to one year (and that time period can be extended).[40]

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[37] Saez, "Trade in Financial Services," p. 19
[38] Ibid., p. 28-29
[39] "Evaluation of the Economic Impact of the Trade Pillar of the EU-Chile Trade Association Agreement," 23 March 2012, p. 18, accessed at http://trade.ec.europa.eu/doclib/docs/2012/august/tradoc_149881.pdf, 6 May 2013.
[40] Saez, "Trade in Financial Services," pp. 32-3.

Beyond its prudential carve-out, the agreement includes Annex XIV that enables the Foreign Investment Committee or the government to employ special investment regimes that could include minimum periods for the repatriation of capital. The provision is very similar to that in the Canada-Chile FTA, with a condition that measures be applied on a non-discriminatory basis. There is also a maximum URR of 30% and a maximum holding period of two years.[41]

The prudential carve-out and Annex XIV give a similar degree of freedom to use capital account regulation as the GATS and the Canada agreement. During emergency situations there is a greater degree of flexibility to impose capital account regulations, and it appears that Chile has retained its ability to use a URR if necessary.

IV. Malaysia

Throughout most of the past thirty years Malaysia has pursued a relatively open capital account with few regulations on capital flows. On two occasions Malaysia decided to experiment with extensive capital regulations: once in 1994 and most famously again in 1998. In 1998, it declined IMF funds during the Asian Financial Crisis in order to implement capital regulations and expansionary fiscal policy. Malaysia's policies during the crisis are now largely seen as successful. Since 2000, Malaysia has undertaken reforms and re-liberalization of its financial sector. Table 2 provides an overview of regulations used by Malaysia in the 1998 crisis and presently.

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[41] Ibid.

Table 2: Capital Regulations Implemented by Malaysia

1998	- One-year ban on outflows - Taxes on outflows (graduated taxes based on length of stay) - Limitations on the transfer of funds in the country from external ringgit accounts - Limitations on abilities of foreigners to borrow domestically - Only authorized institutions could handle ringgit financial assets - All trade transactions required to be settled in foreign currency - Limitations on ability of residents to borrow abroad
2012	- Limitations on exchanging currency - Limitations on access to ringgit by foreigners - Special requirements for foreign exchange accounts (must be held in Labuan) - Limitations on foreign equity participation and shareholding of financial institutions

Source: Gerald Epstein, Ilene Grabel, and K.S. Jomo, "Capital Management Techniques in Developing Countries," in Jose Antonio Ocampo and Joseph Stiglitz, eds., Capital Market Liberalization and Development, Oxford: Oxford University Press (2008) p. 26-29.

The regulations implemented during the 1998 crisis were designed to limit foreign currency outflows and speculation on the ringgit. In order to eliminate the offshore ringgit market, Malaysia prohibited the transfer of funds into the country from external ringgit accounts except for investment or purchase of goods in Malaysia. Malaysia also shut down the offshore market that was operated by the Central Limit Order Book (CLOB) in Singapore. These measures effectively prevented the operation of the offshore ringgit market and eliminated a major source of foreign speculation on the currency.

There was a one-year ban on the outflow of the principle of foreign portfolio capital. In order to prevent a sudden outflow at the end of the one-year period, and to attract investment from abroad, the government implemented a system of graduated exit levies to the profit of foreign portfolio investment. Larger exit levies were applied to short-term investments.[42] In order to make the circulation of ringgit outside of Malaysia more difficult, large denomination ringgit notes were demonetized. Malaysian residents needed approval in order to invest abroad.

