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IIA Issues Paper Series

The main purpose of the UNCTAD Series on issues in international investment agreements is to address key concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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Preface

The United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on a possible multilateral framework on investment, with a view to assisting developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces capacity-building seminars, regional symposia, training courses, dialogues between negotiators and groups in civil society and the preparation of a series of issues papers.

This paper is part of that series. It is addressed to government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The series is produced by a team led by Karl P. Sauvant, Khalil Hamdani and Pedro Roffe. The principal officer responsible for its production is John Gara, who oversees the development of the papers at various stages. The members of the team include S.M. Bushehri, Anna Joubin-Bret, Patricia Mira Ponton, Aimé Murigande, Cynthia Wallace and Jörg Weber. The series' principal advisers are Arghyrios A. Fatouros, Sanjaya Lall, Peter T. Muchlinski and Patrick Robinson.

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The opinions expressed are those of the author and do not necessarily reflect the views of the IMF or UNCTAD.

Rubens Ricupero
Secretary-General of UNCTAD

Geneva, July 2000

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UNCTAD has carried out a number of activities related to the work programme in cooperation with other intergovernmental organizations, including the Secretariat of the Andean Community, La Francophonie, the Inter-Arab Investment Guarantee Corporation, the League of Arab States, the Organization of American States, and the World Trade Organization. UNCTAD has also cooperated with non-governmental organizations, including the German Foundation for International Development, the Centro de Estudios Interdisciplinarios de Derecho Industrial y Económico - Universidad de Buenos Aires, the Consumer Unity and Trust Society - India, the Economic Research Forum - Cairo, the European Roundtable of Industrialists, the Friedrich Ebert Foundation, the International Confederation of Free Trade Unions, Oxfam, SOMO - Centre for Research on Multinational Corporations, the Third World Network, Universidad del Pacifico, University of the West Indies, and World Wildlife Fund International.

Funds for the work programme have so far been received from Australia, Brazil, Canada, France, Japan, the Netherlands, Norway, Switzerland, the United Kingdom and the European Commission. Countries such as China, Egypt, Guatemala, India, Jamaica, Morocco, Peru, Sri Lanka and Venezuela have also contributed to the work programme by hosting regional symposia. All of these contributions are gratefully acknowledged.

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Executive summary

By establishing a host country's obligation to permit the payment, conversion and repatriation of amounts relating to an investment, a transfer provision ensures that, at the end of the day, a foreign investor will be able to enjoy the financial benefits of a successful investment. While all of the existing multilateral agreements that liberalize and protect investment contain transfer provisions, the features of these provisions vary, depending on the overall purpose of the agreement and the scope of the other obligations that the agreement establishes. For example, the Articles of Agreement of the International Monetary Fund (the Fund's Articles) establish a general prohibition on the imposition of restrictions on payments and transfers for current international transactions. While this obligation protects the free transferability of income derived from an investment, it does not cover the transfer of the proceeds of liquidation. In contrast, the Organisation for Economic Co-operation and Development's (OECD) Code of Liberalisation of Capital Movements requires the free transfer of all amounts relating to international investments, including investments made by a non-resident in the host country, and investments made by the host country's residents abroad.

Notwithstanding these variations, all of the principal multilateral agreements permit countries to impose restrictions on transfers in circumstances where a member is confronted with a balance-of-payments crisis. However, they require that these restrictions be temporary and applied in a manner that does not discriminate among the other signatories to the agreement. These "balance-of-payments derogation" provisions reflect a recognition that, while restrictions on transfers will generally not be the preferred means of addressing balance-of-payments crises, in certain circumstances they may be necessary.

In addition to these multilateral agreements, a number of regional and bilateral investment agreements have, as their primary purpose, the protection of existing foreign investment. The transfer obligations under these agreements are comprehensive and, in many cases, detailed. With certain notable exceptions (such as

the North American Free Trade Agreement (NAFTA)), most of these agreements do not, however, allow for the imposition of restrictions on transfers for balance-of-payments reasons.

The absence of balance-of-payments derogation provisions in most bilateral and regional agreements raises the question of whether such provisions are, in fact, entirely inconsistent with the principle of investor protection, which is the overarching objective of many of these agreements. In that context, the paper discusses the various disadvantages of restrictions, including their lack of effectiveness over the long term and the negative impact they can have on a country's future access to capital markets. However, it concludes that, in certain circumstances, countries may need to rely on restrictions as a complement to their own adjustment efforts and external financial assistance. The inclusion of a balance-of-payments derogation provision in the draft text of the OECD's Multilateral Agreement on Investment (MAI) — generally regarded as a draft agreement that establishes a high standard of investment protection — demonstrates the degree of consensus that has been achieved with respect to this issue.

INTRODUCTION

Given their economic significance, the features of provisions dealing with the transfer of funds are the subject of considerable scrutiny when an international investment agreement (IIA) is negotiated or interpreted. From the perspective of a foreign investor, an investment can hardly be considered protected unless the host country has committed itself to permit the payment, conversion and repatriation of amounts relating to the investment in question. In the light of the importance of transfer obligations to foreign investors, a country wishing to attract investment stands therefore to benefit from the inclusion of a comprehensive and sufficiently detailed transfer provision. But a host country may also seek qualifications, the most important of which relates perhaps to the ability of the country to impose restrictions on transfers in response to balance-of-payments crises.

This paper discusses the treatment of transfers under existing international agreements and, in that context, identifies issues that are of particular relevance in the consideration of IIAs. As will be seen, this analysis will often transcend the developing/ developed country dichotomy. For example, given the growing importance and volatility of international capital movements, developed countries cannot be considered immune to severe balance-of-payments crises, as has been borne out by the experience of the past several years. While the imposition of exchange restrictions may normally not be the preferred response to such a crisis, a country facing a sudden and severe depletion of foreign exchange reserves arising from massive capital outflows cannot rule out the possibility of imposing such restrictions for a temporary period while corrective economic policies take hold. Any IIA therefore needs to address this contingency, irrespective of the stage of development of its signatories.

The paper is organized as follows. Section I identifies the key issues that arise in the design of a transfer provision. Section II analyses the treatment of transfers under existing international agreements. While the first part of this section discusses the treatment of transfers under existing multilateral agreements, the second

part analyses the transfer provisions of those bilateral and regional agreements whose primary purpose is that of protecting existing investment and, in some cases, admitting new investment. Drawing on the comparative analysis set forth in section II, section III identifies the important relationship between transfer provisions and the other provisions of international agreements. Finally, section IV analyses the most important economic policy issues that need to be addressed when considering the design of a transfer provision, namely the existence and scope of a derogation provision that, among other things, allows a country to impose restrictions when confronted with a balance-of-payments crisis.

Section I

EXPLANATION OF THE ISSUE

As noted in the Introduction, the primary purpose of a transfer provision is to set forth a host country's obligation to permit the payment, conversion and repatriation of the funds that relate to an investment. The key issues that arise in the design of a transfer provision can be divided into two categories. The first category relates to the scope of the general obligation undertaken by the host country; this category includes issues relating to the types of transfers that are covered by the transfer provision and the nature of the obligation that applies to these transfers. The second category relates to the principal exceptions and qualifications to this general obligation, the most important of which relate to a derogation for economic reasons.

A. Scope of the general obligation

1. Types of transfers covered

The types of transfers protected under an agreement largely depend on the type of investments covered and the nature of the obligations that apply to these investments.

With respect to the different types of investments, if an agreement only covers *inward* investment (i.e. investment made in the host country by investors of foreign countries), the transfers covered typically include funds that are needed to make the initial investment by the foreign investor and the proceeds of any such investments, including profits and the proceeds of any sale or transfer. These are the types of transfers that are of primary importance in most bilateral and regional investment agreements. However, if an agreement also covers outward investment (i.e. investment made in other countries by the nationals or residents of the home country), it typically also covers funds needed by such nationals to make such outward investment. As will be discussed in this

paper, the requirement to allow for outward transfers by both foreign investors and the country's own investors (which is provided for in some multilateral agreements) can have important foreign exchange implications for the host country.

Regarding the nature of the obligations that apply to these investments, differences in this area have an important impact on the scope of the transfers covered. For example, if an agreement covers the admission of a *new* investment (which is not the case with most bilateral agreements), the transfers protected typically include inward transfers needed to make the initial investment. In addition, a key question is the extent to which the agreement establishes obligations regarding the treatment of *existing* investments. For example, while the OECD Capital Movements Code[1] establishes obligations regarding the ability of a foreign investor to liquidate an investment, many bilateral and regional agreements also establish obligations regarding the way a host country treats an investment prior to liquidation. Thus, for example, where an agreement requires compensation for destruction of an investment as a result of civil strife, such compensation would be covered by the transfer provision.

2. Nature of the obligations

The obligation that applies to transfers is normally of an absolute rather than of a relative nature. This distinguishes it from the national treatment obligation that normally applies to the admission and treatment of investment. Specifically, while the latter obligation ensures that foreign investors are treated no less favourably than a host country's own nationals, the transfer obligation may actually provide the foreign investor with preferential treatment, as is the case with other investment protection obligations (e.g. expropriation).

With respect to the various elements of the obligation, the transfer obligation requires the elimination of restrictions not only on the ability of an investor to receive and repatriate amounts relating to investments, but also on the ability of the investor to convert the currency prior to repatriation. Key issues in this area relate to the type of foreign currency that the investor is entitled to convert into and the applicable rate of exchange.

