Graduate School of Development Studies

# Free Trade Agreements and Financial Instability in Developing Countries:

## The case of Latin America and the Caribbean

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## List of Acronyms

**FTA: Free trade agreement**

**EPA: Economic partnership agreement**

**GATS: General agreement on trade in services**

**WTO: World trade organization**

**MAI: Multilateral agreement on investment**

**FDI: Foreign direct investment**

**BoP: Balance of payments**

**EU: European Union**

**CARIFORUM: Forum of the Caribbean ACP States**

**EFTA: European free trade association**

// Abstract

This paper seeks to explain the effects free trade agreements may have on financial instability in developing countries. In particular, the idea that new trade agreements will increase financial instability through the increasing of competition, the liberalization of the capital account and the proliferation of new and dangerous financial innovation was contrasted with theories and a case study of 4 FTAs.

## Relevance to Development Studies

In the last 30 years developing countries have experienced several financial crises. Unfortunately, the cost and consequences of financial crises are disproportionately paid by the poor in developing countries. Some studies show that the income of developing countries is now 25% lower due to financial crisis (Eichengreen et al.,2004). For these reasons, there is a challenge for development practitioners to explore the sources of financial instability. This paper intends to contribute to this set of literature by analyzing possible threats coming from FTAs, with the ultimate objective of obtaining a more stable financial system.

## Keywords

Free Trade Agreements, Financial Instability, Capital Account Liberalization, Trade in Financial Services, Investment Treaties, Financial Crisis, Competition, Financial Markets, Derivatives, Capital Flows.

# 1. Introduction

## *1.1. Background*

"Every unhappy family is unhappy in its own way", said Anna Karenina, referring to the thought that calamities are always caused by unique reasons and need to be explained on an individual-case basis. Tolstoy´s maxim may apply to family tragedies, but the history of financial crises in the developing world does not appear to follow the principle so often quoted. In contrast, studies of financial crisis in the last 30 years drive the conclusion that there are many similarities, rather than irreconcilable differences, in the cause of financial crisis in the south.

All the worst recent crises in the developing world, beginning with 1994 in Mexico and July 1997 in Thailand, down to the Russian rouble collapse in 1998 and the Argentinean financial crisis at the beginning of the 21st century were preceded by massive net inflows of foreign capital and then followed by outflows of credit and disinvestment that lead to massive currency imbalances (Saccomanni and Chambers,2008)

Those recent crises, together, noticeably changed the way the economic world was conceived. Crises always stimulate the appetite for new ways of understanding the economic world. Kindleberger says that books about economic crisis are procyclical (Kindleberger and Aliber,2005). But the same is true for papers, seminars and articles on any economic topic. Times of crisis are when researchers work harder and very often textbooks need to be rewritten after economic turmoil.

After these aforementioned crises, academia changed its recommendations for the developing world. Although they generally continued advocating free trade to developing countries, the process of financial liberalization was the big loser of the game. Financial liberalization was blamed, and is being blamed still, for producing financial instability[1]. Even now, during the recent world crisis, the financial liberalization process continues to be demonized.

While in theory liberalization of trade is very different from liberalization of finance, in practice this differentiation is blurred under the new generation of Free Trade Agreements. Firstly, free trade agreements imply the liberalization of trade in financial services. Services have become an important component of the global economy in the last 30 years, and although liberalization of trade in services seemed reasonable and was supported by many, it also means liberalization of hybrid-financial services, which imposes new debates.

Secondly, the spirit of FTAs has changed in the last 10 years. The inclusion of investment chapters in the US-Chile and US-Singapore FTAs in 2003 and the Chile-EU FTA was the starting point for a new generation of FTAs which go further than just liberalizing trade in services. While historically investment provision was a matter of other investment treaties, now investment treaties have been incorporated into trade agreements, which has new implications for the way countries can control their economic policies. The inclusion of investment has received lots of attention and criticism. Investment and trade is a controversial topic *per se;* a component of the so-called Singapore issues on which developing countries could not agree in multilateral negotiation. Its inclusion in FTAs has not escaped skeptical scrutiny from those who recognize that issues on which developing countries did not give up when acting together as a group are now being negotiated separately on a bilateral basis, where developing individual countries have no power to negotiate.