Beginning in 2000, regulations were gradually scaled back after the economy stabilized, and by 2007 the regulations were loosened to a level that was more liberal than that prior to the Asian Financial Crisis. There are no more controls over the inflow and outflow of capital. Non-residents can now borrow any amount in Ringgit for use in the real sector within Malaysia. However, limitations are still placed for use of ringgit for speculative purposes. Foreign currency borrowings by Malaysian resident companies and individuals have been raised substantially to the equivalent of RM100 million for corporate group and RM10 million for individuals. The Ringgit has been partially internationalized wherein imports and exports can be invoiced in Ringgit and international trade can be settled in Ringgit on-shore.[43] Nevertheless, some regulations on exchanging ringgit and limiting access to the ringgit for non-residents are still in place in order to prevent the growth of another offshore ringgit market.[44]

WTO Commitments

Malaysia has clearly reserved its right to regulate its capital account, as demonstrated by the capital account regulations that it continues to use (see Table 1). It has chosen to include some liberalization of financial services under the GATS, which

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[42] Epstein, Gerald, Ilene Grabel, and K.S. Jomo, (2008) "Capital Management Techniques in Developing Countries," in Jose Antonio Ocampo and Joseph Stiglitz, eds., *Capital Market Liberalization and Development,* Oxford: Oxford University Press pp. 26-29.

[43] Mah-Hui Lim, "Finance in Asia After the Global Financial Crisis – Case of Malaysia". Presentation at Workshop on Financial Evolution, Regulatory Reform and Cooperation in Asia in Seoul National University, Korea. May 17-18,2013

[44] Ibid.

comes with certain obligations for the movement of capital. Under the GATT there is no restriction on capital account regulations; however, if a WTO member chooses to sign on to the GATS, the liberalization of certain sectors may require the free flow of capital associated with those sectors. The degree to which the WTO demands the liberalization of the capital account depends upon the liberalization of services, particularly financial services.[45]

Capital flows are directly referred to in multiple sections of the GATT and GATS. Article XV of the GATT stipulates that nothing within the WTO can preclude the use of exchange limitations or exchange regulations that are in accordance with the Articles of Agreement of the IMF. GATS Article XII also specifies that prudential measures can be taken to address a balance of payment problem and ensure the stability of a member's economy. However, it is not specified whether capital account regulations, particularly regulations on outflows, are considered a measure taken for prudential reasons.[46]

The GATS uses a positive-list approach where members specify which sectors they will liberalize. Footnote 8 of GATS Article XVI stipulates that if a member commits to market access and movement of capital is essential, it must allow the associated movement of capital.[47]

Members can place horizontal limitations on market access and national treatment in each mode that are in effect across all GATS sectors that are liberalized. They can also place horizontal limitations on specific modes within each sector that apply

[45] Viterbo, *International Economic Law and Monetary Measures*, p. 215.
[46]Ibid., 217.
[47]Ibid., 216.

to all sub-sectors. Lastly, within each sub-sector members can stipulate limitations and limitations to each mode.

Malaysia places horizontal limitations only on mode three and mode four that limit the GATS's national treatment and market access requirements (see Table 3). In its general horizontal limitations for mode three, Malaysia specifies it can impose limitations on foreign ownership of companies and businesses. Under mode three horizontal limitations Malaysia also specifies that approval may be denied if dealings in land, property, and real estate are for speculative purposes. Other horizontal limitations indicate that incentives can be used for Malaysia-owned firms. Measures taken for national economic or development purposes remain unbound to mode three.[48] These limitations to national treatment and market access allow Malaysia greater control over the ability over foreign service providers setting up branches in Malaysia.

Table 3: Malaysia's Horizontal GATS Exceptions by 2012

Market Access	**National Treatment**
- Approval is required when a single foreign interest or group gains more than 15 percent voting rights in a Malaysian company or business, the aggregate foreign interest is 30 percent or more (or exceeding 5 million ringit), or when the transaction results in foreign ownership or control of a Malaysia corporation.	- Approval may be denied if dealings on land, property, or real estate are for speculative purposes. - Services are unbound for measures to assist development of any Malaysian financial institution to achieve objectives of the National Development Policy (NDP). - Corporation in which the government has an interest will give first consideration to service providers in which the government also has an interest. - Existing or future policies limiting foreign equity or interests in companies and businesses in Malaysia shall be carried out in a preferential and differentiated manner.

Source: "Horizontal commitments of Malaysia," World Trade Organization Services Database, accessed at http://tsdb.wto.org/simplesearch.aspx, 10 May 2012.