B. Exceptions

Perhaps the most critical issue that arises in the design of a transfer provision in IIAs is whether or not a qualification to the general obligation described above needs to be made that effectively excuses the host country from performing its obligations on the basis of its economic circumstances. While multilateral agreements generally provide for such a derogation, most regional and bilateral agreements do not, out of a concern that these qualifications would undermine the principle of investor protection, which is the overriding objective of most of these agreements.

The principal economic derogation provisions can be divided into two categories. The first sets forth the conditions under which a host country can impose *new* restrictions on a temporary basis for reasons relating to balance of payments and macroeconomic management ("temporary economic derogation"). The second category permits the host country to maintain *existing* restrictions that would otherwise not be permitted, on the grounds that the economy of the host country is not yet in a position to eliminate these restrictions ("transitional provisions").

1. Temporary derogation

Any discussion of the merits of a temporary derogation provision must begin with an analysis of the economic costs and benefits of liberalization. Over the years, the global economy has benefited from the global transfers of savings that have been associated with the growth of international investment flows. For economic policy makers, however, the expansion of international investment has presented new challenges. The volatility of certain types of capital flows, in particular, can be disruptive in a number of respects. Large surges of *capital outflows* can exacerbate a country's balance-of-payments problems by making it more difficult for the country to implement adjustment policies that are designed to correct the underlying problem. Surges in *capital inflows* can also complicate the tasks of policy makers, particularly where the inflows are of a short-term nature.

In circumstances in which a country that has eliminated restrictions on a broad range of investments is confronted with the type of crises discussed above, the extent to which restrictions on transfers can play a constructive role in the resolution of these crises is limited for a number of reasons. First, one of the dangers of such restrictions could be that a country facing a crisis may rely upon them as a substitute for policy adjustments, which will often be necessary in the light of the new external environment. Second, the imposition of restrictions by a country that has benefited from access to international capital markets may jeopardize such access in the future or, at a minimum, make it more expensive. Moreover, there is a risk that it may have contagion effects in other emerging markets and contribute to an intensification of a crisis. Third, when restrictions are imposed in an economy that has grown accustomed to the free movement of capital and where, accordingly, capital markets are relatively well developed, controls will have limited effectiveness, since they will quickly be circumvented through sophisticated techniques of financial engineering.

Nevertheless, there may be circumstances where the temporary reliance on restrictions may be necessary. As will be discussed in this paper, the resolution of balance-of-payments problems normally requires both the implementation of appropriate adjustment policies and external financing. However, there may be situations in which, for example, outflows are so large that the extent of adjustment required and the magnitude of the official financing needed far outstrip both the adjustment capacity of the country and the amount of external financing that can be obtained. In these circumstances, and as evidenced in most multilateral agreements, there may be a need to impose restrictions on a temporary basis while economic adjustment efforts take hold.

Given the limited — but important — role that restrictions on transfers may play, care must be taken to ensure that any temporary derogation provision carefully circumscribes the conditions under which new restrictions may be imposed. Most derogation provisions contain some mechanism to ensure that the restrictions are of a temporary basis and also require that restrictions be of a non-discriminatory nature. As will be discussed, whether restrictions

may be permitted to apply to certain transfers but not to others raises a number of complex issues, given the fact that, in the midst of a crisis, a country may not have the capacity to make such distinctions.

2. Transitional provisions

The temporary derogation issues discussed above are of particular relevance for countries that have already liberalized foreign investment but need to maintain adequate flexibility regarding the temporary reimposition of restrictions in times of a balance-of-payments or macroeconomic crisis. However, multilateral agreements also contain provisions that allow a host country to maintain restrictions that are in place upon its accession to an agreement. These provisions are normally designed to address situations in which a host country's economy may not yet be prepared for full liberalization and where the continued maintenance of restrictions may, in fact, contribute to macroeconomic and balance-of-payments stability.

In the light of the purpose of these provisions, one of the critical questions is whether the protection provided by such provisions should, in fact, be transitional. In other words, should a country be required to phase out these restrictions once the economic weaknesses that justified them disappear? As will be seen, multilateral agreements differ in this regard.

Note

1 Unless otherwise noted, all instruments referred to here are contained in UNCTAD, 1996 or 2000.

Section II

STOCKTAKING AND ANALYSIS

A. Multilateral agreements

1. The Articles of Agreement of the International Monetary Fund

The Articles of Agreement of the International Monetary Fund (the "Fund") (IMF, 1976) constitute an international treaty and the Fund's charter. As will be seen, while the obligations established under the Fund's Articles serve to liberalize investment flows in a number of important respects, it is not an international investment agreement as such.

Although the Fund's Articles enumerate a number of purposes for the Fund, two of them are of particular relevance for this paper:

- The establishment of a multilateral system of payments in respect of current transactions between members of the Fund and in the elimination of exchange restrictions which hamper the growth of world trade (Article I(iv)).
- The provision of financial assistance to Fund members so as to enable them to resolve balance-of-payments crises without resorting to measures destructive of national or international prosperity (Article I(v)).

These two purposes should be viewed as self-supporting. Specifically, by providing financial support to a member that is adopting appropriate measures to resolve its balance-of-payments problems, the Fund reduces the need for the member to rely on exchange restrictions as a means of responding to the crisis in question. Indeed, as will be discussed, the relationship between external financial support and exchange restrictions is a key issue when considering the design of a transfer provision within IIAs.

To enable the Fund to achieve the purpose of establishing a multilateral system of current payments, the Articles establish obligations that must be observed by all Fund members, while also providing for specific exceptions to these obligations. The most relevant of these obligations and exceptions are described below.

a. Restrictions

Under Article VIII, Section 2(a), of the Fund's Articles, members may not, absent Fund approval, "impose restrictions on the making of payments and transfers for current international transactions" (IMF, 1976). For purposes of understanding the extent to which this obligation serves to protect transfers relating to foreign investments, the following observations may be made with respect to its meaning.

- "*Current*". As defined in the Articles, payments arising from "current" transactions include not only payments relating to trade and services but also a number of investment-related payments. Specifically, they include: all income arising from investments, including interest on loans and other debt instruments, net of any income tax that may be levied by the country from which the payment is to be made; and a "moderate amount" for amortization of the principal of loans (or other debt instruments) or for the "depreciation of direct investments" (Article XXX(d)) (IMF, 1976). Accordingly, investment-related payments that fall outside the Fund's definition of current payments (and, therefore, are not subject to a member's obligations) include payments arising from the liquidation of either the original capital or any capital appreciation. Indeed, Article VI, Section 3, of the Articles specifically provides that members are free to impose restrictions on capital transfers.
- "*International transactions*". The meaning of the term "international transactions" derives from the Fund's mandate regarding the balance of payments of its members. Since the transactions that affect a member's balance of payments are normally those entered into between residents and non-residents, it is these transactions that are treated as "international" for purposes of this obligation. Since the foreign

affiliate of a foreign investor is considered a resident of the host country where it is incorporated, this definition has important implications with respect to the degree of investment protection that the Fund's Articles provide. Specifically, transactions between a foreign affiliate and other companies located in the host country (and any payments arising from these transactions) would constitute transactions between two residents and, therefore, would not be considered "international" within the meaning of this provision. However, the repatriation of profits by the foreign affiliate to its non-resident parent firms would be "international" within the meaning of the Fund's Articles.

- "*The making of payments and transfers*". By covering the "making of payments and transfers" relating to current international transactions, this obligation embraces two different circumstances. First, members are not permitted to restrict a resident from making a current "payment" to a non-resident. Second, in circumstances where this payment is made within the jurisdiction of the resident, the member may not restrict the non-resident from making a "transfer" of the proceeds of this payment from the jurisdiction in question. It is important to note, however, that in both of these cases the obligation only extends to *outward* payments and transfers relating to investments. Since this provision applies to the "making" — but not the "receipt" — of current payments and transfers, members are free to restrict their residents from receiving payments and transfers from non-residents. Accordingly, while this provision protects the ability of a non-resident to repatriate certain proceeds of an investment, it does not ensure that the non-resident can execute payments and transfers associated with the making of investments, i.e. it does not liberalize *inward* payments and transfers associated with the making of new investments.

- "*Restriction*". The type of international current payments and transfers covered by this provision having been identified, the final issue relates to the nature of the obligation that extends to these payments. The key principles may be summarized as follows.

First, any governmental action, whether of a formal or informal nature, that impedes the making of current international payments and transfers constitutes a restriction. Thus, even if payments and transfers are permitted, a governmental measure gives rise to a restriction if it increases their cost or subjects them to an unreasonable burden or delay.

Second, limitations on the ability of a resident or non-resident, as the case may be, to purchase foreign exchange for the purpose of making the payments or transfers in question constitute a restriction. For this purpose, the type of foreign exchange that must be made available has generally been understood as including either the currency of the non-resident or a currency that the non-resident can readily convert into its own currency.

Third, limitations imposed on the ability of residents to enter into underlying current transactions generally do not constitute restrictions. Thus, for example, a member is free under the Articles to impose restrictions on the making of imports. Moreover, if it does impose such a prohibition, it may also restrict the making of any payments and transfers associated with the import since the Articles do not require members to permit payments and transfers associated with illegal transactions. The application of the above principle has the consequence that, as a general rule, a member wishing to restrict the availability of foreign exchange for balance-of-payments reasons may do so under the Articles as long as the restriction is imposed on the underlying transaction rather than the payment and transfer. Accordingly, it has been the *nature* of the measure (i.e. whether it is a trade measure, which limits the underlying transaction, or an exchange measure, which limits payment or transfer) rather than the *purpose* or the *effect of the measure* that is determinative.

Fourth, the concept of a restriction requires the imposition of a governmental measure upon a third party. Thus, if a Government defaults on its own external obligations (e.g. it fails to make interest payments on a loan to which it is

a party), this action is considered proprietary rather than governmental in nature and, therefore, does not give rise to a restriction.

b. Multiple currency practices

Under Article VIII, Section 3, of the Articles (IMF, 1976), members are prohibited engaging in "multiple currency practices". This obligation provides an important form of investment protection in that it generally provides that the rate at which a resident and a non-resident purchase foreign exchange when making a payment or transfer may not, as a result of governmental action, deviate significantly from any market rate that prevails in the country in question.[1] However, members' obligations regarding multiple currency practices under the Fund's Articles are limited in at least two important respects.

First, as noted above, the Articles provide that members may impose restrictions on capital transfers. In the light of this provision, members have been permitted to impose official rates for foreign exchange transactions that are associated with capital payments and transfers. Thus, applying the definition of "current payments" contained in the Articles, while the authorities would be precluded from establishing a special exchange rate for the repatriation of profits, they would be free to impose a special rate for the repatriation of the original capital or capital appreciation.

Second, members are only precluded from establishing a special rate for certain current payments in circumstances in which the exchange rate for other current payments is, in fact, a legal rate. The authorities are not required to ensure that the exchange rate offered corresponds to an illegal black market rate. Accordingly, if the authorities establish an official exchange rate that is required to be utilized for exchange transactions associated with all current payments and transfers, that rate will not give rise to a multiple currency practice even if the official rate is not determined by market forces.

c. Transitional arrangements

When the Articles of Agreement entered into force in 1944, most of the original members were not in a position to adhere to the above obligations because of severe weaknesses in their balance of payments. For example, the Exchange Control Act of the United Kingdom, enacted in 1948, imposed comprehensive controls on current international payments and transfers. So as to enable the Fund to be an organization of broad membership, the drafters of the Articles provided for transitional arrangements that enabled members to "maintain and adapt to changing circumstances" exchange restrictions and multiple currency practices in existence at the time of membership that would otherwise be subject to the Fund's jurisdiction (Article XIV, Section 2) (IMF, 1976). It was only in the late 1950s and early 1960s that most of the Fund's original European members were in a position to eliminate measures that were protected by these transitional provisions. The process of liberalization has quickened over the past ten years for all other members: of the Fund's 182 members, only 34 continue to maintain restrictions under the transitional arrangements.

It should be noted that the transitional provisions differ in important respects from the "standstill" of "grandfather" provisions that are often found in other multilateral agreements. For example, the obligation does not require a strict standstill since the relevant provision allows the member to "adapt to changing circumstances" restrictions that were in place when it became a member. This provision has been interpreted as allowing a member to relax, intensify or vary a restriction that it already applies to payments and transfers of a particular current international transaction. The imposition of a restriction on previously unrestricted payments and transfers would not be an "adaptation" and would therefore not be protected by the transitional provisions.

In a different respect, however, the Fund's transitional provisions are less generous than the typical standstill or grandfather provision. Specifically, the period of time during which a member may avail itself of these arrangements is not open-ended: Article XIV gives the Fund the authority under exceptional circumstances to make

representations to a member that conditions are favourable for the general or partial abandonment of restrictions that have been protected by these provisions. Given the purpose of the transitional arrangements, discussed above, conditions would be favourable when the Fund is of the view that the member's balance of payments is sufficiently strong that continued reliance on the restrictions is no longer justified. [2]

d. Temporary balance-of-payments derogation and financial assistance

The second principal exception to the general obligations described above is the provision of the Fund's Articles that permits members to impose new restrictions with the prior approval of the Fund. The criteria for approval are not set forth in the Articles themselves. Rather, as in many other instances, the criteria have been developed through the adoption of "approval policies" by the Fund's Executive Board. Under the Fund's principal approval policy, exchange measures that have been imposed for balance-of-payments reasons will be approved if they are temporary and do not discriminate among Fund members. The requirement that the measure be temporary (approval is normally granted for up to a one-year period) is designed to ensure that members do not rely on exchange restrictions as the principal means of addressing balance-of-payments difficulties. Rather, if the problem is not one that will automatically correct itself within a short period of time, members are expected to introduce the necessary macroeconomic, exchange rate or structural adjustment policies that will address the underlying causes of the difficulties. However, since such policy measures may take some time to take hold, it is recognized that reliance on exchange restrictions may be necessary for an interim period. Regarding the criterion of non-discrimination, this is dictated by the mandate of the Fund to promote a multilateral — rather than regional or bilateral — system of payments and transfers.

Perhaps the design of the Fund's approval policy can be best understood in the context of the policies it applies regarding the use of its financial resources. As noted earlier, the Fund's financial assistance enables members to reduce their reliance on exchange

restrictions. It does so in two ways. First, the Fund's resources normally support an economic adjustment programme that is designed to address a balance of payments problem. Second, the foreign exchange provided by the Fund can assist members in dealing with their external problems, either by reducing the size of the balance of payments deficit or by building up the member's foreign exchange reserves, or both. Although the amount of assistance actually provided by the Fund may be relatively modest in comparison with the member's needs, the fact that the Fund is supporting an economic adjustment programme is intended to "catalyse" financial assistance from other sources. In some cases, however, the size of the problem is such that the combination of external financing and strong economic adjustment may be insufficient to enable the member to weather the immediate crisis. It is in these circumstances that temporary exchange restrictions may be necessary. Unless these restrictions are imposed on a non-discriminatory basis, however, it may prove difficult for a member to receive adequate financing from a broad range of sources. As will be discussed in Section IV, these principles are also of relevance when considering the possible design of a temporary balance-of-payments derogation provision under IIAs.

2. The OECD Liberalisation Codes

Under the OECD Convention, OECD members are required to "pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and maintain and extend the liberalisation of capital movements" (Article 2(d)) (United Nations, 1960). As a means of implementing this obligation, the OECD has adopted two legally binding codes, the Code of Liberalisation of Capital Movements (the "Capital Movements Code") and the Code of Liberalisation of Current Invisible Operations (the "Current Invisibles Code") (collectively, the "OECD Codes"). Taken together, these two Codes serve to liberalize a broad range of transfers relating to investments. As a means of understanding the scope and nature of the Codes' transfer provisions, it is useful to take into consideration the following general features of these instruments.

From an investment perspective, the scope of coverage of the OECD Codes is considerably broader than that of the Fund's Articles and, in some respects, also broader than the typical foreign investment agreements discussed in the following subsection. First, the transfer provisions of these Codes, taken together, cover all proceeds of investments, unlike the Fund's Articles. Second, the Capital Movements Code requires the liberalization not only of the proceeds derived from an investment but also of the making of the investment itself. In this important respect, therefore, the Capital Movements Code serves not only to protect existing investment but also to liberalize the admission of new investment. As will be seen, many of the bilateral and regional agreements discussed in the next subsection do not cover admission. Third, the investment liberalization obligations of the Capital Movements Code extend not only to the ability of non-residents to make investments in a host country, but also to the ability of a country's residents to make investments abroad. In this latter respect, the liberalization obligations of the Capital Movements Code are also broader than the typical foreign investment agreements discussed in the next subsection, which only liberalize inward investments and, accordingly, allow host countries to retain control of the outward investments — and related transfers — of their own residents.

Notwithstanding the broad scope of the OECD Codes, they are limited in one important respect: as with the Fund's Articles, they focus exclusively on transactions and transfers between residents and non-residents, i.e. cross-border investments. Thus, while the Capital Movements Code and the Current Invisibles Code serve to enable a non-resident to establish a foreign affiliate in a host country and also ensure that the profits and capital of the affiliate can be repatriated to the parent firm, they do not establish obligations regarding the ongoing treatment of foreign affiliates, i.e. they do not create what are generally referred to as "post-establishment" obligations, obligations that are considered a critical feature of investment protection. As will be discussed in the next subsection, such obligations are normally found in IIAs and also shape the design of the transfer obligations found in these agreements.

a. The scope of the transfer obligations

Given the comprehensive coverage of the OECD Codes, as described above, the scope of the transfer obligations in these agreements is very broad. These obligations may be summarized as follows:

- With respect to investments made by a non-resident, the Capital Movements Code requires that members permit the non-resident to transfer from abroad the funds that are necessary to make such investments. As noted in the previous section, the Fund has no jurisdiction over such inward transfers.

- Regarding the outward transfer of amounts that a non-resident has earned on investments made in the territory of a member, the Current Invisibles Code covers all income arising from such investments (including dividends, interest and royalties and fees arising from licensing agreements involving intellectual property rights). The Capital Movements Code covers all other amounts, i.e. the original capital, capital appreciation and all principals on loans.

- Since the Capital Movements Code liberalizes the making of investments by residents abroad, it requires that residents be permitted to transfer abroad the amounts that are necessary to make these investments. As noted above, such transfers are covered under neither the Fund's Articles nor the foreign investment agreements discussed in the next subsection.

Although the types of transfers that are covered under the OECD Codes are considerably broader than those covered by the Fund's Articles, the principles that apply for purposes of determining when a transfer is restricted are similar. Thus, as under the Fund's Articles, the obligation to permit a transfer includes the obligation to avoid restricting the availability of foreign exchange

that is needed for that purpose. Moreover, even if the transfer is not prohibited, a restriction arises if a governmental measure causes unreasonable delay, costs or other constraints on the making of the transfer. As under the Fund's Articles, members may maintain controls for the purpose of verifying the authenticity of the transfer or to otherwise prevent the evasion of their laws and regulations. Thus, for example, members may require that transfers be made through authorized agents and may also impose withholding taxes on payments to non-residents. Finally, proprietary measures (i.e. limitations that the government imposes on transfers relating to its own transactions with non-residents) are excluded.

Although the OECD Codes cover both underlying transactions and associated transfers, the nature of the obligation that applies to these two different operations is not identical. With respect to underlying transactions, the principal obligation is essentially that of national treatment, i.e. while the authorities may restrict transactions, they may not do so if the restriction results in transactions among residents being treated more favourably than transactions between residents and non-residents. Thus, while the authorities may, for example, prohibit the issuance of commercial paper in the domestic market generally, they may not permit such issuances to resident purchasers but restrict sales to non-residents. In the case of transfers, however, such a relative standard is not applied. Even if the authorities impose an across-the-board limitation on the availability of foreign exchange that serves to restrict all types of transfers (whether made by residents or non-residents), this non-discriminatory exchange restriction still gives rise to a restriction on transfers to the extent that it actually limits, for example, the transfer of the proceeds of a non-resident's investment abroad.

b. Reservations

Similar to the approach followed under the Fund's Articles, the OECD Codes permit members to maintain restrictions, including restrictions on transfers, that were in existence when the country became a member of the OECD. Such restrictions are grandfathered through "reservations" that are lodged by the country upon membership. These reservations are subject to periodic "peer reviews"

which are designed to promote their progressive elimination. After a country's admission to the OECD, new restrictions on most transactions and transfers may only be imposed in certain circumstances (discussed below). However, restrictions on certain transactions (and their related transfers) may be imposed at any time through the lodging of reservations. These latter transactions are currently limited to financial operations that are considered short-term in nature, including money market and foreign exchange operations, negotiable instruments and non-securitized claims and financial (non-trade-related) credits. The generous treatment of these transactions is attributable to their volatility and, accordingly, their potentially adverse impact on the macroeconomic and balance-of-payments stability of OECD members.

c. *Temporary derogation*

As noted above, new restrictions may only be imposed on most items in specified circumstances. Consistent with the policies developed by the Fund under its Articles, the OECD Codes provide that members may impose restrictions "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" (Article 7(c) of both of the OECD Codes) (UNCTAD, 1996, vol. II). However, unlike under the Fund's Articles, restrictions do not require approval by the relevant organ (in this case the Council) before they are imposed. Rather, the OECD Codes provide that a member may take the initiative to introduce restrictions for balance of payments reasons, but that they must be promptly notified to the OECD, where they are examined. Continued maintenance of these restrictions requires a decision by the Council based on an evaluation of whether the member is taking adequate economic adjustment measures to address the underlying balance-of-payments problems.

Another important difference between the temporary derogation provisions under the Capital Movements Code and the approval policies of the Fund is that derogation under the Capital Movements Code also applies to inward transfers. As noted

above, unlike the Fund's Articles, the Capital Movements Code requires that a member permit non-residents to make investments in its territory and, in that context, to permit all inward transfers associated with such investments. As has been recently demonstrated, in some cases large surges of capital inflows may complicate the task of exchange-rate and macroeconomic management. In particular, if a member's exchange rate and interest rates are broadly appropriate, a large surge in capital inflows may involve disruptive adjustments that are inconsistent with longer-term stability. In these circumstances, restrictions on capital inflows may be justified. The ability of countries to impose restrictions on such capital inflows is covered under Article 7(b) of the Capital Movements Code, which allows for the temporary imposition of controls if the liberalized operation in question results "in serious economic and financial disturbance" not caused by balance-of-payment difficulties (UNCTAD, 1996, vol. II).

Because the Capital Movements Code, unlike the Fund's Articles, covers both underlying transactions and associated transfers, the scope of the temporary derogation is not limited to restrictions imposed on transfers; it also covers measures that restrict the underlying transactions. The coverage of underlying transactions is particularly necessary in the case of inflows, where restrictions are normally imposed at that level. For example, if the authorities wish to restrict inflows arising from the acquisition by non-residents of domestic securities, they will normally restrict the actual purchase of the securities (the underlying transaction). They will generally avoid permitting the non-resident to enter into the transaction but then restrict the ability of the non-resident to transfer the funds necessary to make the payment.

As in the case of the Fund's Articles, the OECD Codes provide that any restrictions imposed by a member be applied in a manner that does not discriminate among other signatories to the treaty. It should also be noted that the OECD Codes provide that "Members shall endeavour to extend the measures of liberalization to all members of the International Monetary Fund" (Article 1(d) of both the OECD Codes) (UNCTAD, 1996, vol. II).

3. The General Agreement on Trade in Services

The General Agreement on Trade in Services (GATS), which entered into force on 1 January 1995, is a multilateral agreement that focuses on the liberalization of trade in services. Nonetheless, given the broad range of services covered under the agreement, it has the potential to liberalize investments and, in that context, also serves to protect the transfers associated with such investments.

More specifically, one of the "modes of delivery" covered under the GATS is the cross-border supply of services. Since the GATS covers financial services, liberalizing the supply of cross-border services liberalizes investments in those cases in which the investment is an integral part of the service itself. For example, to the extent that a member restricts its residents from borrowing from non-residents, a member's commitment to allow banks of other members to provide cross-border lending services to its nationals would require a relaxation of this restriction. Similarly, if a member also makes a commitment to permit non-resident banks to provide cross-border deposit services, such a commitment would require the member to liberalize restrictions it may have imposed on the ability of residents to hold accounts abroad. In these respects, the GATS serves to liberalize the making of both inward and outward investments.

A second "mode of delivery" covered under the GATS involves the "establishment" of a commercial presence by a foreign service provider in the territory of a member. Accordingly, the liberalization of this mode of delivery could serve to liberalize restrictions on the making of foreign direct investment (FDI). In view of the broad scope of services covered under the GATS, this could be of considerable significance, given that approximately 60 per cent of FDI flows are estimated to be in service industries (UNCTAD, 1999).

Notwithstanding the breadth of its coverage, the structure of the GATS is such that the extent to which investments and their associated transfers are actually covered depends on the outcome of negotiations. The GATS is a framework agreement, attached

to which are schedules negotiated individually with each member and setting forth the extent to which it commits itself to liberalizing a particular industry. Under this approach, a member only makes a commitment with respect to a service industry if it has made a "specific commitment" with respect to the industry in its schedule. This approach contrasts with that of the Fund and the OECD Codes, where members incur obligations with respect to all transactions and payments and transfers covered, but find protection through transitional arrangements (in the case of the Fund) or reservations (in the case of the OECD Codes).

a. Scope of payments and transfers covered

The GATS provides that, subject to important exceptions (discussed below), members must refrain from imposing restrictions on international payments and transfers associated with the current and capital transactions that are covered by the specific commitments made by that member. Given the coverage of the cross-border trade in services described in the previous section, this rule would serve, for example, to liberalize both the interest and principal portion of loan repayments made by a consumer to a foreign bank. Moreover, both inward and outward transfers relating to the service committed are covered where the cross-border movement of capital is an essential part of the service itself. Thus, a member must permit the non-resident bank to disburse the amount it has agreed to lend to a local consumer; the consumer must also be free to transfer the amounts it wishes to deposit with a non-resident bank.

Regarding commitments made with respect to trade in services through establishment, the member is obligated to allow all related inflows of capital into its territory that are necessary to enable the enterprise to establish a commercial presence. However, regarding the treatment of outflows arising from the activities (e.g. repatriation of profits or liquidation of the enterprise), a determination of whether a restriction on such inflows would be precluded depends on whether they would be considered "inconsistent" with the commercial presence commitment. Although there has been no formal interpretation of this provision in that context, there do not appear to have been such restrictions on scheduled commitments to date.

b. Derogation and relationship with the Fund's Articles

When the GATS was negotiated, it was recognized that any derogation for restrictions imposed on payments and transfers would need to take into consideration members' rights and obligations under the Fund's Articles so as to ensure that the two treaties did not give rise to conflicting rights and obligations for a very similar (i.e. almost universal) membership. As a consequence, the relevant provisions of the GATS (Articles XI and XII) respect both the Fund's jurisdiction and its mandate in the area of balance of payments assessment. Although these provisions have never been the subject of authoritative interpretation, their substance can be summarized as follows.

First, regarding restrictions on current payments and transfers, Article XI of the GATS ensures that the exercise by a member of its rights under the Fund's Articles to impose or maintain such restrictions does not give rise to a breach of a member's obligations under the GATS. Thus, if a restriction has been temporarily approved by the Fund for balance of payments reasons, or is maintained under the Fund's transitional arrangements, the restriction is automatically consistent with the member's obligations under the GATS. Conversely, the GATS is precluded from permitting a signatory to impose a restriction on a current payment relating to a commitment under the GATS if such restriction is not consistent with the Fund's Articles because, for example, it has not been approved by the Fund.

Second, with respect to derogation for restrictions imposed on capital movements, the Fund plays a more limited role, reflecting the fact that the Fund does not have approval jurisdiction over restrictions on capital payments and transfers. With one exception, discussed below, derogation for such restrictions appears to be covered under Article XII of the GATS, which sets forth the conditions upon which a member may impose restrictions "in the event of serious balance of payments and external financial difficulties or threat thereof," (UNCTAD, 1996, vol. I). As can be seen from the text of Article XII, some of these conditions are similar to the approval criteria that are applied by the Fund and under the OECD Codes

(e.g. non-discrimination and temporariness). The conditions set forth in the GATS are more numerous and detailed, however, and are clearly drafted to limit the possibility that this balance of payments derogation provision (which is designed to address a crisis in the entire economy) is used to justify restrictions that may, in fact, be imposed to protect a particular industry. Thus, while members may give priority to the supply of services that are more essential to their economic or development programmes, such restrictions are not adopted or maintained for the purpose of protecting a particular service industry.

Third, similar to the OECD Codes, but unlike the Fund's Articles, the GATS does not require that restrictions be approved before they are introduced. Rather, when a member invokes Article XII as the basis for the imposition of a restriction, it is required to notify the General Council of the WTO and to "consult" with the Balance of Payments Restrictions Committee appointed by the Council so as to give this Committee the opportunity to determine whether — and for how long — the imposition of restrictions is justified under this provision. In that context, Article XII provides that, in such consultations, all statistical findings regarding a member's balance of payments position shall be accepted; conclusions made by the Committee are to be based on the Fund's assessment of the balance of payments and external financial situation of the member.

Finally, it is unclear from the text of Article XII whether a derogation is also intended to apply to restrictions on capital inflows; the resolution of this issue will need to await a formal interpretation of the provision. As noted in the discussion of the OECD Codes, restrictions on inflows are normally imposed on the underlying transaction rather than the payments and transfers associated with such transactions. Although Article XII is clearly broad enough to cover restrictions imposed on transactions and transfers, there has not been a formal interpretation as to whether the phrase "balance of payments and external financial difficulties" (UNCTAD, 1996, vol. I) is broad enough to cover the type of macroeconomic difficulties that members experience with capital inflows.

B. Bilateral and regional investment agreements

1. General considerations

Although the transfer provisions of the agreements discussed in the previous section serve, to a greater or lesser extent, to protect investments, the primary purpose of these agreements is not the protection of investment. In contrast, investment protection is one of the central objectives (and, in some cases, the only objective) of bilateral and regional investment agreements.

As with the agreements reviewed in the previous section, the treatment of transfers under bilateral and regional investment agreements is shaped by the objectives of these agreements and, more specifically, by the other obligations that they establish. Thus, before analysing in detail the design of transfer provisions under these agreements, it is useful to highlight how the scope of these other obligations shapes the treatment of transfers.

First, these agreements normally require a host country to liberalize the full range of investments made by the treaty party's investors. However, they do not require the host country to liberalize international investments made by its own residents. Thus, these agreements serve to liberalize inward, but not outward, investments, in contrast to the OECD Codes, which liberalize both. Accordingly, they do not require the liberalization of transfers associated with such outward investments.

Second, the protection of investment provided by bilateral and regional investment agreements is not limited to the right of the investor to liquidate and repatriate the proceeds of the investment. Rather, such agreements typically establish a number of obligations regarding the manner in which a host country must treat the investment in question prior to such liquidation and outward transfer of the proceeds. Thus, while the manner in which a host country treats, for example, the operations of a foreign affiliate generally goes beyond the scope of the OECD Capital Movements Code, which focuses on cross-border investments (i.e. investments

between residents and non-residents), the standard of such treatment is the very essence of bilateral and regional investment agreements. For this reason, the latter are viewed as a particularly effective instrument for the protection of FDI, i.e. investment that involves the establishment of a local presence by the investor. As will be discussed in greater detail below, the scope of the transfer provisions of most foreign investment protection agreements specifically takes into consideration the existence of a broad array of other investment protection obligations.

Third, as in the case of the OECD's Capital Movements Code, the nature of the transfer obligation needs to be distinguished from the general national treatment obligation that applies to the general treatment of investment. Specifically, while the latter obligation ensures that foreign investors are treated no less favourably than a host country's own nationals, the transfer obligation actually provides foreign investors with preferential treatment, as is the case with other investment protection obligations (e.g. expropriation, protection from strife).

Fourth, although the scope of investment protection provided under bilateral and regional investment agreements is of particular applicability to FDI (as noted above), the scope of investment covered under most of these agreements is not technically limited to this type of investment. For example, many bilateral investment treaties contain a very expansive, asset-based definition that would include all the types of cross-border investments that are covered by the OECD Capital Movements Code.

Fifth, while bilateral and regional investment agreements typically protect investments that have already been made, only some of them establish firm legal obligations with respect to the admission of new investment, as is provided for in the OECD Capital Movements Code and, to a lesser extent, in the GATS. Thus, as will be seen, not all the transfer provisions of such agreements specifically liberalize transfers that are necessary in order to make new investments.

2. The treatment of transfers

Although the overall treatment of transfers under bilateral and regional investment agreements is shaped by the general considerations discussed above, the specific design of these provisions varies from agreement to agreement. In certain respects, these differences reflect varying drafting approaches: while some provisions express the transfer obligation in general terms, others do so in considerable detail, with an illustrative list of the type of transfers that are covered and a carefully defined convertibility obligation. As will be seen, however, the variations may also be attributable to the fundamentally different bargains that have been struck by the signatories to the respective agreements. In that regard, the key issues that arise when negotiating an investment agreement are the types of transfers to be covered; the scope of the convertibility requirement that applies to these transfers; and the nature of the limitations, exceptions and derogations that apply to the transfer obligation. Each of these issues will be discussed in turn.

a. Types of transfers protected

The types of transfers protected under the transfer provisions normally contained in bilateral and regional investment agreements may be described as falling into three general categories.

The **first category** consists of the *outward transfer of amounts derived from or associated with protected investments*. Assuming that the investment in question is covered under the agreement (some investment may be specifically excluded), a very comprehensive transfer provision will normally include:

(i) "returns" on investments, which are normally defined as including all profits, dividends, interest, capital gains, royalty payments (arising from the licensing of intellectual property rights), management, technical assistance or other fees or returns in kind;

(ii) proceeds from the sale or liquidation of all or any part of the investment;

(iii) payments under a contract including a loan agreement (including payments arising from cross-border credits) ; and

(iv) earnings and other remuneration of personnel engaged from abroad in connection with an investment.

Several comparative observations can be made with respect to the above category of transfers. First, it includes all transfers that are covered under the OECD Codes, i.e. all capital and income derived from an international investment. Second, like the Fund's Articles, it includes earnings of foreign personnel that are employed in connection with an investment. Although such transfers are clearly not "derived" from an investment (hence the use of the term "associated with an investment") their coverage is generally considered an important feature of investment protection: in the absence of such coverage, a foreign investor may not be able to attract foreign labour to be employed in connection with its investment, which could undermine its viability. Third, by including transfers "in kind", the comprehensive transfer provisions of bilateral and regional investment agreements are broader than both the OECD Codes and the Fund's Articles, which only include monetary payments.

Finally, it should be noted that, as under the Fund's Articles and the OECD Codes, a protected transfer may involve a single operation, in which, for example, the borrower situated in the host country wishes to make an international payment of interest to the foreign investor located abroad. As noted in the previous section, such an operation is described as a "payment" under the Fund's Articles. Alternatively, a foreign investor may first receive the interest payment from the borrower in the territory of the host country and then transfer the proceeds of the payment outside the territory. The subsequent repatriation of the proceeds by the foreign investor in this case is described as a "transfer" under the Fund's Articles.

The **second category** of transfer covered under transfer provisions consists of the *outward transfer of amounts arising from the host country's performance of other investor protection obligations under an agreement*. The transfers falling within this category are

outward transfers of payments that the Government of a host country is required to make to the foreign investor pursuant to other investment protection provisions contained in an agreement. If the investment agreement is comprehensive, these payment obligations consist of the following, none of which are provided for in the OECD Codes or the Fund's Articles:

(i) payments received as compensation for a host country's expropriation of the investment;

(ii) payments received as compensation for losses suffered by an investor as result of an armed conflict or civil disturbance ("protection from strife");

(iii) payments arising from the settlement of disputes; and

(iv) payments of contractual debts owed by the Government of a host country to the foreign investor.

The **third category** of transfer consists of the *inward transfer of amounts to be invested by a foreign investor*. There are, in fact, two types of inward transfers that fall into this category. The first type are those that are made for purposes of making a new investment; the second type are those that are made to develop or maintain an existing investment (e.g. increased capitalization of a foreign affiliate). Almost all foreign investment agreements cover the latter type, on the basis that the right of an investor to provide additional infusions of capital into an existing investment is an important attribute of investment protection. However, only those agreements that require the host country to admit new investments include the first type of transfers in the transfer provisions. Most bilateral investment agreements do not include such admission obligations.

b. Convertibility requirement

Under the Fund's Articles and the other agreements discussed in the previous sections, an international transfer is considered restricted if the authorities of a host country restrict either the

availability or the use of the foreign exchange that is required to make the transfer in question. Although this principle is incorporated into the transfer provisions of most investment agreements, the specific nature of the obligation tends to vary. There are two issues of particular importance in this regard.

The first issue relates to the *type of foreign currency that must be made available* for the transfer to take place. Although investment agreements generally attempt to incorporate the principle that the currency to be made available must be "freely convertible" or "freely usable", many of them fail to define what these terms actually mean. Into what currencies should foreign investors be able to convert the foreign currency that is being made available to them? Where must a foreign currency be used in order for it to qualify as a "freely usable" currency and what type of transactions are relevant for making this assessment? In order to avoid uncertainty in this regard, some agreements using the above terms have defined them by relying on the definition of "freely usable currency" contained in the Fund's Articles, namely a currency that the Fund determines is, in fact, widely used to make payments for international transactions and is widely traded in the principal exchange markets (Article XXX(f)) (IMF, 1976). Exercising the authority provided under the Articles, the Fund's Executive Board has identified the currencies that, until otherwise decided, meet this definition: the United States dollar, the Japanese yen, the British pound and the euro. Following the Fund even further in this regard, some investment agreements have actually identified these currencies as being freely usable currencies for purposes of their transfer provisions. While this approach creates a degree of certainty, it may also be too rigid given the fact that the Fund's definition of freely usable currency is not a permanent one. For this reason, the most appropriate approach may be to provide that transfers may be made available in a freely usable currency "as defined by the Fund from time to time".[3]

The second issue that arises in this area relates to the *exchange rate at which the foreign currency is to be made available at the time of the transfer.* Although most investment agreements apply the general rule that the foreign investor should be able to purchase

the necessary foreign currency at the market rate of exchange prevailing on the date of the transfer, many of them do not address the contingency that, in some cases, there may not be such a market rate. Specifically, in circumstances in which a country relies on exchange restrictions, it is possible that the Government mandates a rate of exchange for all foreign exchange transactions. Such official rates often overvalue the local currency for the purpose of subsidizing payments for certain imports and are accompanied by a surrender requirement which will force exporters to sell the foreign exchange proceeds of exports to the Government at this overvalued rate. To take into account these circumstances, some investment agreements provide that, in circumstances in which a market rate does not exist, the foreign currency must be made available at the rate prescribed under the applicable regulations in force. Going one step further, the most sophisticated transfer provisions provide for the contingency that the exchange control regulations may set forth multiple rates of exchange, with the applicable rate depending on the type of transaction involved. In these circumstances, an agreement can provide that the foreign investor receives the most favourable rate.

c. Limitations, exceptions and temporary derogation

As discussed below, the exceptions and limitations to a host country's obligations regarding transfers under an investment agreement are generally consistent with the exceptions and limitations that exist under the multilateral agreements discussed in the previous section. In most cases, however, the scope for temporary derogation is considerably narrower.

(i) Taxes

The Fund's Articles preclude a member from imposing restrictions on international payments of "net income". As discussed earlier, this has been interpreted as permitting income taxes arising from a payment to be deducted before the payment is effected. The transfer provisions of most investment agreements provide for a similar limitation, the difference being that these agreements also allow for the deduction of capital gains taxes, reflecting the

fact that, unlike the Fund's Articles, these agreements cover both capital and current payments.

(ii) Reporting and screening

The obligation to permit transfers does not require a host country to abandon measures that enable it to ensure compliance with those laws and regulations that are otherwise consistent with the host country's obligations under an investment agreement. For example, as discussed earlier, the transfer obligations of investment agreements do not preclude a host country from maintaining restrictions on the ability of its own residents to make investments abroad. Thus, when a resident seeks to purchase foreign exchange, the host country may request written evidence of the purpose of the payment before providing the foreign exchange so as to assure itself that the foreign exchange is not, in fact, going to be transferred by the resident for the purpose of making its own outward investment (e.g. the making of a deposit in an offshore bank account). While these and other types of reporting and screening requirements are generally permitted under investment agreements, comprehensive agreements also contain language to the effect that such reporting requirement should not give rise to "undue delays" in the making of transfers and should otherwise not be used by a host country as a means of avoiding the transfer obligations set forth in the agreement.

(iii) Adjudicatory proceedings and enforcement of creditor rights

The transfer provisions of many investment agreements provide that transfers may be restricted to satisfy judgements arising from adjudicatory proceedings in a host country or as a means of protecting creditor rights. What type of situations are these exceptions to the general transfer obligation trying to address? With respect to adjudicatory proceedings, a foreign investor may become the defendant in civil, administrative or criminal proceedings within a host country and, if these proceedings result in the issuance of a monetary judgement against the investor, the proceeds of

amounts derived from the foreign investor's investments may be attached and, in those circumstances, the investor would be restricted from making the necessary transfer. In this situation, the above-described exception enables the host country to effect such an attachment without violating its transfer obligation.

Regarding the protection of creditor rights, the primary purpose of this second exception is to ensure that the operation of a host country's insolvency laws does not give rise to a breach of the host country's transfer obligations. For example, if a host country's liquidation or reorganization laws are activated with respect to a local company (as a result of a petition filed by a creditor or by the debtor), all assets of the company may be frozen, including amounts that the company may owe to a foreign investor (e.g. payment on a loan). Not only do the insolvency laws restrict the making of such payments, but also they may give the administrator of the insolvency proceedings the authority to nullify earlier payments that may have been made to the extent that, for example, such payments are considered to have unfairly benefited the recipient at the expense of other creditors.

The above exceptions are often qualified by a proviso that states that these measures must result from the non-discriminatory application of the law. In some respects, this proviso may be considered unnecessary since restrictions that are exempted under this provision must still satisfy the general obligation of national treatment that would still apply to these restrictions.

(iv) Temporary derogation

A notable feature of the agreements discussed in the previous section is that they all contain provisions that specifically allow for the imposition of restrictions on transfers in circumstances in which a host country is confronted with a balance-of-payments crisis. In contrast, most bilateral and regional investment agreements do not contain such provisions. For example, only a very small proportion of the nearly 1,800 bilateral investment treaties in existence specifically allow for temporary balance-of-payments derogation.

Of the regional agreements in force, only the North American Free Trade Agreement (NAFTA) contains such a provision. The general absence of temporary balance of payments derogation provisions may be attributable to the general perception that these agreements are generally designed to protect FDI. Since this type of investment is generally not volatile, signatories may therefore not view temporary balance of payments derogation as being a necessary safeguard. Two observations can be made regarding this explanation. First, irrespective of the primary purpose of bilateral investment agreements, their definition of investment is typically broad enough to include investments other than FDI. Second, as will be discussed in the next section, when a country is forced to impose restrictions in the context of a balance of payments crisis, it will find it difficult to exclude — at least at the outset of the crisis — any form of transfer from the restrictions, including transfers associated with inward FDI.

The balance-of-payments derogation provision of NAFTA is relatively elaborate and, when compared with the provisions contained in the agreements discussed in the previous section, is noteworthy in at least two respects.

First, the type of treatment provided under the derogation provision of NAFTA varies according to the type of transfer restricted. Specifically, if the restriction is imposed on transfers relating to *financial services* (which, as noted in the discussion of the GATS, can give rise to investments), the restriction must be temporary, non-discriminatory and consistent with the Fund's Articles. Accordingly, if it falls under the Fund's jurisdiction but is not approved by the Fund, it will not qualify for derogation. However, if it is imposed on transfers relating to any other type of investment covered under NAFTA, it only qualifies for derogation if it satisfies additional criteria. The more generous treatment afforded to restrictions imposed on transfers relating to financial services is attributed to the fact that the financial flows associated with such services (e.g. interbank deposits), being more volatile, may be more destabilizing from a balance of payments perspective. Accordingly, it was considered appropriate for the signatories to have greater latitude regarding their ability to impose restrictions on these measures.

Second, in one important sense, the degree to which NAFTA relies on the Fund is broader than either the GATS or the OECD. Specifically, if a restriction meets the criteria described in the previous paragraph, NAFTA also requires that the host country "enter into good faith consultations with the IMF on economic adjustment measures to address the fundamental underlying economic problems causing the difficulties; and adopt or maintain economic policies consistent with such consultations" (Article 2104(2)(b) and (c) (NAFTA, 1993). Since consultations regarding an adjustment programme normally take place in the context of a member's request for the use of the Fund's financial resources, NAFTA relies not only on the Fund's jurisdiction but also its financial powers. The Fund's role in this area will be discussed further in the next section.

Notes

1 Pursuant to a decision of the Fund's Executive Board, a multiple currency practice only arises if the action by a member or its fiscal agencies, in and of itself, gives rise to a spread of more than 2 per cent between the buying and selling rates for spot exchange transactions between the member's currency and any other member's currency (see Decision No. 6790-(81/43), adopted on 20 March 1981, as amended (IMF, 1999)).

2 It should be noted that the failure by a member to act upon such a representation by the Fund would not give rise to a breach of obligation under the Articles and, therefore, could not result in compulsory withdrawal from the Fund. However, the Articles specify that a member's failure to take such action can result in the Fund declaring the member ineligible to use the Fund's financial resources (Article XIV, Section 3).

3 While the transfer provisions of many investment agreements rely on the Fund's concept of freely usable currency, this concept is not, in fact, relied on by the Fund for the application of its own transfer provision. As was noted earlier, under the Articles the emphasis is on the non-resident's own currency; more specifically, a member imposes a restriction on a current international payment or transfer if it restricts the non-resident from transferring either its own currency or a currency that the non-resident can readily convert into its own currency. In contrast, the concept of freely usable is relied on by the Fund for other, unrelated purposes.

Section III

INTERRELATIONSHIPS

As has been demonstrated in the previous section, the treatment of transfers under existing international agreements is largely shaped by the overall objectives of an agreement and, more specifically, by the design of the other obligations that it establishes. As a means of distilling these relationships, it is possible to identify two categories of provisions that directly affect the treatment of transfers: provisions that specify the type of underlying investments that are to be covered under the agreement; and provisions that specify the nature of the obligations that will apply to these investments.

A. Types of investments

As has been illustrated by the review of the relevant agreements in the previous section, an investment agreement protects a transfer if the transfer in question is associated with an underlying investment that is covered under the agreement. Thus, for example, if the types of investment that are required to be admitted and/or protected only include direct investment, transfers relating to other types of investment do not benefit from protection under a transfer provision.

The scope of the transfer provision also depends on whether an agreement covers both inward and outward investment. One of the important features of the bilateral and regional investment agreements discussed in the previous section is that they only establish obligations with respect to a host country's treatment of *foreign* investors (i.e. investors of other signatories). In contrast to the OECD Capital Movements Code, they do not set forth obligations with respect to a country's treatment of its own investors. From a developing country perspective, this limitation can be an important one. Specifically, one of the principal reasons why many developing countries enter into investment agreements is to obtain the foreign exchange that accompanies such investment. Since a commitment that permits foreign investors to repatriate the proceeds of their investments is a necessary means of attracting such investment,

a host country is normally willing to relax its exchange controls to the extent necessary to achieve this purpose. However, the very shortage of foreign currency that makes foreign investment attractive also makes it difficult for a host country to allow its own residents to invest their foreign exchange abroad. Not surprisingly, restrictions on the ability of residents to purchase foreign exchange in connection with overseas investment (e.g. the establishment of foreign bank accounts, the purchase of foreign securities, the acquisition of foreign real estate) are often the last element of exchange control to be removed by a country as its overall balance of payments position improves.

The relationship between the types of underlying investments that are covered and the scope of the derogation provision that allows for the imposition of restrictions on transfers is more complicated. For example, with respect to temporary restrictions imposed for balance of payments reasons, it may seem reasonable to assume that the need for derogation increases to the extent that the underlying investment covered is broad enough to include, for example, short-term, cross-border flows (e.g. interbank credits), which are the most volatile and, therefore, the most problematic in terms of macroeconomic and balance of payments management. But experience demonstrates that a country facing a balance-of-payments crisis may find it difficult to exclude certain types of transfers (including transfers relating to FDI) from the scope of its exchange control regime. Accordingly, the relationship between temporary balance of payments derogation and the scope of investments covered may, in fact, be somewhat limited. This issue is discussed in greater depth in the following section.

B. Nature of obligations

The design of the transfer obligation depends on the nature and scope of the obligations that apply to the types of investment that are covered. Two issues are of particular importance in this regard.

First, does an agreement establish firm obligations with respect to the admission of investments? As discussed in the previous section, while the OECD Capital Movements Code contains such obligations, most bilateral and regional investment agreements do not. If an admission obligation is to be established, the transfer obligation would need to encompass the inward transfer of amounts that are needed to make the initial investment. While it is true that countries wishing to restrict the inflow of capital normally impose the restriction at the level of the underlying transaction rather than transfers associated with these transactions, failure to cover inward transfers explicitly under an agreement could create the risk that a signatory may try to circumvent its admission obligation by imposing the control on the transfer rather than on the underlying transaction.

Second, does an agreement establish investment protection obligations other than the transfer obligation? The premise of the bilateral and regional investment agreements reviewed in section II is that a host country is only able to attract FDI if it also makes undertakings with respect to the treatment of this investment once it has been made. Thus, in addition to guaranteeing the free transfer of the proceeds of an investment, an agreement also, for example, typically provides for compensation following either expropriation or civil strife. Moreover, in some cases, an agreement establishes obligations regarding a host country's repayment of any debt that it may have contracted with a foreign creditor. Unlike the general national treatment obligation that also exists in investment agreements, these investment protection obligations (including the transfer provision) actually result in the foreign investor receiving more favourable treatment than a host country's own investor. If an investment agreement is to provide for such comprehensive investment protection, it is appropriate for the transfer provision to provide specifically for the free transfer of amounts that have been received as a result of a host country's performance of these investment protection obligations.

Section IV

THE DESIGN OF A TRANSFER PROVISION: KEY ECONOMIC POLICY ISSUES

While there are a number of important decisions that need to be made when designing a transfer provision, the issue that has the greatest impact on the economic policy of a host country is the existence and scope of a provision that allows for derogation from the general transfer obligation. From the analysis contained in the previous sections, it is clear that bilateral and regional agreements establish a framework that places considerable emphasis on the protection of investment, particularly when compared with the multilateral agreements currently in existence. One of the key differences in this respect is the fact that, while the multilateral agreements discussed contain relatively comprehensive derogation provisions, most bilateral and regional agreements (with some important exceptions) do not contain such clauses. Does this signal that investor protection is incompatible with derogation?

This section of the paper first discusses the merits of a temporary derogation clause, before making some observations regarding the possible need for some type of transitional arrangements for countries that are not yet in a position to liberalize all investments immediately, a need that is particularly relevant for developing countries. It then concludes with a brief discussion of the draft text of the MAI. As will be seen, the relevant provisions of the MAI text provide evidence of a growing recognition that investor protection and derogation are not mutually exclusive concepts.

A. Temporary derogation: a limited role for restrictions

When a country that has eliminated restrictions on a broad range of investments is confronted with a balance-of-payments crisis, to what extent can the reimposition of restrictions play a constructive role in the resolution of this crisis? Given the magnitude of the balance-of-payments crises that have faced both developed

and developing countries over the past several years, the debate on the efficacy of controls has recently intensified. While an exhaustive analysis of the costs and benefits of restrictions is beyond the scope of this paper, there are a number of considerations that are of particular relevance to the treatment of transfers under IIAs.

First, one of the biggest dangers of restrictions is that a country facing a crisis may rely upon them as a substitute for necessary policy adjustments. Even in circumstances where it has maintained appropriate macroeconomic policies, a country that is trying to weather a crisis arising from a large withdrawal of capital normally has no choice but to introduce corrective macroeconomic and, in some cases, structural policies in order to adapt itself to the new external environment. To the extent that the adoption of corrective polices is delayed by the reliance on restrictions, this delay can make the eventual adjustment more painful.

Second, the damage caused by the imposition of restrictions can be considerable. For a country that has benefited from access to capital markets, the imposition of restrictions may jeopardize such access in the future or, at a minimum, make it more expensive. This is particularly the case where restrictions impede the types of transfers that are normally covered under investment agreements, i.e. when they prevent residents from performing their contractual obligations to non-residents or when they prevent non-residents from repatriating the proceeds of their investment. Moreover, such action may trigger a flight of residents' capital. Finally, investors may perceive such measures as a signal that other countries may also rely on controls as a means of dealing with difficulties and, as a result, the controls may have "contagion" effects, i.e. they may prompt foreign investors to withdraw their capital from other countries in the region or, more generally, from all developing countries.

Third, when restrictions are imposed in an economy that has grown accustomed to the free movement of capital and where, accordingly, capital markets are relatively well developed, controls are likely to have limited effectiveness. While, for an initial period, the restrictions may serve their purpose, over time their effectiveness

is likely to erode as the private sector, through financial engineering techniques, discovers the means to circumvent them. This is particularly the case with restrictions on outflows.

Notwithstanding the above considerations, there are circumstances in which the temporary reliance on restrictions may be necessary. As noted earlier in this paper, the resolution of balance of payments problems normally requires both the implementation of appropriate adjustment policies and external financing. In circumstances in which the crisis has undermined market confidence and, therefore, a country's access to capital markets, such financing is provided by the official sector, normally led by the Fund. Such financing is designed to tide the country over until corrective economic policies take hold and market confidence is restored. As has been recently demonstrated, however, this formula may not be sufficient in circumstances in which the outflows are so large that the extent of adjustment required and the magnitude of the official financing needed far outstrip both the adjustment capacity of the member and the amount of financing that can be provided by the Fund and other official creditors.

What choices are available in these circumstances? In many, but not all, cases the primary problem is the maturity structure of a country's short-term debt. In these circumstances, a country tries to convince creditors to maintain their exposure, e.g. by agreeing to roll over their credit lines. Another — more difficult — option is to persuade creditors to agree upon a restructuring that will result in longer maturities (coupled, perhaps, with a government guarantee). If such *ex ante* attempts to restructure are not successful, however, a country may have no choice but to impose restrictions as a component of its overall adjustment programme. A number of observers are of the view that, in these circumstances, a restructuring of external debt — whether done on a voluntary or involuntary basis — also has broader systemic benefits. Specifically, to the extent that a crisis has been precipitated by imprudent lending by foreign investors, forcing them to bear some of the burden in its resolution provides an important means of ensuring that they fully understand and measure the risks of their international investment decisions, thereby limiting imprudent lending in the future.

The considerations that are relevant for purposes of determining when restrictions may be necessary, as described above, also provide guidance as to how such controls should be designed and implemented. In this regard, several issues are of particular importance in the design of a temporary balance of payments derogation provision:

- Restrictions should be temporary. As discussed above, if a country is facing a crisis, the primary purpose of controls should be to give the country a breathing space until corrective policies take hold. Moreover, experience demonstrates that controls can become less effective the longer they are in place.

- Restrictions should be imposed on a non-discriminatory basis, as is required under all of the relevant multilateral agreements discussed earlier. As noted above, a critical feature of a country's strategy to resolve a balance of payments crisis is to mobilize external financing, both from the Fund and from other multilateral and bilateral creditors. Such a "burden sharing" strategy within the international community would be severely undermined if restrictions were imposed with respect to the investors of certain countries but not others.

The question of whether restrictions should differentiate between certain types of transfers raises a number of complex issues. Clearly, if an IIA only covers foreign investment, the imposition of controls that only apply to outward investments (and associated transfers) by residents would be beyond the scope of the framework and, therefore, would not require derogation. Moreover, as discussed earlier, such a limited application of restrictions would, from a policy perspective, limit the disruption of the country's access to financial markets that otherwise would arise from the imposition of restrictions on transfers relating to inward investment. But should restrictions only apply to transfers relating to certain types of foreign investment? For example, given the volatility of short-term investment (portfolio equity investment and short-term debt), there may be merit in trying to limit restrictions to transfers relating to such debt. IIAs could express such a "prioritization" in a number of

different ways. First, as with outward investment made by residents, such investments could be excluded from the coverage of the framework altogether. Alternatively, while short-term investment could be included, the derogation provision could afford more generous treatment to controls on such transfers, as appears to be the case under NAFTA.

In considering this issue, it should be borne in mind that, in the midst of a crisis, countries often are not able to make distinctions as to which types of transfers are to be restricted. This is due in part to the fact that, if such an attempt is made, foreign investors operating in a well-developed financial market quickly find a means of taking advantage of these distinctions so as to circumvent the restrictions. For this reason, it may be necessary for the derogation provision of an IIA to apply the same standard for all restrictions that are covered under the agreement, but with the requirement (similar to the one found in the GATS) that the measures be no more restrictive of foreign investment than is necessary to address the crisis that required their imposition.

Regarding the possibility of excluding certain types of investment from the scope of an agreement (e.g. short-term debt), such an exclusion would not, in and of itself, obviate the need for a balance of payments derogation provision since, as noted above, a country responding to a sudden and massive outflow of capital may find it difficult to avoid imposing restrictions with respect to all transfers, at least for an initial period. It is notable that, under the OECD Capital Movements Code, the signatories of which are the world's most developed countries, the balance of payments derogation clause is applicable to all types of investment, including for example FDI. As will be noted below, while it may be appropriate for an IIA to make distinctions as to different types of investment, these distinctions may be more relevant to the pace at which a relatively restrictive economy should liberalize; they may be of less relevance when discussing how a relatively open economy should react to a balance of payments crisis.

What of the design of a temporary derogation provision to address macroeconomic problems caused by inflows rather than outflows? The imposition of restrictions on inflows would normally

only be justified for macroeconomic reasons in circumstances where a sudden — and potentially reversible — surge in inflows threatens to disrupt macroeconomic and exchange rate policies that are broadly appropriate for the country in question over the medium term. However, to the extent that this surge of inflows is not temporary, this would normally signal that the resolution of the problem requires an adjustment of macroeconomic policies. For this reason, the criteria applicable to restrictions on outflows are also of relevance for restrictions on inflows, namely that they be temporary and non-discriminatory. It is important, however, to distinguish this analysis from that which addresses the question of when a country with a restrictive system should liberalize restrictions on inflows. This latter question, which is of critical importance, will now be addressed.

B. Transitional provisions

Issues relating to the need for, and design of, a temporary derogation are of primary relevance for a host country that has already liberalized foreign investment but needs to maintain adequate flexibility regarding the temporary reimposition of restrictions in times of balance of payments or macroeconomic crises. But what of the countries that have not yet liberalized their restrictions on foreign investments? Viewed from a balance of payments and macroeconomic perspective, what benefit, if any, is to be gained by the continued maintenance of a restrictive system and what implications would the maintenance of the system have for the design of any liberalization obligations under IIAs?

These are questions of critical importance for developing countries that are weighing the cost and benefits of eliminating restrictions on foreign investment. At the outset, it needs to be recognized that one of the biggest drawbacks to restrictions — the extent to which they are effective — is not as problematic in circumstances in which a host country has never liberalized foreign investment, particularly short-term investment. In these circumstances, financial markets are typically relatively undeveloped, and the problem of circumvention, which makes the reimposition

of restrictions in a previously liberal market so difficult, is not as acute. While the continued maintenance of restrictions by relatively closed economies may involve costs in that they may deny the country the opportunity to utilize foreign savings as an engine of growth, they can be ineffective.

Even if effective, what role, if any, do they have in promoting macroeconomic and balance of payments stability? While the economic benefits of international investment for developing countries point to liberalization as an objective, recent international financial crises also serve to demonstrate that it is an objective that countries should not necessarily try to achieve overnight, or at least not until certain preconditions have been met. The precondition of macroeconomic stability is relatively undisputed: a liberalized system, in some respects, imposes greater demands on policy makers since it requires them to correct the financial imbalance that they were able to suppress for an extended period through reliance on restrictions. However, recent financial crises have also demonstrated that, if the regulation of a host country's financial sector is inadequate, the consequence of this inadequacy is exacerbated by liberalization and may precipitate large balance of payments crises. For example, in the absence of appropriate prudential regulations, financial institutions that are in a position to access international capital markets may take inappropriate risks, including the accumulation of a large volume of unhedged, short-term liabilities. The fact that the State normally provides the financial sector with some form of financial safety net can exacerbate this problem by creating "moral hazard": financial institutions may be encouraged to take even greater risks on the assumption that, if necessary, they will be "bailed out" by the State. When international market sentiment does begin to shift, experience demonstrates that those investors who were willing to extend large amounts of short-term credit to the banking system will be the first investors to "head for the exits" and withdraw their investments, often leaving the financial sector (and, as a consequence, the rest of the economy) in distress.

To address the issue of risk management that is magnified by the liberalization of investment, adequate prudential regulations need to be supplemented by other reforms. One of the reasons

why capital flows give rise to crises is attributable to "asymmetries" in information, which may lead to imprudent lending in the first instance and a large, excessive and herd-like withdrawal in the second instance. For this reason, liberalization should be preceded by, or at least go hand in hand with, measures that serve to reduce these inefficiencies, including the introduction of adequate accounting, auditing and disclosure requirements in both the financial and corporate sector.

For all of the above reasons, in order to maximize the benefits of international investment and minimize the associated risks, it is critical that liberalization be appropriately "sequenced" with reforms in the financial system that serve to ensure that the risks incurred can be appropriately managed. Until such reforms have been put in place, restrictions on foreign investment, particularly short-term investment, can play a constructive role.

What implications does the above analysis have for the design of IIAs? On one level, the issue of "sequencing" liberalization is not directly applicable to the treatment of transfers. The restrictions that play the most important role in maintaining stability while the regulatory framework for the financial system is being developed are restrictions on inflows. And, as discussed earlier in the paper, these are normally imposed at the level of the underlying transaction rather than the associated transfer. Indirectly, however, the treatment of these restrictions is of considerable relevance: to the extent that adequate safeguards are not put in place to guard against the incurring of unsustainable risks, any ensuing balance of payments crisis arising from a loss in market confidence raises the issue of the need for restrictions on outflows, which includes restrictions on transfers.

Given the fact that the most volatile type of foreign investment is of a short-term nature, one means of addressing the need for sequencing is to exclude such flows from the coverage of an IIA altogether, thus enabling signatories to maintain restrictions on the making of such investments for as long as they wish. Such an approach is complicated by the fact that, as a result of the development of financial engineering techniques, the distinction

between short-term, medium-term and long-term debt is becoming increasingly blurred. Alternatively, while such investments would not be excluded, they could be protected by some form of transitional arrangements that would enable them to be maintained until a signatory has put in place alternative, non-restrictive means of limiting the risk of such investments, of the variety discussed above. The advantage of the latter approach is that it would avoid throwing the proverbial "baby out with the bath water". To the extent possible, therefore, IIAs should find a means of pacing the liberalization of these investments in line with the circumstances of each host country, while avoiding the risk of such flexibility being used as a means of unnecessarily delaying beneficial liberalization.

C. Investment protection and derogation in a multilateral context: the example of the MAI

The draft MAI serves to demonstrate the growing recognition that derogation — or at least temporary derogation — is neither inconsistent with the objective of investor protection nor an issue that is only of relevance to developing countries. One of the objectives of the negotiators of the MAI was to negotiate an agreement that establishes the highest standards of investor protection. In that regard, most bilateral agreements — the provisions of which provided important precedents during the negotiations — do not include balance-of-payments derogation provisions.

But it was precisely because the MAI was intended to be more than a bilateral investment treaty that the inclusion of a balance-of-payments derogation provision was eventually accepted in the text. Two considerations were of particular importance in that regard. The first may be described as a concern for "jurisdictional coherence". Although the text of the MAI was negotiated at the OECD, it was envisaged that developing countries would become signatories. In that context, it was recognized that a situation needed to be avoided in which two treaties with potentially the same universal membership contained provisions that could give rise to conflicting rights and obligations. The conflict could arise with the Fund's Articles because the Fund's jurisdiction includes many investment-related transfers, such as the repatriation of investment

income. Thus, if the Fund were to approve a restriction imposed by a country on the repatriation of profits of an investment, would such approval exempt it from its obligations under the MAI? As noted in a previous section of this paper, the drafters of the GATS effectively addressed this issue by specifically providing in that agreement that restrictions approved by the Fund would be consistent with a signatory's obligations under the GATS.

The second consideration related to the potential impact of unrestricted investment flows on a signatory's balance of payments, as discussed in detail above. In brief, while there was a general recognition that unrestricted capital flows can be very beneficial to individual countries and the world economy in general, the MAI negotiators also recognized that the volatility of these flows (many of which fall outside the Fund's jurisdiction) can also be detrimental to a country's balance of payments position. In these circumstances, it would be necessary to ensure that restrictions are applied in a non-discriminatory manner.

The above considerations ultimately shaped the design of the balance of payments derogation provision that is contained in the draft MAI. With respect to restrictions imposed by a signatory on transfers that fall within the Fund's jurisdiction, the MAI text provides that Fund approval renders such restrictions consistent with the signatories' obligations under the MAI. Interestingly, where the restrictions fall outside the Fund's jurisdiction, the Fund's determination that the measures satisfy the criteria set forth in the MAI (which include temporariness and non-discrimination) would have the same result. The prominent role of the Fund in the implementation of the derogation provisions reflects the fact that the Fund is charged with both assisting countries in the design of programmes that address balance of payments problems and providing the financial assistance that is necessary to support these programmes. As noted earlier, when a country faces a balance of payments crisis there is a very close relationship between issues relating to the need for restrictions, the degree of economic adjustment and the amount of external financing.

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