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Working Group on the Relationship between Trade and Investment

EXCEPTIONS AND BALANCE-OF-PAYMENTS SAFEGUARDS

Note by the Secretariat

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EXECUTIVE SUMMARY

This Note reviews the way in which general, security and regional integration exceptions and balance-of-payments safeguard provisions are treated in the GATT, the GATS, and in the international investment agreements (IIAs). These constitute one of the topics that are to be clarified by the Working Group under Paragraph 22 of the Doha Ministerial Declaration, which also requires Members to take into account, in any multilateral framework on investment, exceptions for governments to regulate in the public interest and to participate in regional trade and economic integration agreements.

General and security exceptions to GATT and GATS rules provide room for WTO Members to regulate in the public interest in ways that would otherwise not be consistent with their WTO obligations. In addition to national security matters, these exceptions cover areas such as the protection of public safety and health and certain environmental and cultural policy objectives. Strict conditions are set out for applying measures in these areas, notably that the measures must not involve arbitrary or unjustifiable discrimination or create disguised restrictions to trade. The purpose of these conditions, as viewed in dispute settlement proceedings, is to safeguard against abuse and to ensure that the measures do not frustrate or defeat a Member's legal obligations under the WTO's substantive rules.

Exceptions allowing Members to participate in regional trade agreements (RTAs) are also available under the GATT and the GATS, and are also subject to conditions, in this case both substantive and procedural. They allow Members to provide preferential market access to other RTA parties, and as such constitute an important exception to the most-favoured-nation (MFN) principle. The economic logic on which these exceptions is built is that RTAs can lead to trade creation among participants and thereby to trade expansion for all WTO Members. Key substantive conditions attached to the exceptions are that an RTA should involve the elimination of trade restrictions and discriminatory measures on substantially all the trade between parties to the RTA, and that it should not involve an increase in trade barriers against non-parties. Flexibility is provided to developing countries in meeting these conditions. Procedural conditions include notification, review in a WTO working party, and periodic reporting requirements.

Both the GATT and the GATS allow Members to restrict imports so as to safeguard their external financial position and balance-of-payments. Conditions for doing so are that the measures should not discriminate among Members; are temporary and subject to a time-schedule for their removal; are the least trade-disruptive, with a strong preference for the use of price-based measures as opposed to quantitative restrictions; are used to control the general level of imports, but not to protect specific sectors or industries; and do not exceed what is necessary to address the balance-of-payments problem. Provision is made for more flexible access to these safeguard measures for developing countries (and in the case of the GATS also to economies in transition) in recognition of their need to maintain monetary reserves adequate to implement their programmes of economic development (or economic transition). Procedural conditions include notification, consultation, and regular reporting throughout the period that the measures remain in place.

General and security exceptions are not usual features of IIAs. An important part of the explanation for this lies in the fact that the majority of IIAs, and in particular most bilateral investment treaties, do not circumscribe the extent to which host countries can apply domestic laws to regulate foreign investment, both pre- and post-establishment, for public interest purposes. However, the NAFTA, which substantially limits a Party's ability to restrict or discriminate against foreign investment at the pre-establishment stage of investment, does contain general exceptions to its investment rules that allow governments to regulate in the public interest, particularly to meet environmental objectives.

Exceptions for regional integration purposes are a feature of many IIAs, particularly bilateral investment treaties. Their aim is to prevent the MFN rule in an IIA from conferring on IIA participants the special benefits that one participant wishes to reserve for its partners in a separate regional integration agreement.

Most IIAs contain provisions guaranteeing that a host country will permit current payments and transfers related to foreign investment. Very few contain balance-of-payments safeguards. Part of the explanation for this lies in the fact that most IIAs do not contain substantive provisions on the admission of cross-border capital flows, leaving participating governments a free hand to apply restrictions as they see fit, including for balance-of-payments purposes. An additional part of the explanation would appear to lie in the fact that IMF obligations on current payments and transfers apply to individual IIA participants, and that these obligations are not negated by an IIA. Nevertheless, balance-of-payments concerns, associated in particular, although not exclusively, with the cross-border movement of short-term capital flows, have been raised by many participants in the Working Group's discussions. This, coupled with the fact that the GATS contains balance-of-payments safeguard provisions, suggests that the issue may be more relevant at the multilateral level than at the bilateral level. If so, careful attention would need to be paid to ensuring consistency with WTO Members' obligations under the IMF's Articles of Agreement.

I. INTRODUCTION

1. "Exceptions and balance-of-payments safeguards" are one of the seven topics to be clarified under Paragraph 22 of the Doha Ministerial Declaration in the run-up to the Fifth Ministerial Conference.

2. Exceptions to rules of general application in international commercial agreements, that provide governments with flexibility to apply domestic policies, have been discussed in the Working Group in the context of the non-discrimination and development provisions of IIAs. In an earlier Note[1], the Secretariat classified exceptions into four categories – systemic, general, country-specific, and *ad hoc* exceptions. This Note focuses on the category of general exceptions. These are

[1] WT/WGTI/W/118.

permanently available for any eligible participant to use, subject to specific conditions. The two most important components of this category are exceptions for governments to regulate for a variety of public interest objectives and to participate in regional trade and economic integration agreements. Both are mentioned in Paragraph 22 of the Doha Ministerial Declaration as issues that should be taken into account in any multilateral framework on investment.

3. Balance-of-payments safeguards have also been discussed in the Working Group, in the context of governments' need to manage capital inflows and outflows associated with foreign investment, particularly potentially volatile capital flows, in a way that is compatible with prudent management of the balance-of-payments.

II. DISCUSSIONS IN THE WORKING GROUP[2]

4. General exceptions have been raised in the context particularly of the Working Group's discussions on the admission of investment and the transparency of investment policies.