[48] "Sector-Specific Commitments of Malaysia," WTO Service Database, accessed at http://tsdb.wto.org/simplesearch.aspx 10 May 2012.

In its financial services sector, Malaysia includes even more limitations on national treatment and market access. Some of the biggest limitations include mode three limitations provisions that allow Malaysia to confine offshore banks, investment banks, insurance companies, and other companies to the island of Labuan. These banks are permitted to accept foreign currency deposits only. As of 2011, there are 27 foreign banks (commercial and Islamic banks) from 14 countries with a presence in Malaysia.[49] Pp. 26 & 92 of Bank Negara (BN), Financial Sector Blueprint, 2011-2020, Aggregate foreign shareholding in a commercial bank cannot exceed 30 percent.[50] (This has been liberalized. Apr 27, 2009 Bank Negara press statement states "In terms of foreign shareholding, the new commercial bank may have a foreign equity interest of up to 100%" and 70% foreign equity interests for Islamic and investment banks). Lending of more than 25 million ringgit must be undertaken jointly with a Malaysian commercial or merchant bank.

Malaysia's commitments essentially bind it to the level of foreign access that it provided foreign service providers at the time of the Uruguay WTO negotiations.[51] These limitations on Malaysia's GATS commitments do not reflect Malaysia's current liberalization. By binding its commitments below its actual level of liberalization, Malaysia has some flexibility to implement certain capital account regulations.

Exceptions and limitations allow greater control of the offshore ringgit market and

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[49] Bank Nagara Financial Sector Blueprint, 2011-2020, pp. 26 & 92.

[50] "Schedule of Commitments and List of Article II Exemptions," World Trade Organization, accessed at http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm#commit_exempt, 10 May 2012.

[51] "Malaysia's Commitments to Services Liberalization under the Framework of General Agreement on Trade in Services (GATS) and ASEAN Framework Agreement on Services," Shivee Ranjanee, University of Putra Malaysia, accessed at http://econ.upm.edu.my/researchbulletin/artikel/Vol%204%20March%202009/94-101%20Shivee.pdf 10 May 2012, p. 96.

speculation on real estate. They also allow for the violation of national treatment in order to implement domestic development policies. Malaysia retains the ability to limit foreign market access and require joint ventures. The GATS limitations allow Malaysia to implement many regulations on the lending, borrowing, and trading of domestic and foreign currency.[52]

Malaysia's commitments do, however, preclude it from implementing measures such as the ban and tax on outflows during the 1998 crisis. Malaysia must allow transfers and payments for financial services that it has chosen to liberalize, and a ban or tax on inflows or outflows would impede transfers and payments. Measures taken in 1998 were specifically targeted at foreign investors, and they would violate the national treatment discipline of the GATS. Malaysia would likely only implement these measures during a crisis, so it may be able to use the GATS balance of payments exception in order to enact temporary capital account regulations. However, it is not clear if limitations on outflows are allowed under the balance of payments clause. Furthermore, the ban and tax on outflows in 1998 was not short-term and therefore would likely not be permissible under the balance of payments clause. Were a crisis such as the one in 1998 to arise, Malaysia may face less flexibility in its policy options than it did in the 1990s.

Association of Southeast Asian Nations (ASEAN)

The Association of Southeast Asian Nations (ASEAN) created the ASEAN Economic Community (AEC) in 2002 with a goal of regional economic integration by 2015. The AEC builds on integration achieved through the Asia Free Trade Agreement

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[52]Ibid.

(AFTA). ASEAN members commit to non-binding goals for economic liberalization and integration. Furthermore, the ASEAN Economic Community was created after the Asian Financial Crisis. After the crisis many Asian countries recognized the volatility of capital flows and the potential for destabilization. Thus, while ASEAN commits members to liberalization, it also recognized capital account regulation as an important tool for developing countries. This has created somewhat contradictory policy recommendations.