Arguments from supporters of the new generation of FTAs are that trade in financial services and investment chapters represent enormous benefits for developing countries. From their perspective, liberalization of trade in services and investment is not substantially different from liberalization of trade on goods and, and since trade in goods has been the growth engine policy *par excellence*, liberalization under FTAs should produce growth based on the same principles, namely specialization on the basis of comparative advantage, dissemination of know-how and new technologies and realization of economies of scale (Kono et al.,1998).

Arguments of the critics of new free trade agreements are that liberalization of trade in financial services and investment is not on a par with free trade in goods. In contrast, from their perspective, the effect of new generation FTAs is not substantially different from financial liberalization, and therefore they represent the same threat: financial instability.

This dilemma has strengthened due to the exponential propagation of bilateral south-north free trade agreements with components of liberalization of financial services and investment chapters. Since the end of multilateral trade liberalization, a new system emerged which is usually illustrated with a "spaghetti bowl" (Abugattas, 2004). This system is intensifying the discussion about those who think that FTAs will be beneficial to developing countries and those who believe that they will lead to financial instability.

This latest critique has intensified even more as a product of the 2008 global financial crisis. The moments of anxiety driven by the unprecedented level of generalized instability in the world has made civil society react against trade in financial services. Civil society actors such as the Transnational Institute, the Centre for Multinational Corporations, the World Development Movement, and the South Centre have been pioneers in addressing the

possible harmful effects of chapters of trade in financial services and investment in developing countries in the light of lessons from the current crisis. Also, well known economists such as Nobel Prize winner Joseph Stiglitz and Columbia University professor Jagdish Bhagwati have displayed doubts about FTAs and financial instability[2]. Furthermore, the United Nations has shown concerns in its recommendations for reforms of the international monetary and financial system after the 2008 global crisis.[3]

In light of this discussion, this paper will be concerned with the second set of arguments: whether new generation FTAs could potentially increase financial instability in developing countries. The manner in which FTA commitments affect financial sector instability has received little attention in literature despite the real concern among civil society and some recognized economists. There is then a lack of serious research on this topic and an evident literature gap that this paper is intended to fill.

### *1.2. Research objective and questions*

This paper seeks to aid to comprehend the effects of the free trade agreements on financial stability. Considering the ways in which free trade agreements can lead to financial instability and contrasting these theoretical findings with the facts of the case of Latin-America and the Caribbean will help us to understand deeply the theory and also the practice of those agreements as well as its implications

The leading question: do the new generation of FTAs between north and south potentially increase financial instability in developing countries?

Sub-questions:

1. Which components of financial liberalization have been recognized as harmful to financial system stability?
2. In which ways can these dangerous components be present in FTAs?
3. How do the agreements selected impose countries to the dangers theory suggest?

### *1.3. Methodology*

The approach to the problem will be based on qualitative techniques, in particular:

1. Literature review of the theory behind financial instability and its links to financial liberalization
2. Literature review of the links between FTAs and financial instability and between FTAs and financial liberalization
3. Descriptive analysis of texts

## 2. Analytical framework

Even though the relevant of the new generation of FTAs (trade on financial services and investment treaties) are not new[4], there is surprisingly little literature linking them with financial instability[5], making the objective of this paper problematic. Given this lack, this paper will use the old concept[6] of financial liberalization to construct a coherent analytical framework that relates FTAs with financial instability.

The concept of financial liberalization has been used several times to criticize FTAs. Critics argue that financial liberalization is analogous to FTAs and therefore, if financial liberalization leads to financial instability then, by definition, FTAs would create the same result[7].