5. In discussions on different standards and concepts used in existing IIAs with regard to the admission of foreign direct investment (FDI), it was noted that each approach to admission was qualified by various types of exceptions, including those covering national security and public order. One written submission on the impact of international investment rules on national policies concluded that there was widespread acceptance of the principle of non-discrimination once investment had been admitted to a host country, but that governments typically retained a measure of flexibility by subjecting this principle to a number of exceptions that were either general in nature or that pertained to specific sectors or policies. In that context, it was suggested that there need be no incompatibility between non-discriminatory standards of treatment and measures to secure domestic policy objectives in areas such as development, education and training, employment and environmental protection.

6. It was noted that bilateral and regional investment agreements typically included general exceptions as a common feature. In this context, some Members said that general exceptions should not go beyond what already existed in the WTO Agreements, and in particular that they should not be used to defeat basic principles of an investment agreement such as non-discrimination.

7. General and security exceptions were raised also in the context of transparency requirements. It was noted that sector-specific GATS transparency provisions, as exemplified by the Reference Paper on Basic Telecommunications and the Provisional Disciplines on Domestic Regulations in the Accountancy Sector, were subject to general exceptions designed to protect confidential information. In the context of support for wide-ranging transparency obligations in any investment agreement, it was suggested that these should be coupled with exceptions to protect essential security and law enforcement needs by providing governments with the ability to withhold certain information.

8. There has been no substantive discussion in the Working Group on the topic of how exceptions for participation in regional trade and economic integration agreements apply in IIAs.

9. The impact of FDI on the balance-of-payments has been discussed at length in the Working Group, but to date there has been little discussion of the need for, and the precise form of, a possible balance-of-payments safeguard provision in any future multilateral framework on investment. Discussions have focused mainly on the effects of FDI on the balance-of-payments.

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[2] References to the topic of general and security exceptions in reports of the Working Group can be found in WT/WGTI/M/4, para. 52, M/5, para. 63, M/11, para. 39, M/12, para. 48, and M/14, paras. 23, 27-28, 30-31, 33-34 and 37. References to the topic of balance-of-payments safeguards can be found in WT/WGTI/M/2, paras. 9 and 37, M/4, paras. 22, 46-47, M/5, paras. 29 and 63, M/14, paras. 3-5, 7-11, 13 and 15, and M/15, paras. 4-7, 9, 11-14. Secretariat Notes on "Foreign direct investment and the balance-of-payments" are contained in WT/WGTI/W/95 and W/103.

10. Views and positions of Members on this issue have reflected country-specific experience. Some have expressed the view that adverse balance-of-payments effects can arise out of anti-competitive practices of foreign affiliates or their parent companies. Some Members have focussed on the impact of FDI on component parts of the balance-of-payments, taking the view that imports as well as the repatriation of profits and other transfers associated with FDI can weigh heavily on the current account of a host country.

11. The role of FDI in times of financial crisis has been discussed, with some emphasizing that outflows of capital associated with FDI (e.g., the repatriation of profits and dividends) can place pressure on the current accounts of crisis-stricken countries, and others focussing on the stabilizing effect of FDI flows during a crisis in contrast to the behaviour of other forms of private capital flows.

12. Some Members have expressed the view that FDI has strengthened their balance-of-payments, by increasing the competitiveness of their exports and helping finance their current account deficits. One view has been that while FDI may have negative balance-of-payments effects in certain sectors at certain periods in the life of an investment, on the whole it makes a positive contribution to economic growth and the sustainability of the balance-of-payments. Regarding the issue of the repatriation of profits and dividends and the payment of royalties, several Members have stated that the outward payment of direct investment income should not be viewed in isolation but in conjunction with other balance-of-payments effects of FDI, and with the reinvestment of profits by foreign affiliates.

13. There was support for a view expressed in two Secretariat Notes[3] that it was difficult to draw general conclusions on the impact of FDI on the balance-of-payments, whether through greenfield investment or through merger and acquisition activity. Many factors could affect a host country's balance-of-payments situation, and FDI was not necessarily the most important. It was also felt important to take account of all the direct and indirect, and static and dynamic effects of FDI on the balance-of-payments, and this made it difficult to draw firm conclusions on the overall impact.

14. With regard to balance-of-payments exceptions, some Members have noted that this is an area of considerable divergence between existing bilateral investment treaties; not all treaties allow for a temporary balance-of-payments exception. Some others have noted that a significant number of bilateral treaties do incorporate such provisions, showing that balance-of-payments concerns can be accommodated in IIAs. Another view was that bilateral investment treaties do not need to incorporate balance-of-payments provisions because they do not impose restrictions on the right to regulate inflows of FDI, so that balance-of-payments concerns of host countries are minimal.

III. GENERAL, SECURITY AND REGIONAL INTEGRATION EXCEPTIONS IN THE GATT AND THE GATS

A. General Exceptions

15. General exceptions are permanently available under both the GATT and the GATS for WTO Members to regulate in the public interest, in areas such as the protection of public safety and health and for certain environmental and cultural purposes. Conditions for applying measures in these areas are set out in Article XX of the GATT and Article XIV of the GATS. The Articles are similar, containing a "Chapeau" which lays down the basic requirements and the limits under which the provisions can be invoked, and a list of policy objectives, many of them public interest objectives, in pursuit of which measures can be applied.

16. Policy objectives that are common to both the GATT and the GATS are the protection of public morals and public order and of human, animal or plant life or health, and securing compliance

[3] WT/WGTI/W/95 and W/103.

with laws and regulations that are not inconsistent with the provisions of the GATT or the GATS. The GATT covers also measures relating to the importation or exportation of gold and silver, the products of prison labour, the protection of national cultural treasures, the conservation of exhaustible natural resources, and obligations under intergovernmental commodity agreements. The GATS covers measures relating to certain tax issues.