The AEC was created with the view of creating "free movement of goods, services, investment, skilled labor, and freer flow of capital" in the ASEAN region. The AEC charter envisages a single market and production base for ASEAN countries, a highly competitive economic region, equitable economic development, and full integration in the global economy.[53] In 2007, ASEAN leaders adopted the ASEAN Economic Blueprint in order to guide the establishment of the AEC by 2015. According to the Blueprint, a single market production will comprise five core elements: (1) free flow of goods, (2) free flow of services, (3) free flow of investment, (4) freer flow of capital, and (5) free flow of skilled labor.[54] The elimination of capital regulations within the ASEAN community is part of the integration plan for 2015.[55]

The free flow of capital is also part of a larger ASEAN Capital Market Development and Integration Plan. The ASEAN Capital Market Development and Integration Plan seeks to allow more cross-border capital flows, open markets to other

[53]"ASEAN Economic Community," ASEAN website, accessed at http://www.aseansec.org/18757.htm 10 May 2012.
[54]Ibid.
[55]"ASEAN Economic Community Factbook," ASEAN, accessed at http://www.aseansec.org/publications/ASEAN_AECFactBook.pdf 10 May 2012.

ASEAN countries, and create a broader investor base.[56] The AEC Blueprint and the ASEAN Capital Market Development and Integration Plan both explicitly and implicitly commit members to moving toward greater capital market liberalization. Freer flow of capital is called for directly, and the free flow of services, particularly financial services, implicitly calls for free flow of capital.

Within the Blueprint and the Development and Integration Plan, however, are special clauses that recognize the use of capital regulations. In the Blueprint's plan for liberalizing service sectors, there is a special clause for financial services that says that countries should be able to slowly liberalize their financial sector.[57] Financial services liberalization also contains flexibilities for certain subsectors. While the plan still aims at liberalizing the financial sector, it also recognizes that capital flows are potentially destabilizing and countries may need to liberalize slowly.

The Capital Market Development and Integration Plan also recognizes the destabilizing potential of capital flows. It names several guiding principles that should be followed in liberalizing capital movements.[58] Capital accounts should be liberalized in a manner that is consistent with each countries' national agenda and the readiness of the economy. There should also be adequate safeguards against potential macroeconomic instability and systemic risk that may arise in the process of liberalization—countries should maintain the right to adopt necessary measures to ensure macroeconomic stability. Finally, liberalization should be shared by all ASEAN countries. These guiding principles

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[56] Singh, Datuk Ranjit Ajit, (2009) "ASEAN Capital Market Integration Issues and Challenges," in *ASEAN: Perspectives on Economic Integration,* IDEAS (June), accessed at http://www2.lse.ac.uk/IDEAS/publications/reports/pdf/SR002/SR002_singh.pdf, 10 May 2012.

[57] "ASEAN Economic Community," ASEAN website, accessed at http://www.asean.org/communities/asean-economic-community, 6 August 2013.

[58] Ibid.

reflect the attitude of many ASEAN members toward capital flows. In fact, after the Asian Financial Crisis, Asian nations are acutely aware of the potential for destabilization. Despite these reservations, however, the Development and Integration plan still aims at liberalizing capital movements. It appears that even though members are concerned about destabilization, there is still a general consensus that liberalization of the capital account is beneficial for economic growth.

As a smaller community that includes many developing countries, ASEAN may appear to members as a safer environment to experiment with capital account liberalization. The United States is not a member, and ASEAN countries may be inclined to try liberalization within its smaller community. Liberalization within the ASEAN community could have multiple ramifications for the ability of members to use capital regulations. Firstly, capital regulations are inherently imperfect. Financial agents find ways to evade regulations that countries implement. By liberalizing their capital account to the AEC, member countries would create more openings for evading regulations. Financial agents outside of ASEAN could exploit the different level of capital market liberalization among ASEAN members in order to evade regulations.

Even though there are special clauses to allow for slower liberalization, ASEAN commits members to moving toward capital market liberalization. Liberalization and integrated capital markets remains the long-term goal. There are no binding agreements or steps that members must take, however, once a member has made some liberalization it may be more difficult to move away from capital account liberalization. Furthermore, members are supposed to work toward a goal of full integration by 2015, so it is possible that even stagnation would violate AEC agreements.