This paper finds the methodology used by these critics very problematic for one important reason: FTAs and financial liberalization are two related but very different concepts. First, in the case of trade in financial services, the two concepts have remarkably different objectives. While trade in financial services entails policy reform designed to remove discriminatory and other access impeding barriers to foreign competition, the interest of financial market liberalization is to remove distortions in the financial system (Goncalves and Stephanou,2007).

Secondly, it is also difficult to relate investment with the objectives of financial liberalization. Although the process of financial liberalization endows a country with the freedom to invest in the financial sector of another country, the objective of a chapter in investment is to create clear rules for international investors within the domestic regulatory system, and not to change domestic regulation on external markets (although that may be the case).

Third, as will be seen in the next section, the liberalization of trade in financial services and investment promotion (at least in the financial sector) are a subset of the broader financial liberalization agenda (Goncalves and Stephanou,2007), namely, the one that is related to allowing the entry of foreign banks and foreign services into domestic markets.

This paper recognizes fundamental differences between the process of financial liberalization and new generation FTAs and uses a different approach to link FTAs with financial instability based on two steps. The first step will analyze the relationship between financial liberalization and the components blamed for producing financial instability. The second step will discuss the ways in which these elements of the process of financial liberalization that harm financial stability can be present in free trade agreements.

## *2.1. Step 1: financial liberalization and financial instability*

In general terms, financial liberalization refers to a set of reforms that have been used since the 1980s in an attempt to achieve a transition away from a repressive financial system to a more market oriented one. Those reforms usually imply two components: a domestic reform package which includes the removal of rate ceilings, directed lending, controlled interest rates, discriminatory reserves, and limits on ownership of banks, and an external financial liberalization which involves allowing financial flows and removing price controls over domestic and international financial markets. This implies the removal of capital controls the liberalization of exchange rates and allows foreign banks and foreign services entry into domestic markets[8].

The reason for supporting such a set of reforms was based on the belief that financial liberalization would produce enormous welfare gains to the economy. Domestic reforms were seen as a financial development mechanism capable of contributing to greater long-term economic growth. External reforms, at the same time, derived their benefits from a more efficient allocation of capital, higher investment rates, and higher growth.

But the honeymoon for the process of financial liberalization ended soon. After some episodes of financial crisis, the process of financial liberalization started to be blamed by some for creating financial instability. It was as early as 1985 when Diaz-Alejandro explained and proved that saying goodbye to the era of financial repression meant saying hello to financial crash(Diaz-Alejandro,1985).

Diaz-Alejandro's evidence was the beginning of a battle between those who thought that financial liberalization creates financial instability and those who thought that financial liberalization only represents benefits. In the 1990s, however, Diaz-Alejandro´s evidence stopped stirring up skepticism (Chandrasekhar,2003) and presently this theoretical battle has been concluded.

There is today increasing acceptance of the view that financial liberalization is not good for developing countries because it can increase financial instability (Chandrasekhar,2003) ( **box 1** for a definition of financial instability). Even the IMF, a fervent promoter of financial liberalization, in an extensive study of the effects of financial liberalization on developing countries, found empirical evidence to support the recommendation that liberalization should be implemented with caveats, because it has often been accompanied by vulnerability to crises (Prasad,2003).

Not all components of the wide-ranging process of financial liberalization have been blamed for having negative effects on financial stability, and the objective of this first step is to link the broad process of financial liberalization with financial instability recognizing the components of financial liberalization that have been accepted in literature as harmful for financial markets. In general, the criticism has been focused in the capital account liberalization process and the increasing competition.

### 2.1.1. Capital account liberalization and financial instability

There is agreement that an excess of capital flows coming in and suddenly out are a main cause of financial instability and financial crisis in developing countries (Blair,2003, Ocampo et al.,2008, Rodrik and Velasco,1999, Semmler and Young,2008, Stiglitz et al.,2006) In recent history, this kind of massive movement of capital flows has been made possible by a process of financial liberalization that imposed capital account liberalization[9]. And for that reason, the process of financial liberalization has also been blamed for the occurrence and scope of recent crises (Semmler and Young,2008). If massive inflows and outflows of capital is causing crisis and financial liberalization is encouraging capital flows, then financial liberalization must be reconsidered –is the thought-.