17. The Chapeau of the two Articles reads as follows:

> *"Subject to the requirements that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on [international trade][trade in services], nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures: ....".*

18. The language of the Chapeau has consistently been interpreted through dispute settlement practice to provide for limited and conditional exceptions from GATT obligations, and as not establishing obligations in itself. Panels have examined the language of GATT Article XX only when the Article has expressly been invoked by a Member, and the burden of proof that the conditions contained in the Chapeau are being met has been placed on the Member. Panels have interpreted Article XX narrowly[4], viewing the Chapeau as a safeguard against abuse.

19. For example, the Appellate Body's Report on "*United States – Import Prohibition of Certain Shrimp and Shrimp Products*" stated:

> *"language in the chapeau makes clear that each of the exceptions in paragraph (a) to (j) of Article XX is a limited and conditional exception from the substantive obligations contained in the other provisions of the GATT 1994, that is to say, the ultimate availability of the exception is subject to the compliance by the invoking Member with the requirements of the chapeau".* The Panel concluded that the language of the chapeau is *"but one expression of the principle of good faith".*[5]

20. Similarly, the Dispute Settlement Panel Report on "*United States – Standards for Reformulated and Conventional Gasoline*" concluded that:

> *"the chapeau of Article XX, interpreted within its context and in the light of the object and purpose of the GATT and WTO Agreements, only allows Members to derogate from GATT provisions so long as, in doing so, they do not undermine the WTO multilateral trading system, thus also abusing the exceptions contained in Article XX.*"[6]

21. The Appellate Body Report on the Gasoline case stated that

> *"the chapeau is animated by the principle that while the exceptions of Article XX may be invoked as a matter of legal right, they should not be so applied as to frustrate or defeat the legal obligations of the holder of the right under the substantive rules of the General Agreement. If those exceptions are to be abused or misused, in other words, the measures falling within the particular exceptions must be applied reasonably, with due regard both to*

[4] A full analysis of WTO jurisprudence on Article XX relating to the protection of the environment is available in WT/CTE/W/53/Rev.1 of 26 October 1998.

[5] WT/DS58/AB/R.

[6] WT/DS2/R.

the legal duties of the party claiming the exception and the legal rights of the parties concerned".[7]

22. While not trying to interpret the concepts of "arbitrary discrimination", "unjustifiable discrimination" or "disguised restrictions", the Appellate Body in the Gasoline case determined that the three concepts ought to be read side-by-side, since "*the fundamental theme is to be found in the purpose and object of avoiding abuse or illegitimate use of the exceptions to substantive rules available in Article XX*".

B. SECURITY EXCEPTIONS

23. Exceptions for national security purposes are set out in Article XXI of the GATT and Article XIV*bis* of the GATS, respectively. They cover the disclosure of information which a Member considers to be contrary to its essential security interests, other actions necessary for the protection of its essential security interests relating to trade in military equipment and related services, and actions taken pursuant to UN obligations for the maintenance of international security and peace.

C. EXCEPTIONS FOR REGIONAL INTEGRATION

24. Exceptions for regional integration purposes are contained in Article XXIV of the GATT, along with the Marrakesh Understanding on its interpretation, and in Article V of the GATS. These exceptions apply, in particular, to the principle of MFN treatment, which is a rule of general application in both the GATT and the GATS.

25. Subject to certain conditions being met, WTO Members may participate in regional trade agreements that allow them to give preferential treatment to trade originating in other parties to the RTA. The two main conditions that apply are that an RTA should involve the elimination of trade restrictions and discriminatory measures on substantially all the trade between parties to the RTA, and that it should not involve an increase in trade barriers against non-parties. Flexibility is provided to developing countries in meeting these conditions. Procedural conditions include notification, review in a WTO working party, and periodic reporting requirements.

IV. EXCEPTIONS IN INTERNATIONAL INVESTMENT AGREEMENTS

26. General and security exceptions are not usual features of IIAs, particularly not bilateral investment treaties.[8] In part, this may be explained by the fact that the majority of bilateral treaties treat the entry of foreign investment by requiring a Party to "admit it in accordance with its laws and regulations", which does not circumscribe the extent to which the Party is able to restrict or discriminate against the entry of foreign investment when regulating in the public interest or to achieve national security objectives, and which subjects the foreign investment to all domestic laws and regulations once it has been established in the host country.

27. Some bilateral treaties do address these issues, particularly the issue of national security. For example, the 1994 Model treaty of the United States provides that "*the Treaty shall not preclude a Party from applying measures necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential*

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[7] WT/DS2/AB/R, p. 22.

[8] See UNCTAD, Bilateral Investment Treaties in the Mid-1990's, (1998) p. 86.

security interests".[9] Earlier US Model treaties associated the notion of "public order" also to that of "national security".[10]

28. Wider general exceptions can be found in some bilateral treaties. For example, the model protocol to Germany's Model bilateral treaty contains the following language: "*Measures that have to be taken for reasons of public security and order, public health or morality shall not be deemed "treatment less favourable" within the meaning of Article 3 [the non-discrimination clause]*".[11] The bilateral treaty between Bolivia and Peru stipulates that "*Nothing in this Treaty shall prevent a Contracting Party from adopting measures, if not discriminatory, for reasons of internal and external national security, public or moral order*", and similar language is contained in the Paraguay-Peru treaty.[12] A few bilateral agreements refer specifically to GATT Article XX and GATS Article XIV and XIV*bis*. Also, UNCTAD notes a few examples of IIAs that contain specific provisions preserving national regulatory space for environmental protection.[13]

29. The investment provisions of the NAFTA deal explicitly with several of the matters covered by the general exceptions provisions of the GATT and the GATS, in particular the environment. Its key provisions in this respect are:

- Scope and Coverage *"Nothing in this Chapter shall be construed to prevent a Party from providing a service or performing a function such as law enforcement, correctional services, income security or insurance, social security or insurance, social welfare, public education, public training, health and child care, in a manner that is not inconsistent with this Chapter."*

- Performance Requirements. *"Provided that such measures are not applied in an arbitrary or unjustifiable manner, and do not constitute a disguised restriction on international trade or investment, nothing in paragraph 1(b) or (c) or 3(a) or (b) [prohibitions on domestic content and domestic purchasing requirements] shall be construed to prevent any Party from adopting or maintaining measures, including environmental measures:*

  (a) necessary to secure compliance with laws and regulations that are not inconsistent with the provisions of this Agreement;

  (b) necessary to protect human, animal or plant life or health; or

  (c) necessary for the conservation of living or non-living exhaustible natural resources."

- Environmental Measures. *"Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns."*

30. Most IIAs contain exceptions from the rule of MFN treatment for regional integration purposes. However, their objective is not built on the GATT/GATS logic that RTAs can lead to trade creation among participants and thereby to trade expansion for all WTO Members. Rather, their

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[9] UNCTAD, International Investment Instruments: A Compendium, Volume III, p. 195. See also UNCTAD, Bilateral Investment Treaties in the Mid-1990's, p. 86, footnote 124.

[10] UNCTAD states that the first set of bilateral treaties signed by the United States included a provision that the Agreement could only receive Senate ratification if the Resolution approving the Treaty contained the following mention: "Either Party may take all measures necessary to deal with any unusual and extraordinary threat to its national security". UNCTAD, Bilateral Investment Treaties in the Mid-1990's, p. 48.

[11] UNCTAD, International Investment Instruments: A Compendium, Volume III, p. 175.

[12] UNCTAD, Bilateral Investment Treaties in the Mid-1990's, p. 86.

[13] UNCTAD, Environment, Series on issues in international investment agreements, (2001).

objective is to prevent the MFN rule in an IIA from conferring on IIA participants the special benefits that one participant wishes to reserve for its partners in a separate regional integration agreement.

31. A typical example in a bilateral investment treaty, contained in its provisions dealing with standards of treatment (fair and equitable, MFN and national treatment), is:

> *If a Contracting Party [to the bilateral investment treaty] accords special advantages to investors of any third country by virtue of an agreement establishing a free-trade area, a customs union, a common market, an economic union or any other form of regional economic organization to which the Party belongs …, it shall not be obliged to accord such advantages to investors of the other Contracting Party.*[14]

V. BALANCE-OF-PAYMENT SAFEGUARDS

A. Balance-of-Payments Safeguards under the GATT and the GATS

32. Under the GATT, Members have the possibility, under certain conditions, to restrict the quantity or value of imports to safeguard their external financial position and balance-of-payments. The basic legal framework is set out in Articles XII and XVIII:B of the GATT, which were further clarified by the Marrakesh Understanding of the Balance-of-Payments Provisions of the GATT 1994. The Marrakesh Understanding emphasized in particular the need for measures taken under the balance-of-payments provisions to be: temporary and subject to a time-schedule for their removal; the least trade-disruptive, with a strong preference for the use of price-based measures as opposed to quantitative restrictions; to be used to control the general level of imports and not to protect specific sectors or industries; and not to exceed what is necessary to address the balance-of-payments problem.

33. Procedures that apply to the invocation of the balance-of-payments safeguard provisions include notification, consultation, and reporting during the period that the measures remain in place. Generally consultations in the Committee on Balance-of-Payments Restrictions (BOPs Committee) should take place within four months of the adoption of the measures. The BOPs Committee should determine whether there is a serious balance-of-payments problem, and whether the trade measures are meeting the criteria set out in the relevant GATT provisions. Documentation has to be submitted by the Member imposing the measures and by the WTO Secretariat. The BOPs Committee examines the timetable for the elimination or phasing-out of the measures. Conclusions are to be reported to the General Council, along with possible recommendations.

34. In accordance with Article XV of the GATT, the IMF is invited to participate in the consultations and to provide statistics and other facts relating to foreign exchange, monetary reserves and the consulting country's balance-of-payments, as well as, where appropriate, a determination on whether action by the consulting country in exchange matters is in accordance with the IMF's Articles of Agreement.

35. To a very large extent, Article XII of the GATS applies the same terms, conditions and procedures defined by the GATT for the invocation of balance-of-payments safeguards provisions. In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may restrict trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. As in GATT Article XVIII:9, there is recognition in the GATS that a developing-country Member may need to use trade restrictions in order to ensure the maintenance of a level of financial reserves adequate for the implementation of

[14] Chile: Model Agreement on the Reciprocal Promotion and Protection of Investments, Article 4:3. Similar provisions are contained in the Model bilateral agreements of China, France, Germany, Switzerland, and the United Kingdom. UNCTAD, International Investment Instruments: A Compendium, Vol. III.

its programme of economic development, and in the GATS this provision extends also to economies in transition. The restrictions should be non-discriminatory, consistent with the IMF Articles of Agreement, temporary and phased-out progressively, avoid unnecessary damage to the commercial, economic and financial interests of other Members, not exceed what is necessary to address the balance-of-payments problem, and not be used to protect specific sectors or industries.

36. Procedural requirements are also very similar to those contained in the GATT. Consultations in the BOPs Committee shall address the balance-of-payment situation of the Member concerned and the restrictions adopted or maintained, taking into account, *inter alia*, such factors as the nature and extent of the balance-of-payments and the external financial difficulties, the external economic and trading environment of the consulting Member, and alternative corrective measures which may be available. The role of the IMF is also similar: *"In such consultations, all findings of statistical and other facts presented by the International Monetary Fund relating to foreign exchange, monetary reserves and balance-of-payments, shall be accepted and conclusions be based on the assessment by the Fund of the balance-of-payments and the external financial situation of the consulting member*."

B. BALANCE-OF-PAYMENTS SAFEGUARDS IN INTERNATIONAL INVESTMENT AGREEMENTS

37. Most bilateral investment treaties are not aimed at the removal of impediments to cross-border capital flows and they do not contain obligations regarding the admission of foreign investment.[15] In this respect at least, they differ from instruments aimed at the liberalization of capital flows, such as the OECD Code of Liberalization of Capital Movements.

38. Virtually all bilateral investment treaties contain provisions that guarantee the right of transfer of funds related to covered investments. However, their content and requirements vary as each treaty strikes its own balance between a home country's desire to obtain guarantees on the repatriation of investment-related payments and concerns of a host country about the impact of a sudden repatriation of funds on its balance-of-payments. As this balance differs from one treaty to another, no standard language exists, but most such provisions are relatively protective of repatriation rights.

39. The provisions normally specify the kinds of transfers that benefit from this right, the type of currency in which transfers shall take place, the timing of the transfer and the applicable exchange rate.[16] Following UNCTAD, the main kinds of transfers covered by these provisions are: (i) the outward transfer of amounts derived from or associated with protected investments;[17] (ii) the outward transfer of amounts arising from a host country's performance of other investor protection obligations under an agreement; and (iii) the inward transfer of amounts to be invested by a foreign investor.[18] These provisions are often qualified by exceptions and limitations, notably in respect of taxation, reporting requirements in relation to currency transfers, adjudicatory proceedings and enforcement of creditor rights.

40. In some cases, provision has been made for limitations of the right of free transfer on account of balance-of-payments problems through the inclusion of balance-of-payments safeguards

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[15] UNCTAD, Transfer of Funds, Series on Issues in International Investment Agreements, 2000, pp. 28-29.

[16] UNCTAD, Bilateral Investment Treaties in the Mid-1990s, pp. 75-81; and UNCTAD, Transfer of Funds, pp. 30-38.

[17] This category comprises returns on investment; proceeds from the sale or liquidation of all or any part of the investment; payment under a contract including a loan agreement; and earnings and other remuneration of personnel engaged from abroad in connection with an investment.

[18] This includes transfers made to develop and maintain an existing investment and, in the case of agreements that contain requirements regarding the admission of investment, transfers made for the purposes of making an investment.

provisions.[19] It would appear, however, that this is not typical. An analysis of 335 bilateral investment treaties found that about one-fifth of the treaties dealt with balance-of-payments problems in provisions that allowed for the transfer of large sums in instalments extending over a period of between three to five years.[20] Another source states that "[o]nly a few recent BITs contain a clause admitting the right of a contracting party to restrict the transfer of any payment connected with a covered investment in exceptional financial or economic circumstances affecting its balance-of-payments."[21] UNCTAD notes that "only a very small proportion of the nearly 1,800 bilateral investment treaties in existence specifically allow for temporary balance-of-payments derogations".[22] Among regional investment agreements that are similar in scope and content to bilateral investment treaties, only a small number contain safeguard clauses for balance-of-payments problems. Examples are the NAFTA and the Treaty on Free Trade between Colombia, Mexico and Venezuela.[23]

41. Where balance-of-payments safeguard provisions are included in bilateral investment treaties, the terms and conditions for their invocation differ quite substantially from one treaty to another. Some treaties refer simply to GATT and GATS Articles as the standard that applies; others contain more specific conditions related to duration and deadlines, convertibility of currency, monetary policy and exchange controls. The following are examples.[24]

42. An example of a fairly standard balance-of-payments safeguards clause is that contained in the Free-Trade Agreement between Mexico and Guatemala. While it establishes the freedom of transferring investment-related funds – "*Each Party will allow that in its territory all transfers related to the investment of an investor of another Party will be made freely and without delay*" – it goes on to provide the following exception for balance-of-payments purposes:

> *"Notwithstanding the provision of this Article, when the balance-of-payments of the Party in question presents a serious instability […], each Party will be able to establish controls for exchange operations".*

43. A different version, emphasizing compliance with GATT and IMF rules, can be found in the Euro-Mediterranean Agreement between the European Union and Tunisia, which provides that:

> *"Where one or more Member States of the Community, or Tunisia, is in serious balance-of-payments difficulties, or under threat thereof, the Community or Tunisia, as the case may be, may, in accordance with the conditions established under the General Agreement on Tariffs and Trade and Articles VIII and XIV of the Articles of the Agreement of the International Monetary Fund, adopt restrictions on current transactions which shall be of limited duration and may not go beyond what is strictly necessary to remedy the balance-of-payments situation. The Community or Tunisia, as the case may be, shall inform the other Party forthwith and shall submit to it as soon as possible a timetable for the elimination of the measures concerned".*

44. WTO compatibility is also stressed in the balance-of-payments Article of the bilateral investment treaty between the United States and Jordan:

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[19] UNCTAD, Bilateral Investment Treaties in the Mid-1990s, p. 79.

[20] Mohammed Khalil, "Treatment of Foreign Investment in Bilateral Investment Treaties", F*oreign Investment Law Journal-ICSID Review*, Vol.7, No.2, Fall 1992, pp. 339-383, pp. 360-361.

[21] Giorgio Sacerdoti, Bilateral Treaties and Multilateral Instruments on Investment Protection (1997), p. 363.

[22] UNCTAD, Transfer of Funds, p. 36.

[23] UNCTAD, Transfer of Funds, p. 37 and OAS Trade Unit, Investment Agreements in the Western Hemisphere: A Compendium, (1997), p. 12.

[24] The examples are taken from UNCTAD, International Investment Agreements: A Compendium.

> *"Should either Party decide to impose measures for balance-of-payments purposes, it shall do so in accordance with the Party's obligation under the WTO Agreement. In adopting such measures, the Party shall strive not to impair the relative benefits accorded to the other Party under the Agreement".*

45. Another approach is to guarantee the right of transfer but subject it to the domestic laws of the host country that govern exchange controls. An example is the bilateral investment treaty between China and Japan:

> *"Nationals and companies of either Contracting Party shall be guaranteed by the other Contracting Party freedom of payments, remittances, and transfers of financial instruments or Funds, including value of liquidation of an investment between the territories of the two Contracting Parties as well as between the territories of such other Contracting Party and any third country" ……. "the provisions of paragraph 1 of the present Article shall not preclude either Contracting Party from imposing exchange restrictions in accordance with its applicable laws and regulations".*

46. A more general safeguard provision covering balance-of-payments difficulties as well as monetary and exchange rate policies is contained in the Economic Partnership, Political Coordination and Cooperation Agreement between the European Union and Mexico. While the Agreement *"encourages the progressive and reciprocal liberalization of capital movements and payments*" between the two Parties, it states that the relevant provisions on capital movements and payments should include *"clauses allowing the Parties to introduce restrictions in this area in case of difficulties in the operation of exchange rate or monetary policy of one of the Parties, balance-of-payments difficulties or, in conformity with international law, the imposition of financial restrictions on third countries".*

47. A link between currency convertibility, the IMF Articles of Agreement, and the balance-of-payments is contained in the Partnership and Cooperation Agreement between the European Union and the Ukraine. While stipulating that "*the Parties undertake to authorize in freely convertible currency any payments on the current account of the balance-of-payment*", the Agreement provides that *"until a full convertibility of Ukrainian currency within the meaning of Article VIII of the Articles of Agreement of the IMF is introduced, Ukraine may, in exceptional circumstances, apply exchange restrictions connected with the granting or taking-up of short- and medium-term financial credits to the extent that such restrictions are imposed on Ukraine for the granting of such credits and are permitted according to Ukraine's status under the IMF"*, and *"where, in exceptional circumstances, movements of capital between the Community and Ukraine cause, or threaten to cause, serious difficulties for the operation of exchange rate policy or monetary policy in the Community or Ukraine, the Community and Ukraine, respectively, may take safeguard measures with regard to movements of capital between the Community and Ukraine for a period not exceeding six months if such measures are strictly necessary".*

48. Some balance-of-payment exceptions, while not restricting the right to repatriate capital, allow the amounts that can be repatriated to be limited so as to avoid a sudden depletion of reserves. The bilateral investment treaty between the United Kingdom and Jamaica refers to the powers of taking such limitations in the following terms:

> *"(a) such powers shall not however be used to impede the transfer of profits, interest, dividends, royalties or fees;*
>
> *(b) as regards investment and any other form of return transfer of a minimum of 20% per year is guaranteed".*

49. The possible adverse balance-of-payments or financial implications of certain kinds of investment flows are addressed more explicitly in the context of international rules on the liberalization of capital movements. For example, the OECD Code of Liberalization of Capital Movements provides that:

> *"If the overall balance-of-payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious, that Member may temporarily suspend the application of measures of liberalization…"*
>
> *"If any measures of liberalization taken or maintained in accordance with the provisions of Article 2(a) result in serious economic and financial disturbances in the Member states concerned, that Member may withdraw those measures."*

50. In addition, the Code provides that Members may lodge reservations when a new item is added to the list of capital movements covered by the Code, and when an obligation relating to an item is extended or begins to apply to a Member. The Code also provides that in respect of certain transactions included in a "List B" members may reintroduce restrictions at any time. The coverage of this List B is currently limited to financial operations of a short-term nature.

51. Balance-of-payments safeguard provisions in IIAs focus on controlling cross-border capital transactions rather than trade flows. This explains the prevalence of provisions regarding the imposition of exchange controls and other instruments of monetary policy which aim at restricting capital account transactions and related current payments. In commenting on this, UNCTAD states that "policy differences in this respect are not so much the result of controversies on matters of principle but of the specific balance-of-payments constraints facing countries and their need to maintain foreign exchange in sufficient levels for essential purposes. For policy makers, a main issue to consider therefore is the type of qualifications and limitations to the freedom of transfer that can be reasonably imposed for balance-of-payments crises without unduly restricting transfers under normal circumstances".[25]

52. An important factor influencing the necessity for, and role of, a balance-of-payments safeguard provision in an IIA is the type of foreign investment covered by the agreement. As described in the Secretariat Note on "Scope and Definition"[26], most bilateral investment treaties take as their starting-point a comprehensive, asset-based definition of investment. The kind of balance-of-payments safeguard provisions described above provide, then, a means for a host country to react consistently with the terms of the treaty where a need arises to control inflows and outflows of investment, particularly short-term, speculative capital flows, and to control outflows of transfers and payments associated with established investment. It should be noted, however, that balance-of-payments safeguard provisions are designed to apply only in exceptional circumstances and typically are subject to conditions such as those that apply under the GATT and the GATS, notably that they must be maintained on only a temporary basis and phased out as the balance-of-payments situation improves. They do not amount to a permanent carve-out from the terms of an IIA.

53. One approach to dealing with concerns about the effects on the balance-of-payments of a host country of short-term, speculative capital flows is illustrated by the bilateral investment treaties concluded by Chile. These contain provisions that permit the parties not to allow the transfer of capital for a period of one year after the date of entry. Similarly, the investment provisions of the Canada-Chile Free Trade Agreement contain an annex in which Chile reserves the right to take certain measures "for the purposes of preserving the stability of its currency". These pertain, *inter alia*, to the

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[25] UNCTAD, Bilateral Investment Treaties in the Mid-1990's, pp. 80-81.
[26] WT/WGTI/W/108.

maintenance by Chile of requirements that transfers of proceeds from the sale or liquidation of an investment not take place until the expiry of specified periods of time and the application by Chile of a reserve requirement on investment from Canada, other than foreign direct investment, and on foreign credits relating to an investment.

54. Another approach that has been referred to in the Working Group would be to exclude from the coverage of an IIA those categories of foreign investment – notably short-term, speculative capital flows – that can be most problematic from a balance-of-payments point of view. One difficulty that can arise in this regard, however, is defining which are those categories of foreign investment.

55. To a certain extent, this is an empirical issue. Two Secretariat Notes[27] examined the relationship to the balance-of-payments of FDI, both greenfield investment and merger and acquisition activity, and portfolio investment in the context of the Asian financial crisis. They concluded that FDI had been very stable, even at the peak of the financial crisis, and recent research confirms that current transfer payments related to FDI are stable too.[28] The Notes pointed out also that balance-of-payments considerations did not figure in recent recommendations of the UNCTAD Commission on Investment, Technology and Related Financial Issues on mergers and acquisition activity.[29]

56. In the case of foreign portfolio investment, in general equity investments appear from the empirical evidence to pose less of a potential problem for a host country's balance-of-payments than bond (debt) instruments. Equity investments do not mature and are therefore not subject to redemption; they are priced in domestic currency terms as long as they are issued and traded on the domestic stock market, so that the foreign investor shares in any exchange rate risk which may occur; and they are subject not only to possible capital gains but also losses, depending on the performance of the domestic enterprise, so that the foreign investor shares in the operating risk too. In contrast, debt securities do mature, they typically have a fixed payment due at maturity which is independent of the commercial fortunes of the borrower, and they may be denominated in foreign currency. In addition, while equity holders can withdraw their funds in the event of a domestic financial crisis, this can be done typically only by incurring large capital losses, so that equity investments may be less prone to contributing to capital flight. However, evidence on this point appears to be mixed. The World Bank notes, for example, that in the three financial crises of the 1990s – Mexico, East Asia and Russia – mutual funds (which represent some of the most significant investments in emerging markets) withdrew large sums of money and contributed to the loss of liquidity, but the World Bank also cites a study that draws opposite conclusions from the available empirical evidence.[30]

57. UNCTAD has suggested that different degrees of potential volatility can be associated with different kinds of foreign portfolio equity investment.[31] The least volatile seem to be venture capital investments; investments placed through large institutional investors (i.e. through country funds) seem to be less volatile than investments made directly through the local stock market; also, closed-end investment funds seem to be less volatile than open-end investment funds. The highest degree of volatility is associated with direct portfolio equity investments in the local stock market managed by retail investors, who tend to invest more speculatively. UNCTAD notes that the issue of volatility

[27] WT/WGTI/W/95 and W/103.

[28] IMF Working Paper (forthcoming), A. Lehmann and A. Mody, "Dividend Repatriations and Financial Stability".

[29] UNCTAD, Report of the Commission on Investment, Technology and Related Financial Issues on its Fifth Session (12-16 February, 2001), "Impact of international investment flows on development: Mergers and acquisitions – policies aimed at maximizing the positive and minimizing the possible negative impact of international investment" (TD/B/48/4). See also background material contained in TD/B/COM.2/29, /26, and TD/B/COM.2/EM.7/2.

[30] World Bank, Global Development Finance 2001, p. 47 and footnote 12.

[31] UNCTAD World Investment Report 1997, p. 111.

does not arise in the case of investment flows in the secondary market for depositary receipts, since the trading activity is conducted on foreign exchanges and does not affect the flow of funds in and out of the local stock market.

58. There are well-established reasons to expect foreign portfolio investment in general to be more variable and footloose than FDI, and the data support that conclusion. For example, UNCTAD has calculated that the relative variance of foreign portfolio equity flows is four times higher than that of FDI.[32] Separately, UNCTAD found from a survey of 29 countries for the period 1990-98 that the values of the coefficients of variation were highest for the category "other investment" (primarily bank loans) in 16 countries; they are the highest for foreign portfolio investment in 9 countries, and for FDI in only 4 countries, of which two were Kuwait and Saudi Arabia whose results were clearly skewed by the effects of the Gulf war.[33] Comparing the coefficients of variation of portfolio equity securities and portfolio debt securities, UNCTAD found that debt securities were more variable than equity securities in 19 cases out of 29.

59. The fact that foreign portfolio investment is found to be more variable than FDI, because portfolio investors generally have a shorter time horizon and are able to liquidate their investments more easily, does not necessarily imply that it is inherently "volatile" or prone to cause balance-of-payments problems. The difference between variability and volatility is in practice mainly one of degree, but volatility carries with it also the notion of large, more frequent, and unpredictable changes in the volume of capital inflows and outflows. When this happens, it can destabilize the domestic investment environment and be highly detrimental to growth, development, macroeconomic management and the balance-of-payments of the host country.[34]

60. It is not coincidental that the 1990s saw emerging market economies register a sharp increase in inflows of foreign portfolio investment, and some of these economies experience serious financial crises. The behaviour of foreign portfolio investors contributed to both the timing and the amplitude of the financial crises. At the same time, it would be simplistic to draw the conclusion that financial crisis is an inevitable consequence of allowing increased flows of foreign portfolio investment. By and large, it seems likely that most categories of foreign portfolio investors (other than perhaps those operating at the most speculative end of the market) are as averse to volatile capital market conditions as are the governments and private enterprises of recipient countries, and that both have an equal interest in seeing regulatory measures taken, and policies put in place, to limit volatility.[35]

C. BALANCE-OF-PAYMENTS SAFEGUARD PROVISIONS AND THE IMF ARTICLES OF AGREEMENT

61. Since balance-of-payments safeguard provisions in IIAs focus on controlling cross-border capital transactions rather than trade flows, attention has to be paid to existing obligations of Members under the Articles of Agreement of the IMF. Under the IMF Articles, Members have an obligation not to impose restrictions on the making of payments and transfers for current international transactions, unless authorized to do so by the IMF.[36] The IMF definition of what constitutes current account transactions is relatively broad. It includes income from foreign direct investment (i.e.,

[32] *Ibid.*

[33] UNCTAD/GDS/DFSB/5, p. 26.

[34] For an analysis of the causes and effects of portfolio investment volatility, see UNCTAD: "The Growth of Domestic Capital Markets, Particularly in Developing Countries, and Its Relationship with Foreign Portfolio Investment" (TD/B/COM.2/EM.4/2, 19 March 1998) and "Foreign Portfolio Investment: Implications for the Growth of Emerging Capital markets" (UNCTAD/GDS/GFSB/4, 9 September 1998), and World Bank Global Development Finance 2001, pp. 71-76.

[35] For a discussion of policy options to address volatility, see World Bank Global Development Finance 2001 and UNCTAD/GDS/DFSB/5, pp. 38-39.

[36] IMF Article VIII:2(a) states that "no Member shall, without the approval of the Fund", impose restrictions on the making of payments and international transfers for current international transactions".

earnings not re-invested in the host country), payments falling due on loans and other investments, payments for moderate amount of amortization of loans, as well as depreciation of the value of direct investments.[37]

62. The role of the IMF in the context of balance-of-payments restrictions and their consistency with the IMF's Articles of Agreement is addressed in the GATT and the GATS. GATT Article XV:9(a) states that: "*Nothing in this Agreement shall preclude the use by a Contracting Party of exchange controls or exchange restrictions in accordance with the Articles of the Agreement of the International Monetary Fund...*", and a number of other GATT provisions refer to the need for consistency and coherence between a Member's WTO obligations and its IMF obligations in regard to the use of exchange restrictions and exchange arrangements.[38]

63. The main provisions of the GATS are as follows:

- Article XI:1 provides that a WTO Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments, except in the circumstances envisaged in Article XII (the balance-of-payments exception). Such restrictions may not be maintained, and cannot be inscribed as limitations in Schedules of Specific Commitments.

- Article XI:2 states that nothing in the GATS shall affect the rights and obligations of the Members of the IMF under its Articles of Agreement, including the use of exchange actions which are in conformity with those Articles, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the IMF.[39]

- Despite the general obligation to liberalize capital transactions when a market-access commitment is made in a Member's schedule, Article XVI footnote 8 provides that if a Member undertakes a market-access commitment in relation to the cross-border supply of a service, and if the cross-border movement of capital is an essential part of the service itself, that Member is committed to allow such movement of capital (both inflows and outflows). It also stipulates that if a Member undertakes a market-access commitment in relation to the supply of a service through commercial presence, it is committed to allow related transfers of capital into its territory.

- Article XII allows Members in exceptional circumstances to impose emergency controls on capital movements in the event of a financial crisis of a threat thereof. Restrictions to trade in services may apply to payments and transfers for services on which the Member has taken a specific commitment. The conditions attached to invocation of this provision were described earlier in this Note.

64. The two main GATS provisions relating to restrictions on payments and transfers were drafted with a view to respecting the IMF's jurisdiction in the area of balance-of-payments matters as well as the obligations contained in Articles VI and VIII of its Articles of Agreement.

65. GATS Article XI aims to ensure that the exercise by a Member of its right to impose restrictions on the making of payments or transfers with the approval of the IMF will be preserved,

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[37] IMF Article XXX(d).

[38] See WT/WGTDF/W/3.

[39] The phrase "provided that" would normally be interpreted to mean that a Member cannot impose restrictions on capital transactions inconsistently with its specific commitments even when such restrictions are allowed under the IMF Articles of Agreement.

and will be consistent with the Member's GATS obligations and commitments.[40] However, a Member is not allowed to impose a restriction on a current account payment linked to a GATS commitment if the restriction has not been approved by the IMF.

66. A more open question arises over restrictions imposed on capital account movements where the IMF's jurisdiction is less clear. One notable exception derives from Article VI:1 of the IMF's Articles[41], under which restrictions inconsistent with commitments under the GATS can be imposed when the IMF requests one of its members to impose capital controls as a condition for a continued use of IMF resources. This is reflected in GATS Article XI:2.

67. In the context of the use of the GATS balance-of-payments provisions, the following restrictions on payments or transfers allowed under the IMF Articles of Agreement appear relevant: Section 3(b) of Article VII on limitations on the freedom of exchange operations in a scare currency; Section 3 of Article XIV on exchange restrictions; and Section 2(a) of Article VIII on restrictions on current payments with the approval of the IMF.

68. A general question relating to balance-of-payments safeguard provisions and the IMF's Articles of Agreement is whether balance-of-payments restrictions can apply to both capital inflows and outflows or only to outflows. This was discussed in 1996 in the OECD, when the IMF staff expressed a preliminary view that balance-of-payments restrictions applied to capital outflows but not to inflows, based on their view that serious balance-of-payments and external financial difficulties or the depletion of monetary reserves could occur only through excessive capital outflows.[42] At the time, some OECD delegations did not agree with this interpretation, stating that there was no apparent reason to exclude restrictions on capital inflows from the scope of a balance-of-payments provision, taking as examples situations where excessive capital inflows tended to be associated with large current account deficits, which could justify the imposition of controls. Later, in a letter from the Acting General Counsel of the IMF to the Director of the WTO Legal Affairs Division (31 July 1997), the Fund asked for confirmation of the view that the terms "serious balance-of-payments and external financial difficulties or threat thereof" contained in GATS Article XII were intended also to cover difficulties caused by capital inflows. In the absence of authoritative interpretation of this issue by Members, the WTO Secretariat was not able to respond and the issue was left outstanding.

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[40] On the other hand, when a country has reserved the possibility to engage in discriminatory currency arrangement with another country by taking an Article II (MFN) exemption under the GATS, it would not be exempt from its obligations under Article VIII:3 of the IMF which states that this can only be done with the approval of the IMF.

[41] Article VI:1(a) of the IMF's Articles states that: A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.

[42] This interpretation was expressed in a note by the Fund staff entitled "The Relationship between the Multilateral Agreement on Investment and the International Monetary Fund" (DAFFE/MAI/RD(96)35, 2 September 1996).