Japan-Malaysia FTA

Malaysia signed an FTA with Japan in 2006. The agreement covers capital flows in both a financial service section and a separate investment chapter. The services agreement contains a commercial presence mode similar to Mode 3 of the GATS. It uses a GATS-style positive-list approach. The FTA differs from the GATS in that members are required to make binding commitments at the current level of liberalization that is in force. Under the GATS, members tend to make binding commitments below the actual level of liberalization that is in force, but the Japan-Malaysia FTA requires binding at the actual level of liberalization. Moreover, there is a "ratcheting up" policy where any liberalizations that are made in the future become binding.[59] The dispute settlement mechanism is through ad hoc arbitration and parties can block disputes by failing to appoint arbitrators. Investor-state disputes are allowed specifically for disputes concerning the investment chapter.[60]

Malaysia's commitments to Japan in financial services and investment go only slightly beyond what it offers through the GATS. Foreign equity participation limitations in some institutions was raised by 5 percent. The agreement's rules on subsidies and domestic regulation for financial services are lenient. The agreement contains disciplines on national treatment, market access, and most favored nation. The MFN clause demands that trade privileges extended to other countries also be extended to Japan and Malaysia. However, there is a carve-out that exempts financial services from other obligations of the FTA relating to market access and national treatment. The carve-out states:

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[59]Fink and Molinuevo, "East Asian Free Trade Agreements in Services," 13.
[60]Ibid., 55.

> Notwithstanding any provisions of Chapter 8, a Country shall not be prevented from taking measures for prudential reasons, including measures for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of Chapter 8, they shall not be used as a means of avoiding the Country's commitments or obligations under Chapter 8.

The agreement also contains an emergency safeguard measure (ESM) that allows for provisional measures to be taken during a crisis. The agreement has special rules of origin for services. Each party can deny a service if it establishes that the service is provided from or within the territory of another country. However, there is no specified qualification for how the origin of a service provider will be determined.[61]

Malaysia's commitments to Japan allows some flexibility to implement capital regulations. The carve-out for financial services means that Malaysia is not required to provide full market access and national treatment for Japanese financial companies. The ESM also allows Malaysia to implement prudential measures during crisis times. Finally, the special rules of origin for services allows Malaysia flexibility to deny service providers if they are not fully Japanese. This helps prevent third countries from accessing Malaysia's special rules for Japan. All of these provide Malaysia with at least equal space to implement capital regulations that it has in the GATS.

The most significant difference between the GATS commitments and the Japan FTA agreement is the binding rules and "ratcheting up" policy. This difference in implementation reduces Malaysia's flexibility and ability to experiment with regulations. If Malaysia were to experiment with more liberalization, its commitments are then automatically bound to the greater level of openness due to the "ratcheting up" policy in the Japan FTA. In order to return to its original commitment, Malaysia would have to

[61]Ibid., 9- 37.

violate its agreement. This policy most likely deters Malaysia from experimenting with different levels of liberalization or capital regulations.

ASEAN-Australia-New Zealand Free Trade Area (AANZFTA)

The ASEAN-Australia-New Zealand Free Trade Area (AANZFTA) came into force in 2010. AANZFTA has followed a "WTO plus" framework for regulation. Regulations minimally follow WTO rules, but may go beyond those rules. Dispute resolution for investment includes investor-state dispute settlement. Similarly to the Malaysia-Japan FTA, AANZFTA binds members to existing levels of market openness.[62] However, there is no automatic "ratcheting up" policy. The agreement specifies that if a market-access commitment is made to a service through the cross-border mode of supply and cross-border movement of capital is essential to the service, the country is committed to allow the movement of capital. If a country commits to market access in relation to the commercial presence of a service, it must also allow for related transfers of capital into that country. The financial services sector also includes an annex with a prudential exception clause that allows for measures to be taken to ensure the stability of the economy.[63]

Article 19 of the trade in services chapter discusses safeguard measures. This article recognized the GATS emergency safeguard measures. However, it requires that any measures taken be mutually agreed on by both parties. The article states that:

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[62] "Overview and Key Outcomes of the ASEAN-Australia-New Zealand Free Trade Area," Department of Foreign Affairs and Trade, Australian Government, accessed at http://www.dfat.gov.au/fta/aanzfta/aanzfta_overview_and_outcomes.html 10 May 2012.