Consequently, the paradigm has changed in relation to liberalization of the capital account. During the 1990's, the IMF recommended a mandate for capital account liberalization for all members of the global trading system during the annual meeting in Hong Kong in 1997 (Bhagwati,1998). But recent crises have offered a silver lining: the liberalization activism of the past is now *passé* (Wyplosz,2001). While previously the question among academics was about whether flows should be regulated in some way, after the crises the question among academics is how to regulate them (Wolf,1998)[10].

The use of the process of capital account liberalization to explain financial crises is not a heterodox observation. Even the IMF abandoned its blanket position about capital controls and recognizes that "the process of capital account liberalization has often been accompanied by increased vulnerability to crisis" (Prasad,2003). In practice, the IMF is recognizing the importance of capital controls to manage and prevent crisis. During the financial crisis that began in 2008, the IMF recommended capital controls to Iceland (IMF,2008), and confirmed that in order to reduce systemic risk associated with large capital inflows there should be constraints on the foreign exchange exposure of domestic institutions and other borrowers (IMF,2009).In March 2009, the IMF recognized that "the existence of capital controls in several countries and structural factors have helped to moderate both the direct and the indirect effects of the financial crisis" (IMF,2009a)

The position of academia is also changing. It is notable that famous pro-liberalization economists are now recommending capital controls as a useful tool against crisis and instability. Very notable in this respect is the recommendation of capital controls by Bhagwati [11] and Calvo[12].

## The dangers of capital flows in theory

The liberalization of the capital account creates instability, particularly macro-instability, by allowing capital flow's mobility. And capital flows are recognized to be dangerous for at least two reasons: 1) because capital flows are very volatile and 2) because capital flows are procyclical.

Firstly, as stated by Keynes, capital flows are volatile because its players respond to expectations, and expectations are based on inherently incomplete and costly information (Ocampo et al.,2008). Those expectations are mainly concerned with what other people think. The famous allegory is to think about a beauty contest where each judge is not interested in picking the face which he himself finds prettiest, but those which he thinks most likely to catch the fancy of the other judges, all of whom are looking at the problem from the same point of view (Kirshner,1999).

In this game of expectations, contagion of opinion is present by definition, and booms and periods of extreme optimism are as frequent as periods of panic and burst (Stiglitz et al.,2006). In this game, big players are listened to very carefully because they are meant to have better information; this leads to the herding effect, when one big player leaves one country, many other players follow, creating a financial stampede. Capital flows are, not surprisingly, characterized by maniacs, manias and panics (Kindleberger and Aliber,2005) reflecting investor herding and associated contagion that exhibits itself not only at the national level with stampedes, but at the international level affecting countries for reasons that have nothing to do with their economies, for instance Chile capital availability was affected by the Asian crisis (Ocampo and Griffith-Jones,2007).

The fact that investors decide to leave a country in a stampede represents enormous investor coordination problems. During periods of capital flight it pays for an individual to stay invested as long as other investors are doing just that. A Pareto-optimal equilibrium would probably be for all investors to leave their funds in the country. But given risk aversion, the equilibrium that emerges involves mass capital flight (Stiglitz et al.,2006). This is a case of the classic prisoner-dilemma outcome in financial markets: although collectively, all investors would be better off cooperating and staying, for each individual it is more advantageous convenient to leave the country and betray the other investors.

Countries are exposed to this exuberance and pessimism of foreign investment when capital markets are open (Stiglitz et al.,2006). A country that is seen as a successful economy is suddenly seen as a "pariah" under capital account liberalized economies (Ocampo and Griffith-Jones,2007).

What is really problematic about the volatility of capital flows is that it creates externalities, those who are deciding to invest in one country are not considering and paying for the cost associated with the transaction. Besides, individual borrowers ignore how their additional borrowing affects others (Stiglitz et al.,2006). This results in discrepancies between the returns to market players and returns to society as a whole (Stiglitz et al.,2006).

Volatility of capital flows creates two kinds of externalities. First, it creates a price externality called exchange rate volatility (Ocampo et al.,2008, Stiglitz et al.,2006). The effect of capital flows on exchange rate is determinant, and if capital flows are volatile, then the exchange rate would is volatile as well. When a county liberalizes, in-coming capital flows appreciate the currency, representing a cost to the external sector. If flows were not volatile, it would not represent a major problem. But, because flows move in mad dashes, after the spigot has been turned on, there must come a moment when the spigot is turned off, forcing depreciation. During outflows, governments often raise interest rates to limit the extent of currency depreciation. Both exchange rate depreciation and interest rate increases can pressurize firms into bankruptcy (Stiglitz et al.,2006) and cause financial sector difficulties.

Secondly, capital flows have a strong effect on capital availability. When capital flows are volatile, the availability of capital will be volatile as well creating a quantity externality. In moments of optimism, credit is abundant, and its abundance encourages uninformed international investors to lend to everyone, even unprofitable individuals and firms, thereby accumulating bad loans in the system (Giannetti,2007). Later on, when moments of pessimism come, banks start to ration credit (Ocampo et al.,2008). The rationing is even more remarkable for developing countries highly in debt, since creditors will see a debt/reserve ratio that is too high and will cut commercial credit lines (Stiglitz et al.,2006). It is in that period of credit rationing when firms and companies struggle to pay back their obligations, creating financial distress.

A theoretically accurate argument would be to think of exchange rate movements and capital availability from a neoclassical point of view; explicitly, that exchange rate and capital are there to balance each other and create a general equilibrium. Declining wages and cheaper asset prices attract international flows; thereby helping to stimulate the economy through more credit (Stiglitz et al.,2006) And when more capital is coming into the country, than is needed, increasing prices will stimulate capital flight, leading to equilibrium where supply of capital equals demand.

If this neoclassical reasoning was realistic, the volatility of capital flows and consequent exchange rate and credit availability would represent no problem. But unfortunately, the behavior of financial sectors is far from this ideal world. Pro-cyclicality is inherent in financial markets (Stiglitz et al.,2006), capital flows into a country when asset prices are rising, and leave domestic markets when asset prices are dropping, creating the when-it-rains-it-pours syndrome (Kaminsky et al.,2004).

What follows is the second problem of capital flows: pro-cyclicality. This is the situation described above: when countries are doing well, capital comes in, but when the economy is in recession capital suddenly stops. This makes the business cycle more extensive (Ocampo and Griffith-Jones,2007). It has been proved empirically that net capital inflows are pro-cyclical in most OECD and developing countries, and, for developing countries, the capital flow cycle and the macroeconomic cycle reinforce each other (Kaminsky et al.,2004).

Capital flows into a country precisely when its economy is booming; causing exchange credit availability and appreciation, and asset prices go up. The three sectors of the economy are doing well; firms are enjoying greater profits, governments are receiving more money and households are both earning and spending more. But, because flows are volatile, a moment of pessimism creates a stampede out of the country, credit is restrained and the exchange rate depreciates. Once a crisis starts, the costs incurred will probably be greater if there is free capital mobility (Edwards,2005).

For developing countries the effect of pro-cyclicality is more severe than in the developed world. This is due to two major institutional differences in their financial markets. Firstly, developing countries have currency mismatches between assets and liabilities(Ocampo et al.,2008). This reflects the fact that, with only a few exceptions, the external debt of developing countries is in foreign currency, exposing them to exchange rate risk and financial instability. Because of this "original sin" (Eichengreen et al.,2004), debt that looked sustainable at a given interest and exchange rate may become unsustainable when the exchange rate changes (Ocampo et al.,2008).

Secondly , creditors are unwilling to lend to developing countries on a long term basis because of the risk associated with lending to immature markets which often have high and variable inflation rates (Mishkin,2000). They cover themselves from risk by lending mainly on a short term basis, creating a maturity mismatch in developing countries (Stiglitz et al.,2006) which become dependent on that short term finance. The implication is that, given the volatility of capital flows, when confidence disappears and debt roll-overs become difficult, the entire stock of a country's short term foreign debt may have to be paid back within a year (Rodrik and Velasco,1999)causing financial distress for companies and governments. The first reaction of governments is to try to restrict capital flight with interest rate measures, which incidentally add much more default risk to the system.

As was said, pro-cyclical behavior is inherent in financial markets, and for this reason, this same problem also exists in domestic investors who leave the country when things get difficult in the domestic economy. But the impact of foreign investors in developing countries is greater "for the simple reason that developing countries´ financial markets are tiny relative to the amount of money sloshing around the international financial system" (Chang,2008). When capital flows are big relative to the receiving economy (as is the case for small developing countries) the effects of volatility and pro-cyclicality will be generalized.

**The hierarchy of capital flows**

One point of clarification must be made before continuing with this discussion, and it is that not all flows are equally harmful to financial stability. As was said before, financial flows increase financial instability because they have the characteristic of being volatile and pro-cyclical, but not all flows have the same level of volatility, and not all flows affects in the same way the capital account.

To elaborate on the concept, talking about capital flows refers to money capital flows, and non-money capital flows. Money capital flows are bank lending and borrowing which can be long term (more than a year) or short term (less than a year), and portfolio flows which can be debt long or short term and equity. Non-money capital flows are mainly foreign direct investment flows.

This hierarchy can be divided in two subgroups; we have on the high position FDI and long term loans, and on the lowest one short term loans and portfolio investment. FDI is in a very privileged position in the capital flows hierarchy. It is volatile in times of crisis but it cannot be easily withdrawn. For instance a company cannot close a subsidiary from one day to the next. Foreign direct investors are usually interested in stability and the long-term performance of the domestic economy (Stiglitz et al.,2006)

However, not all components of FDI are difficult to withdrawn (Ocampo et al.,2007a). FDI consists largely on fixed and illiquid assets which are difficult to sell during a crisis. This is the equity capital flow, used to buy the physical investment. But Sometimes FDI does not even include illiquid assets. Much of what is classified as FDI is finance rather than stable physical investment. Privatizations, mergers and acquisitions are all considered FDI although they only entail transfer of ownership.

FDI also represents earnings from foreign operations and intercompany loans. Once the physical investment is made it is stable, but in times of crisis,

international institutions remain loyal to their foreign parents and use financial trickery to send the money back home(Tamirisa,2000) .A foreign institution in times of crisis may be willing to accelerate profit remittance (Sula and Willett,2006) and reduce its liabilities recalling intra company loans (Chang,2008). An investor can even use illiquid assets (which are difficult to sell during a crisis) to borrow from domestic banks, exchange the money into foreign currency and send the money out of the country (Chang,2008) or use derivatives for making illiquid assets less illiquid in times of crisis.

But even given those volatile components, FDI is still the most highly recommended of all capital flows, Foreign direct investors encounter a different range of incentives during crisis, and this has been empirically proven (Osei et al.,2002). This type of investment in the financial sector also has been recognized for its positive spillover effects in terms of monitoring techniques, financial know-how, etc.

In the lowest position of the hierarchy comes short term lending and short term portfolio investment. Foreign bank lending is very volatile in the developing world. In times of crisis, the illiquid nature of a bank loans means that prices do not adjust automatically, and thus banks adjust the quantity of lending instead (Sula and Willett,2006). Foreign banks curtail their lending more in times of crisis due to their most sophisticated risk management techniques. The shortage of credit is critical for developing countries, which usually depend on short term lending. Developing countries use rollovers to pay past liabilities, and when the availability of credit suddenly stops; firms and institutions not only have no credit to use for further operational expenses, but also have to pay back their debts. This situation is more hazardous when international banks lend to domestic banks (which in turn lend to domestic corporations) because then, since those international banks have no stake in the corporate projects financed by local banks, in anticipation of a crisis it may be rational for a foreign bank not to roll over its loans to the domestic bank, even if, by forcing the domestic bank to call in loans in turn cause corporate bankrupts(Corsetti et al.,1998). This situation was seen in the Asian crisis: Japanese banks were the largest marginal suppliers of bank credit in Asia (particularly in Thailand) and when, due to domestic reasons, Japanese banks did not rollover the intra-banks lending, Thai banks found themselves with $23 billion dollars less credit (King,2001).

The same problems are finding in portfolio investment. Investment in bonds, for instance, has been called the black sheep of the capital flows[13]. there has been an overall decline in net portfolio debt flows to developing countries, but the pattern differs significantly between crisis and non crisis countries(IMF,2004). Periods of non crisis are characterized by massive inflows of this kind of capital and sudden stops are seen in times of crisis. The problems with the sudden stops, contrary to the case of loans, is not that it affects the issuers of bonds in the short term, but there is a monetary effect when the foreign investors which sell shares or bonds to other investors use

the money earned from sells to buy foreign currency and take it out of the country. There is a general consensus in the literature on financial globalization that debt flows, which include portfolio bonds flows and commercial bank loans, generate the greatest risk from financial openness (Kose,2006).

## Underlying assumptions revised

Thus far the argument goes as follows: some flows, particularly short term flows and money capital flows are very destabilizing and the liberalization of those capital flows would be destabilizing as well, generating financial instability at the macro level. It has already been theoretically proven that flows are unstable, but is it feasible that the *de jure* liberalization of those flows would imply a *de facto* increase in the pattern of international capital flows?. The argument presented above assumes that the answer to this question is affirmative, but this is not *necessarily* true.

The answer to the question is closely related to the discussion of the effectiveness of capital controls in restricting capital flows. If capital controls do not effectively restrict capital flows, liberalization or non liberalization would imply the same risk of financial instability, and the argument proposed would lose all its potency.

There is a common belief that globalization will continue, regardless of the legal rules imposed on markets, and that financial globalization, as an important component of the globalization process, is impossible to stop given the advances in technology and communication. A government policy, call it capital controls, cannot restrict a process of such magnitude, because globalization would evade those controls in one way or the other to reach a *de facto* capital account liberalization (Kose et al.,2009). It has been said that only a third world war could stop the expansion of capital flows (Obstfeld,1998).

In response to the vision that capital flows are impossible to stop, it has been proven that, although capital controls do not fully prevent cross-border flows, they appear to work as intended. (Levy Yeyati et al.) [14]. Stiglitz's analogy of capital controls as dams illustrates this point: dams, are effective because, even if they do not stop the flow of water, without them, a sudden powerful flow may cause death (Stiglitz,2000). Even if the water always finds its way out, it may be important to ask whether we want to speed this process with further liberalization (Rodrik,1998). Rodrik (2008) has issued an important point on this in his internet blog:

> *It is paradoxical that the same people who [say that capital controls won't work because they are easy to evade] are those who cry bloody murder at the mention of capital controls. If you can evade capital controls at little cost, you should simply*

*be unconcerned. And if you can evade them only at a cost, well then capital controls are working! Or as my co-author Arvind puts it, ask the people who make this argument whether they will deny that lifting capital controls will cause an increase in the volume of capital flows?*

What has been more widely accepted is that capital controls change the composition of the flows, stimulating FDI and reducing "hotter" capital flows, that is to say short-term portfolio flows and lending (Bank for International Settlements,2008b, Kose et al.,2009, Magud and Reinhart,2006, