

THE RETURN OF CAPITAL CONTROLS?

ANDREW YIANNI*

CARLOS DE VERA**

I

INTRODUCTION

One of the consequences of the global financial crisis is that advanced economies, such as the United States and United Kingdom, currently have very loose monetary policies with very low interest rates. A number of the stronger economies in the emerging markets—China, India, and Brazil, for example—have suffered less than many industrial countries. Not surprisingly, therefore, there has been a tendency for capital to flow to certain emerging markets in search of higher returns. Emerging-market economies with freely floating (or close to freely floating) exchange-rate regimes, open capital accounts, and solid fundamentals, have seen their currency appreciate as a consequence, as Brazil did in 2009. Clearly, this economic consequence creates a policy challenge for the affected emerging markets. If the decision is made to allow the currency to appreciate, exports will become relatively more expensive and imports relatively less expensive. This policy will have an adverse effect on domestic employment and will move the current account towards deficit (or into greater deficit). Such a policy could also make the system vulnerable to a future shock if the capital inflows were subsequently rapidly reversed.

In this environment, there will be a tendency for those in the affected emerging markets to consider a range of measures, including implementing capital controls to slow down or ration the inflow of capital. Clearly, any such step would run counter to the trend towards liberalization of capital movements specifically and globalization generally.

The global financial crisis has also brought capital controls back into focus as a means of responding to a crisis. In the early stages of the current global financial crisis, foreign investors sought to move capital invested in a range of emerging-market economies into safe havens, forsaking the higher risk premium embedded in the higher yield. A number of such economies therefore faced a rapid outflow of capital. For those with freely floating (or close to freely floating) exchange-rate regimes and open capital accounts, the result was a weakening of the exchange rate. The classic policy response would be to

increase the domestic interest rate and to intervene in the foreign-exchange market by using reserves to seek to dampen excessive short-run volatility in the exchange rate. Clearly, significant increases in the domestic interest rate will reduce domestic investment and make raising new domestic debt more expensive.

Increasing the domestic interest rate is not a policy well suited as a response to a looming recession. If the country has, or a large proportion of its residents have, borrowed in foreign currency, a weakening exchange rate will also increase the local currency cost of servicing external debt. One of the measures which will inevitably be considered in this context is the imposition of capital controls to slow the speed at which capital is removed from the country. It may be helpful to refer to this tendency as one driven by a desire to respond to a crisis.

II

WHAT ARE CAPITAL CONTROLS?

Capital controls can take many forms. They range from familiar arrangements—such as prohibitions, the requirement for prior approval, or authorization in respect of inward and outward movements of capital—to far more subtle arrangements under which movements of capital are permitted but discriminatorily taxed. Taxation of inward investment may be calibrated by reference to its duration, with longer-term investments taxed at a far lower rate or not at all. Chile employed such a system through its so-called *encaje* for many years to discourage short-term speculative inflows of capital and to encourage medium- to long-term investment. (This took the form of a mandatory one year, noninterest-paying, variable deposit with the central bank.)

Exchange controls are a type of capital control that regulates the way the domestic currency relates to international currency markets. These may include prohibitions, restrictions (or limits) on the ability to exchange domestic currency for foreign currency, or multiple currency practices in which differing exchange rates are used for different purposes. Repatriation requirements, under which foreign exchange earned through the export of goods or services need to be sold to the home-country central bank, are also a common feature of exchange-control regimes.

III

THEORY OF INTERNATIONAL ECONOMICS

Economic theory tells us—through the Mundell–Fleming model, or the “impossible trinity”—that it is impossible to have all three of the following at the same time:

1. A fixed exchange rate;
2. Free capital movement; and

3. An independent monetary policy.¹

As Paul Krugman once put it,

The point is you can't have it all: A country must pick two out of three. It can fix its exchange rate without emasculating its central bank, but only by maintaining controls on capital flows (like China today); it can leave capital movement free but retain monetary autonomy, but only by letting the exchange rate fluctuate (like Britain—or Canada); or it can choose to leave capital free and stabilise the currency, but only by abandoning any ability to adjust interest rates to fight inflation or recession.²

Restricting capital flows is, perhaps, the most controversial of policy alternatives that a country may use. The global financial crisis has shown us that, in extremis, we reside in a world of financial markets prone to herding, panics, and contagion. In this context, the key rationale for capital controls is that global financial turbulence can have severely negative effects on a domestic economy.

Exchange controls used to be the standard response of countries with balance-of-payments crises. The classic 1970s model required exporters to sell their foreign-currency earnings to the state at a fixed exchange rate; that currency would, in turn, be sold at the same rate for approved payments to foreigners, basically for imports and debt service. Although some countries tried to make other foreign-exchange transactions illegal, other countries allowed a parallel market. Creating such a system is burdensome, but with it in place, there may be more stability. For example, in such a system, a country needing to cut domestic interest rates would have far less concern that the value of its currency would plunge.

Exchange controls suffer from manifest problems in practice, most significantly that they are subject to abuse. Exporters have an incentive to hide their foreign-exchange receipts; importers have an incentive to pad their invoices. Exchange controls are distortionary. There is also the problem that administrative officials may be invited to agree to special arrangements. Most economists feel that exchange controls work badly, particularly if they are in place for an extended period.

There is also a significant concern that exchange controls imposed to stem capital flight arising after a bank run, for example, can replace necessary domestic reform (for example, increased prudential supervision and higher capital ratios) rather than effectively buy time for reform to take place.

1. For a discussion on the Mundell–Fleming model, see Maurice Obstfeld, *International Macroeconomics: Beyond the Mundell-Fleming Model* 5–8 (Univ. of Cal., Berkeley Ctr. for Int'l and Dev. Econ. Research, Working Paper No. C01-121, 2001), available at <http://129.3.20.41/eps/if/papers/0303/0303006.pdf>. For a discussion on the “impossible trinity” of open-economy macroeconomics, see PETER MONTEL, *MACROECONOMICS IN EMERGING MARKETS* 339 (2002); see also John McHale, *Capital Account Convertibility and Capital Controls in Emerging Market Countries: Some Themes from the First Meeting*, NAT'L BUREAU OF ECON. RESEARCH, http://www.nber.org/crisis/capital_report.html (last visited Nov. 21, 2010); Paul Krugman, *The Eternal Triangle*, <http://web.mit.edu/krugman/www/triangle.html> (last visited Nov. 21, 2010).

2. Paul Krugman, *O Canada: Neglected Nation Gets Its Nobel*, SLATE (Oct. 19, 1999), <http://www.slate.com/id/36764>.

Exchange controls can therefore shield inaction. Yet Krugman observed that although exchange controls worked badly in practice, China's exchange controls enabled it to ride out the Asian financial crisis of 1997 and 1998 rather well compared to its neighbors:

Because [China] has been able to cut, not raise, interest rates in this crisis, despite maintaining a fixed exchange rate[,] and the reason it is able to do that is that it has an inconvertible currency, a.k.a. exchange controls. Those controls are often evaded, and they are the source of lots of corruption, but they still give China a degree of policy leeway that the rest of Asia desperately wishes it had.³

IV

RECONCILING CAPITAL CONTROLS WITH INTERNATIONAL-LAW OBLIGATIONS

Whether as a result of a desire for crisis prevention or as a crisis-response measure, the imposition of capital controls also raises a host of international-law considerations, including those arising under the International Monetary Fund (IMF) Articles of Agreement and Bilateral Investment Treaties (BITs).

A. The IMF Articles of Agreement

The IMF Articles of Agreement recognize exchange control in three principal provisions, namely Article VI(3), Article VIII(2)(a), and Article XIV.⁴

1. Article VI(3)

Under Article VI(3), member states have discretion to "exercise such controls as are necessary to regulate international capital movements."⁵ Sir Joseph Gold, former General Counsel of the IMF, explains that Article VI(3) was necessary "because of the destabilising effects that flows of 'hot money' had in the period before the IMF came into existence."⁶ The global financial crisis has made those words, written well over twenty years ago, resonant. Member states can exercise Article VI(3) discretion without the approval of the IMF. Importantly, though, no regulation implemented under Article VI(3) may restrict payments for current transactions or unduly delay transfers of funds in settlement of commitments. In the context of financial crises, Article VI(3) can be used by a country to slow down capital flight by limiting the ability of

3. Paul Krugman, *Saving Asia: It's Time to Get Radical: The IMF Plan Not Only Has Failed to Revive Asia's Troubled Economies But Has Worsened the Situation. It's Now Time for Some Painful Medicine*, FORTUNE, Sept. 7, 1998, available at http://money.cnn.com/magazines/fortune/fortune_archive/1998/09/07/247884/index.htm.

4. Joseph Gold, "Exchange Contracts," *Exchange Control, and the IMF Articles of Agreement: Some Animadversions on Wilson, Smithett & Cope Ltd. v. Terruzzi*, 33 INT'L & COMP. L.Q. 777, 778-79 (1984).

5. Articles of Agreement of the International Monetary Fund Art. VI(3), July 22, 1944, 60 Stat. 1401, 2 U.N.T.S. 39.

6. Gold, *supra* note 4, at 778.

residents to export capital, subject to its other treaty obligations, most particularly under bilateral investment treaties.

2. Article VIII(2)(a)

Article VIII(2)(a) provides the IMF with jurisdiction over restrictions imposed by member states on making payments and transfers for current international transactions. In accepting the obligations of Article VIII's sections 2(a), 3, and 4, members of the IMF agree to not impose restrictions on making payments and transfers for current international transactions and not engage in discriminatory currency arrangements or multiple currency arrangements, except with IMF approval. IMF approval is required so that restrictions on payments and transfers for current international transactions are not deemed breaches of the treaty. Gold explains that "the IMF's practice is to grant approval, when justifiable, for a limited period only because the restrictions are derogations."⁷ So far as the limited time period is concerned, exchange measures taken for national or international security reasons are approached differently. These often take the form of financial sanctions and restrictions to combat the financing of terrorism and will often therefore restrict the making of payments and transfers for current international transactions. Here, in practice, after notification, IMF approval is granted indefinitely.

3. Article XIV

Article XIV deals with transitional arrangements. A member state may take advantage of the transitional arrangements to maintain (and adapt) existing exchange controls that would otherwise be in breach of Article VIII(2)(a) while taking all possible measures, as soon as conditions permit, "to develop such commercial and financial arrangements with other members as will facilitate international payments."⁸

Once withdrawn, the transitional arrangements may not be implemented again by the member state without the approval of the IMF under Article VIII(2)(a).⁹ According to the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions 2009, nineteen countries continue to avail themselves of the transitional arrangements under Article XIV.

4. Other IMF Articles

Article IV(3)(b) imposes upon the IMF the duty to "exercise firm surveillance over the exchange rate policies of members."¹⁰ Gold concludes that

[the] provisions demonstrate that the international interest is served, first, by allowing members to decide whether or not to control capital movements, and second by requiring the IMF to exercise tight invigilation over restrictions on payments and transfers for current international transactions. The approval of the IMF is necessary

7. *Id.* at 779.

8. Articles of Agreement of the International Monetary Fund, *supra* note 5, Art. XIV(2).

9. *Id.* Art. XIV(1).

10. *Id.* Art. IV(3)(b); Gold, *supra* note 4, at 780.

for such restrictions, unless they are authorised by the transitional arrangements, to which, however a member cannot revert for the reintroduction of restrictions.¹¹

Article VIII(2)(b) is also particularly important for the functioning and enforcement of member agreements:

Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement *shall be unenforceable in the territories of any member*. In addition, *members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective*, provided that such measures and regulations are consistent with this Agreement.¹²

In other words, if one member country has a set of exchange-control regulations that satisfy the requirements of Article VI(3), Article VIII(2)(a) (which requires IMF approval), or that is a transitional arrangement under Article XIV, then any exchange contract that breaches those exchange-control regulations is unenforceable in the courts of other IMF member countries. This is clearly powerful, but the scope of the application of Article VIII(2)(b) has been limited in practice by the interpretation of the meaning of exchange contracts, over which two lines of interpretation have emerged: the “narrow construction” and the “wide construction.” These approaches have different consequences for the effective scope of extraterritorial jurisdiction seized by a court and are worthy of further description.

The English, American, and Belgian courts have all adopted the narrow construction that exchange contracts exchange the currency of one state for the currency of another state, either as their primary object or when the contract is a monetary transaction in disguise.¹³ A typical example in today’s marketplace would include spot and forward foreign-exchange contracts including, most likely, derivative equivalents, such as nondeliverable forwards.

The French and Luxembourgian courts have preferred the wide construction that an exchange contract is any contract that affects the exchange resources of a state. In addition to contracts whose objective is an exchange of currency (or are such contracts in disguise), this interpretation includes contracts that require a party to sell domestic currency to purchase a foreign currency as part of its contractual obligations.¹⁴ An example of this type of

11. Gold, *supra* note 4, at 781.

12. Articles of Agreement of the International Monetary Fund, *supra* note 5, Art. VIII(2)(b) (emphasis added).

13. See, e.g., *Callejo v. Bancomer, S.A.*, 764 F.2d 1101, 1120 (5th Cir. 1985); *Libra Bank, Ltd. v. Banco Nacional de Costa Rica*, 570 F. Supp. 870, 900 (S.D.N.Y. 1983); *Weston Bank Corp. v. Turkiye Garanti Bankasi, A.S.*, 442 N.E.2d 1195, 1198–99 (N.Y. 1982); *J. Zeevi & Sons, Ltd. v. Grindlays Bank, Ltd.*, 333 N.E.2d 168, 174 (N.Y. 1975); *Banco de Brassil, S.A. v. A.C. Israel Commodity Co.*, 190 N.E.2d 235, 236 (N.Y. 1963), *cert. denied*, 376 U.S. 906 (1964); *Emek v. Bossers and Mouthaan*, 22 I.L.R. 722 (1955); *Wilson, Smithett & Cope Ltd. v. Teruzzi*, (1976) 1 Q.B. 683; *United City Merchs. Ltd. v. Royal Bank of Can.*, [1983] 1 A.C. 168 (1982) (appeal taken from Eng. C.A.); *Mansouri v. Singh*, (1986) 1 W.L.R. 139.

14. See, e.g., *Lessinger v. Mirau*, 22 I.L.R. 725 (1955); *de Boer, Widow Moojen v. Von Reichert*, Judgment of June 20, 1961, Cour d’appel, Paris (1st Chamber), 89 J. DROIT INT’L 718; *Société Filature et Tissage X. Jourdain v. Epous Heynen-Bintner*, 22 I.L.R. 727 (1955).

contract would be a dollar-denominated loan made to France requiring the borrower to use euros to buy the dollars needed to repay the lender.

Article VIII(2)(b) restricts the exercise of sovereignty by an IMF member state through its courts' choosing not to enforce the contractual rights of individuals when the court would otherwise take jurisdiction. Such abstentions should not be made lightly, for they promote the rules of another legal order above the rules of that legal order giving the court its legitimacy, and they interfere with the contractual rights of individuals. Notably, courts that provide governing law to many international finance contracts, namely England and New York, are among those least prepared to interfere with contractual rights without a high degree of certainty that the contract falls within the meaning of exchange contracts in Article VIII(2)(b). In practice, the narrow construction can provide efficacy to the international financial system in those jurisdictions where it prevails. It is also interesting to note that in 1993 and 1994, the German Supreme Court held in three decisions that international-capital transfers, such as loan agreements, are not governed by Article VIII(2)(b). Before these decisions, Germany was thought to be a jurisdiction that preferred the wide construction of exchange contracts.

It is conceivable that the second sentence of Article VIII(2)(b) could be cited as support for the narrow construction. Though the first sentence renders exchange contracts unenforceable in other member states without requiring any positive step by the third state (surely an indication that Article VIII(2)(b) is intended to provide an international legal basis for emergency actions), the second sentence envisages further agreements between members "for the purpose of making the exchange control regulations of either member more effective."¹⁵ If a situation justifying exchange controls approved by the IMF has standing acceptance as justifying extraterritorial jurisdiction, the second sentence suggests that this would be an extraordinary interference in the sovereignty of other member states and should be moved, by further bilateral agreement, to a more sustainable basis acceptable to the third state. Providing for this further step after imposing qualifying exchange controls recognizes that the power is extraordinary, suggesting that, as such, it should be construed restrictively.

The wide construction significantly increases the types of contracts included in the definition of exchange contracts. Adopting the wide construction would result in the courts of the forum declining jurisdiction more often, for the extraterritorial jurisdiction permitted by Article VIII(2)(b) applies to a greater range of types of contract.

Despite the provisions allowing for exchange controls in the IMF Articles, the use of all forms of capital controls is inconsistent with the movement towards a globalized financial system. Many took the view that the IMF Articles effectively reflected the world after the Second World War, in which a majority

15. Articles of Agreement of the International Monetary Fund, *supra* note 5, Art. VIII(2)(b).

of countries retained important restrictions over capital transactions. By the 1990s, several countries sought to use the IMF Articles to promote capital-account liberalization by amending the IMF Articles to make the liberalization of capital movements one of the purposes of the Fund. The movement, at one point, had significant support but was, in reality, put to the side as a result of the Asian financial crisis in 1997 and 1998.

Interestingly, the *Growth Report: Strategies for Sustained Growth and Inclusive Development*, prepared by the U.K. Commission on Growth and Development, observed, in relation to capital-account liberalization, that the link between open capital accounts and high-growth countries was questionable and that “policies that actively discourage speculative, short-term capital inflows have proven useful in turbulent times.”¹⁶ Many policymakers in the emerging markets would agree with that assessment.

B. Bilateral Investment Treaties (BITs)

Although the IMF Articles of Agreement have not been amended to make capital-account liberalization one of its purposes, the incorporation of free-transfer clauses in international legal agreements, such as BITs, has, in practice, accelerated the movement towards full capital-account liberalization and convertibility. Free-transfer clauses in investment treaties between countries seek to ensure the right to freely repatriate assets at all times, and arguably, unimpeded transferability is an essential ingredient in the proper operation of investments. Perhaps unable to achieve a blanket free transfer of capital assets at the multilateral level, important multilateral agreements have tended to liberalize capital-account transactions. However, in general, Michael Waibel has observed in an illuminating work that liberalization has been embedded in a carefully designed system of safeguards in case balance-of-payments crises arise.¹⁷ The North America Free Trade Agreement, the General Agreement on Trade and Tariffs, the World Trade Organization, and the General Agreement on Trade in Services generally ensure that host countries retain the flexibility to impose exchange restrictions consistent with the IMF Articles of Agreement.¹⁸ For dealings between two countries, governments often use their model BITs; here, free-transfer clauses can have their strongest effect. The French and U.S. model BITs illustrate the differences in types of free-transfer clauses.¹⁹ For example, the French Model BIT (2005) contains a funds-transfer clause. But it also contains a balance-of-payments safeguard clause and does not guarantee free convertibility at market exchange rates. The wording provides that the free

16. *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, COMM'N ON GROWTH AND DEV. (June 2008), <http://cgd.s3.amazonaws.com/GrowthReportComplete.pdf>.

17. Michael Waibel, *Bit by Bit: The Silent Liberalization of the Capital Account*, in *INTERNATIONAL INVESTMENT LAW FOR THE 21ST CENTURY: ESSAYS IN HONOUR OF CHRISTOPH SCHREUER* 506 (Christina Binder et al. eds., 2009).

18. *Id.* at 506–08.

19. *Id.* at 514–15.

transfer of a number of items (for example, interest, dividends, profits, etc.) is guaranteed, but it then specifies:

[w]hen, in exceptional circumstances, capital movements from or to third countries cause or threaten to cause a serious disequilibrium to its balance-of-payments, each Contracting Party may temporarily apply safeguard measures to the transfers, provided that these measures shall be strictly necessary, would be imposed in an equitable, non-discriminatory and in good faith basis and shall not exceed in any case a six months period.²⁰

This language broadly aligns the French position with the IMF Articles of Agreement.

Unlike the French Model, the U.S. Model BIT (1994) incorporates a fund-transfer provision but applies a broad scope of covered transfers, refers to using a market exchange rate and not an official exchange rate, and expects transfers to be made “freely and without delay.”²¹ Perhaps the most interesting feature here is the noticeable absence of any safeguards relating to balance-of-payments crises.

Waibel notes that the Russian Model BIT (1992) goes even farther than the French Model, subjecting all transfers to compliance with the host state’s currency legislation.²² This is perhaps consistent with Russia’s history of using exchange-control legislation.

Countries rarely negotiate BITs during a financial crisis. If they did, it would be evident that, from a domestic-policy perspective, unqualified free-transfer clauses in BITs are potentially problematic, and balance-of-payments safeguards can provide useful flexibility in extreme conditions.

V

SOVEREIGN DEBT RESTRUCTURINGS CRAFTED AROUND EXCHANGE CONTROLS

How have exchange controls been used as a response to a financial crisis? Many countries that went through sovereign debt restructurings in the 1980s had systems of exchange controls in place, for this model had been the norm in developed countries at the beginning of the 1970s. The typical response to exchange control in sovereign debt restructurings in the 1980s was in some way to include the central bank (or other entity holding the country’s reserves or that was responsible for exchange-control regulations) in the restructuring. From the creditors’ perspective, the ideal position was to have the state and the central bank as joint-and-several obligors in the restructuring. There were a few instances of this approach, including, for example, Poland in 1981, 1983, and 1988. But a more-common formulation was to ensure that the central bank provided a foreign-exchange-availability undertaking, under which, so long as the state provided the requisite local currency, foreign exchange would be made

20. *Id.* at 514.

21. *Id.*

22. *Id.*

available at the prevailing rate to service the relevant external debt—effectively a covenant to ensure free convertibility into the relevant external debt.

But in two cases, the restructurings were crafted around exchange-control regulations: South Africa in 1985 through 1994 and Russia in 1998. In the latter half of 1985, apartheid South Africa encountered a debt crisis that forced the government to declare a temporary moratorium on all short-term debt repayments. By the time the moratorium was in place, South Africa had been affected by years of capital flight out of the country in the form of debt repayments, royalties, interest and dividend payments, and unrecorded or illicit flows.²³ For the South African government, this severe balance-of-payments crisis led it to restructure the country's foreign private debt through an innovative set of policies achieved through exchange-control regulations.

In the early 1980s, a worsening capital-account deficit forced the South African government to restrict imports and currency flows so that an adequate current account surplus might allow the repayment of loans.²⁴ By 1984, foreign debt had reached a peak of \$24.3 billion, which, in South African rands, was 45.7 percent of GDP (reflecting, in part, the decline of the rand against the dollar). In 1985, though the dollar value of South Africa's debt declined slightly, the continuing depreciation of the rand took the debt up to fifty percent of GDP (at about the time South Africa stopped payment on short-term debts).²⁵ Although South Africa's total level of debt was not unmanageable in normal circumstances, and although the country's current account was in substantial and growing surplus, the country faced an acute liquidity crisis. It was not in a position to meet the probable volume of further capital outflow.²⁶ Short-term debt had reached over seventy percent of South Africa's total foreign debt. By August 27, 1985, the rand was at an all-time low of thirty-three cents. With numerous foreign companies repatriating as much as they could of past undistributed profits, and thus worsening the flight of capital, South Africa's liquidity crisis, long recognized by the apartheid regime, forced the government to intervene.²⁷

The South African government's immediate response to the debt crisis was to impose a four-month debt moratorium (subject to a few exceptions) prohibiting the repayment of any foreign indebtedness incurred by South African residents before August 28, 1985. The moratorium was extended twice in 1986. With foreign debt captive, something had to be done about rescheduling the debt that South African debtors owed to the foreign creditors.

23. Alan Hirsch, *The Origins and Implications of South Africa's Continuing Financial Crisis*, 9 *TRANSFORMATION* 31, 31 (1989).

24. *Id.* at 37.

25. *Id.*

26. COMMONWEALTH SECRETARIAT INTER-GOVERNMENTAL GROUP OF OFFICIALS, *BANKING ON APARTHEID: THE FINANCIAL SANCTIONS REPORT 49* (London: Commonwealth Secretariat, 1989).

27. KEITH OVERDEN & TONY COLE, *APARTHEID AND INTERNATIONAL FINANCE: A PROGRAM FOR CHANGE* 84 (1989).

The overwhelming majority of the debt claims were in the form of foreign-currency-denominated loans governed by foreign law.

The South African government's plan in the March 1986 Interim Arrangement covered the debt with maturity dates falling in the period from April 1, 1986, to June 30, 1987. The second Interim Arrangement was presented to creditors as an extension of the 1986 arrangement, covering the debt with maturity dates falling in the period from July 1, 1987, to June 30, 1990. The third Interim Arrangement covered the period from July 1, 1990, to December 31, 1993. The final arrangement dealt with the period from 1994 to 2001.

The South African government had to control the amount of capital leaving the country, even if it required unwelcome interference in many private-sector contracts. Broadly, the government permitted interest to be paid, but termed out principal payments owed by South African debtors to foreign creditors. The solution was achieved through domestic-exchange-control legislation which limited payments to foreign creditors. The legal techniques utilized a straightforward offer-and-acceptance mechanism of the Interim Arrangement Letter, which the foreign creditor could choose to accept. If the foreign creditor did not accept the offer, it was paid on the terms permitted by the Interim Arrangement Letter. These arrangements also included features under which private-sector debt could be converted into South African state debt if the local debtor and its foreign creditor so wished, and if the local debtor effectively paid the local-currency equivalent of the relevant claim to a public body established in part for this purpose. A number of the restrictions affected current international transactions, but South Africa did not seek IMF approval for its exchange controls.

Russia's August 1998 moratorium arose as a result of economic, rather than political, factors. Russia had been financing a budget deficit through the issuance of GKO's (Gosudarstvennoye Kratkosrochnoye Obyazatyelstvo, meaning Government Short-Term Commitments) and other Russian-law governed instruments. GKO's were ruble denominated; other instruments, such as so-called Min Fins, were dollar denominated. The yield on GKO's became very attractive. The GKO market was open only to domestic banks and foreign banks licensed in Russia, but a thriving market in credit-linked notes developed, under which foreign banks combined a ruble-dollar swap with the GKO's and sold a dollar-based return linked to GKO's to European and U.S. investors. The swap component typically took the form of an English-law-governed forward contract with one or more Russian banks, under which the ruble flows on the GKO's could be converted into dollars at a fixed rate. The forward contract often took the form of a nondeliverable forward, under which dollar payments were made by reference to movements in the spot dollar-to-ruble rate. This arrangement avoided the need for physical delivery of rubles, which could be problematic for a non-Russian bank because of convertibility concerns.

On August 17, 1998, Russia defaulted on its GKO payments and, through an exchange-control law, prohibited payments under a number of contracts, including the swap transactions.

Again, although a number of the restrictions affected current international transactions, IMF approval under Article VIII(2)(a) was not sought. In Russia's case, because the only contracts involved that were governed by foreign law were swaps, these contracts would have been qualifying exchange contracts even within the narrow interpretation. This would probably have dampened litigation if the IMF had approved the applicable exchange-control arrangements.

Moving forward ten years, the global financial crisis, marked spectacularly by the collapse of Lehman Brothers in September 2008, has had, for the reasons mentioned earlier, a profound impact in certain segments of the sovereign marketplace. Two other countries that needed to deal with defaults have resorted to the use of exchange controls, namely Iceland and Ukraine.

VI

ICELAND 2008

On November 25, 2008, the IMF approved a standby arrangement for Iceland following the collapse of the Icelandic banking system and the on-shore foreign-exchange market.²⁸ As part of its response to the crisis, on October 10, 2008, the Icelandic government imposed exchange restrictions on certain current international transactions.²⁹ As a member of the IMF, to whom the transitional provisions of Article XIV did not apply, Iceland sought IMF approval of its capital controls, which would bring the exchange restrictions within Article VIII(2)(a). In practice, once approved by the IMF, exchange restrictions maintained in accordance with the Articles, and to the extent they apply to qualifying exchange contracts, are presumed to have extraterritorial effect under Article VIII(2)(b). Accordingly, Iceland requested "temporary Fund approval of the exchange restrictions in line with Fund policy, on the basis that they have been imposed for balance of payments reasons and are non-discriminatory."³⁰ Iceland undertook "not to impose or intensify restrictions on the making of payments and transfers for current international transactions nor to introduce multiple currency practices."³¹ The IMF approved the exchange-control regime and noted Iceland's above undertakings. The IMF's approval of

28. INT'L MONETARY FUND, ICELAND: REQUEST FOR STAND-BY ARRANGEMENT, IMF COUNTRY REPORT NO. 08/362, at 78 (Nov. 2008), available at <http://imf.org/external/pubs/ft/scr/2008/cr08362.pdf> (last visited July 19, 2010).

29. Letter of Intent and Technical Memorandum of Understanding from David Oddsson, Chairman of the Cent. Bank, and Árni M. Mathiesen, Minister of Fr., to Dominique Strauss-Kahn, Managing Dir., Int'l Monetary Fund (Nov. 15, 2008) (on file with *Law and Contemporary Problems*).

30. *Id.*

31. *Id.*

the Icelandic exchange restrictions thus gave extraterritorial jurisdiction to the Icelandic government to render qualifying exchange contracts unenforceable.

The result of extraterritorial effect granted under Article VIII(2)(b) is that courts that adopt the narrow construction would find, in relation to instruments governed by their law, for instance, that forward- and spot-foreign-exchange contracts may not be enforced, but a dollar-loan agreement may be. In courts that adopt the wide construction, none of these types of contracts may be enforced.³²

It is interesting that the IMF approved Iceland's exchange controls (albeit on a temporary basis). Clearly, the circumstances prevailing in Iceland were exceptional. Given other events at that time, giving primacy to financial stability over other considerations also would have been understandable. Among the key factors in the Icelandic crisis were

1. an extraordinary set of numbers relating to gross public-sector debt, the ratio of affected assets to GDP, external indebtedness, and depreciation of the currency (in a nutshell, a genuine crisis that extended to the overwhelming majority of the domestic banking industry);
2. a number of actual steps and other serious attempts at self-help by the local administration;
3. a credible government likely to be proactive in trying to improve the situation; and
4. a transparent system of foreign exchange during the lifetime of the restrictions assembled on a nondiscriminatory basis.

These criteria suggested a demanding threshold for IMF approval. Compare these with the exchange controls imposed by the Ukraine—also in 2008—which were not approved by the IMF.

VII

UKRAINE 2008

Ukraine “imposed a number of exchange controls, including delays on transferability of hryvnia³³ profits, limitations on early repayments of foreign

32. In many respects, in recent years, the distinctions between state debt and private-sector debt have become blurred. Since the onset of the global financial crisis, many private-sector debt claims have been supported in some form by their host state. Exchange controls generally affect specified categories of claims, whether the obligors under them are in the private or public sector, and they therefore represent another area of state involvement affecting private-sector claims. For example, in the case of Russia in 1998, swap claims owed in some instances by strong domestic banks (for example, Sberbank) were caught by the restrictions. In South Africa's case in 1985, obligations owed by well-capitalized, profitable companies with strong balance sheets were also caught within the net, all as a result of conduct by the host state.

33. Hryvnia is the national currency of Ukraine.

exchange loans, and limitations on advance payments.”³⁴ The restriction on advance payments was removed before the Letter of Intent was sent to the IMF, and Ukraine said it would seek IMF approval for the exchange restrictions at the time of the first review of the Stand-By Arrangement, presumably because it was acknowledged that the exchange restrictions affected current international transactions. The IMF commented that “[e]xchange controls . . . could only . . . be a temporary solution [at most], given circumvention and distortionary impacts, and could magnify pressure for outflows.”³⁵ During the first review, the IMF simply noted that “Ukraine [had] accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Fund’s Articles of Agreement”³⁶ and did not approve the exchange restrictions.

The lack of approval from the IMF meant that the obligation of member states to give extraterritorial effect to the Ukrainian exchange restrictions (to the extent they applied to qualifying exchange contracts) was not triggered. This meant that either the exchange-control measures were regarded as being inherently inconsistent with the IMF Articles or the circumstances surrounding the imposition of the Ukrainian exchange controls were not appropriate to justify the interference with either sovereignty or contractual rights that would be a consequence of approval.

Notably, Ukraine had undertaken no equivalent self-help measures, as was done by the Icelandic authorities. In its report, the IMF referred to new exchange restrictions imposed by Ukraine between September 1998 and March 1999, after Ukraine had accepted the obligations under Article VIII.³⁷ This can be contrasted to the Icelandic undertaking not to intensify restrictions and to Iceland’s offer to consult with the major affected institutions, either historically or in 1998. Nor did Ukraine attempt to make the point—which was so persuasive for Iceland—that the exchange restrictions were imposed for balance-of-payments reasons and were nondiscriminatory.

It would be fair to conclude that the IMF has recently set a high standard for approving exchange restrictions affecting current international transactions. The backdrop of an economy suffering major strains itself is unlikely to be sufficient. It is helpful if the exchange restrictions themselves are for a specific purpose and are nondiscriminatory and administered in a transparent manner. Finally, evidence of self-help by the authorities beyond exchange controls—

34. Letter of Intent, Memorandum of Econ. and Fin. Policies, and Technical Memorandum of Understanding from Viktor Pynzenyk, Minister of Fin., et al. to Dominique Strauss-Kahn, Managing Dir., Int’l Monetary Fund (Oct. 31, 2008) (on file with *Law and Contemporary Problems*).

35. INT’L MONETARY FUND, UKRAINE: REQUEST FOR STAND-BY ARRANGEMENT, IMF COUNTRY REPORT NO. 08/384, at 14 (Dec. 2008), available at <http://www.imf.org/external/pubs/ft/scr/2008/cr08384.pdf> (last visited July 19, 2010).

36. INT’L MONETARY FUND, UKRAINE: FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT, IMF COUNTRY REPORT NO. 09/173 para. VII (May 2009), available at <http://www.imf.org/external/pubs/ft/scr/2009/cr09173.pdf> (last visited July 19, 2010).

37. *Id.*

perhaps to a level where it would be difficult to expect the state actor to take any other or further steps—is clearly helpful.

The thresholds for IMF approval cannot be determined from examining just two examples, but useful conclusions can be drawn about the preparedness of the IMF under Article VIII(2)(a) to approve exchange restrictions affecting current international transactions. In Iceland, at the time of this writing, the rescheduling of state-to-state claims owed to the United Kingdom and the Netherlands as a result of the Icesave collapse (and the compensation paid by the United Kingdom and the Netherlands to depositors from their respective jurisdictions) has been halted because Iceland's president has not approved the relevant local law. In Ukraine's case, the external debt restructuring of Naftogaz (the country's largest company, also wholly owned by the state) closed successfully in 2009, with full participation amongst its creditors.

VIII

DEBTOR CONDUCT

Exchange controls used in a manner that is consistent with the IMF Articles could have a useful role in sovereign debt restructurings. There would be limits on their application; for instance, a rescheduling of principal claims with interest remaining current would be easier to reconcile with the IMF Articles than a stock reduction with extensive interest write-off. Whatever the position, though, the more important factor in achieving a successful sovereign debt restructuring is the conduct of the debtor. In this context, collective-action clauses can be very useful, as Ukraine's 2009 Naftogaz restructuring and the Republic of Seychelles 2009–2010 restructuring both demonstrate. In both cases, the collective-action provisions were activated so that the countries achieved one-hundred percent take-up in their restructurings.

IX

CONCLUSION

In extreme conditions, capital controls, including exchange controls affecting current transactions, potentially have a role to play as a policy response. In these conditions, particularly when primacy needs to be given to financial stability, we should expect the IMF, in very limited circumstances, to consider approving nondiscriminatory exchange controls affecting current international transactions on a temporary basis.

Although the circumstances in which the use of exchange controls as a crisis-response tool are likely to be fairly limited, it is not helpful for countries to further restrict their freedom of movement through free-transfer clauses without balance-of-payments safeguards in bilateral investment treaties, as that would have an impact on both crisis-response and crisis-prevention flexibility.