[63] "Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area," ASEAN, p. 110, accessed at http://www.aseansec.org/22260.pdf 10 May 2012.

1. The Parties note the multilateral negotiations pursuant to Article X of GATS on the question of emergency safeguard measures based on the principle of non-discrimination. Upon the conclusion of such multilateral negotiations, the Parties shall conduct a review for the purpose of discussing appropriate amendments to this Agreement so as to incorporate the results of such multilateral negotiations.
2. In the event that the implementation of the commitments made in this Agreement causes substantial adverse impact to a service sector of a Party before the conclusion of the multilateral negotiations referred to in Paragraph 1, the affected Party may request consultations with the other Party or Parties. The requested Party or Parties shall enter into consultations with the requesting Party on the commitments that the requested Party or Parties consider may have caused substantial adverse impact and on the possibility of the requesting Party adopting any measure to alleviate such impact. The requesting Party shall notify all the other Parties of their request for consultations under this Paragraph.
3. Any measures taken pursuant to Paragraph 2 shall be mutually agreed by the Parties concerned.
4. The consulting Parties shall notify the results of the consultations to all other Parties as soon as practicable and by no later than the next meeting of the Services Committee established pursuant to Article 24 (Committee on Trade in Services) following the conclusion of consultations. [64]

Members of AANZFTA each develop their own commitments for the investment chapter. Each member will submit their investment chapters by 2015. The commitments will follow a negative-list approach.[65] The treaty defines a covered investment as "an investment in its territory of an investor of another Party, in existence as of the date of entry into force of this Agreement or established, acquired or expanded thereafter, and which, where applicable, has been admitted [1] by the host Party, subject to its relevant laws, regulations and policies."66 The investment chapter also includes a national treatment clause that states: "Each Party shall accord to investors of another Party, and to covered investments, in relation to the establishment, acquisition, expansion, management, conduct, operation, liquidation, sale, transfer or other disposition of investments, treatment no less favourable than that it accords, in like

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[64] "Chapter 8, Trade in Services," ASEAN-Australia-New Zealand Free Trade Area, accessed at http://www.asean.fta.govt.nz/chapter-8-trade-in-services/#4, 6 August 2013.
[65]"Investment," ASEAN-Australia-New Zealand Free Trade Area, accessed at http://aanzfta.asean.org/index.php?page=investment, 10 May 2012.
[66] "Chapter 11, Investment," ASEAN-Australia-New Zealand Free Trade Area, accessed at http://www.asean.fta.govt.nz/chapter-11-investment/, 6 August 2013.

circumstances, to its own investors and their investments."[67]

Malaysia's commitments to financial service liberalization is limited and they have yet to submit their investment commitments. There is no single undertaking for investment, which means that Malaysia and Vietnam can limit the scope of capital account liberalization when they make their commitments. It remains unbound for many of the subsectors that it has made commitments to through the GATS.[68] The decision to remain unbound to certain subsectors may be due to the policy of binding levels of commitment to the actual level of openness. This binding policy means that Malaysia would have to guarantee at a minimum the actual level of openness that was in effect when it signed the agreement, which would limit its flexibility to reverse capital market liberalization. It is notable that this agreement was signed only two years after the Global Financial Crisis. Malaysia's limited commitment to financial services may reflect new concerns about capital market liberalization after the crisis.

V. Summary and Recommendations for the TPP

This paper pinpoints the commitments made by two TPP countries, Chile and Malaysia under the WTO and various FTAs and BITS. Table 1 summarizes our findings, and reveals that both countries have taken steps to preserve their policy space for capital account regulation. The agreements they have entered into, however, have to varying extents limited this space. As our analysis of Chile reveals, the TPP, as proposed by the United States would place significant obstacles for the ability of these two nations to regulate cross border finance.

[67] Ibid.

[68] "Malaysia – Service Schedule," ASEAN-Australia-New Zealand Free Trade Area, accessed at http://aanzfta.asean.org/uploads/docs/annex3/SERVICES-MALAYSIA_PRINTED_230209.pdf, 10 May 2012; "Vietnam - Service Schedule," ASEAN-Australia-New Zealand Free Trade Area, accessed at http://aanzfta.asean.org/uploads/docs/annex3/SERVICES-VIET_NAM_PRINTED_230209.pdf, 10 May 2012.

Table 1: Comparison of Policy Space for Capital Account Regulation

	Malaysia	Chile	
WTO	Limitations on national treatment and market access in financial services essentially bind Malaysia to the level of openness that it had during the Uruguay negotiations Balance of payments exception	Largely unbound in Modes 1, 2, and 4. Balance of payments exception	**WTO**
Japan	Automatic "ratcheting up" that binds Malaysia to its current level of current account openness Emergency safeguard measures (ESM) provisions allowed during crisis	Annex that allows for measures to be implemented without foreign investors being allowed to litigate for one year No balance of payments exception	**US**
Australia	Limited financial service liberalization commitments, yet to submit investment chapter Remains unbound for many subsectors Agreement contains a binding policy, which requires a minimum degree of openness for any bound sectors GATS-style balance of payments exception	GATS-style balance of payments exception Annex G.09.1 allows a maximum URR of 30% for up to two years	**Canada**
ASEAN	No binding commitments All members commit to move toward greater liberalization Goal of full economic integration among members by 2015 Advocates that countries retain their right for emergency safeguard measures	Capital account regulation measures can be taken "under exceptional circumstances" according to one article of the chapter on the free movement of capital Annex XIV allows a maximum URR of 30% for up to two years	**EU**

For Malaysia, the agreement that most infringes on its policy space is that with Japan. The "ratcheting up" policy of the Japan agreement automatically binds Malaysia to the existing state of openness and limits Malaysia's ability to experiment with various degrees of openness. However, this agreement still contains a balance of payments exception for emergency measures.

Chile's agreement with the United States is its most limiting agreement. Chile can implement a URR under the agreement; however, foreign investors can claim damages from measures that Chile implements. Furthermore, there is no balance of payments exception. This is the only agreement examined in this paper that does not include a balance of payments exception. This means that even in a crisis situation, Chile could face litigation from investors (after a one-year "cooling off" period).Both Malaysia and Chile have made compromises to their policy space in negotiating free trade agreements; however, they have so far in large part retained the ability to implement measures in times leading to or of financial crisis. There may be consequences to implementing such measures, particularly for Chile due to the lack of balance of payments exception.

In the TPP the United States has proposed provisions that offer even less than what Chile received in the US-Chile FTA—a wide definition of investment with no balance of payments provisions and no change in the prudential exception. In fact, is trying to get what was unable in the negotiations of the Chile-US FTA. However, according to leaked text of the investment chapter, TPP negotiating partners have introduced two additions. Analagous to what it negotiated with Canada and the EU, Chile has proposed an annex to the agreement that would give deference to Chile's encaje law. One other nation has proposed a balance of payments exception quite similar to the one in the GATS. This pair of reforms would be more consistent with current thinking on these issues but would not go far enough for Malaysia and other parties to the TPP.

For Chile, deference to its law and a balance of payments provision would grant Chile the ability to regulate both the inflow and outflow of capital to prevent and mitigate financial instability. Malaysia would have the policy space to regulate outflows of capital in the middle of a crisis under a balance of payments exception. However, Malaysia and other TPP nations do not have an encaje on their books and thus would not benefit from a special annex for Chile. In order for TPP nations to have ample space to regulate the inflow of capital there would have to be a deletion of the footnote that constrains the definition of "prudential". It could be replaced with a footnote that has an illustrative but not exhaustive list of measures such as capital account regulations. Only then can TPP nations rest assure that they have all the tools necessary to regulate capital flows for development.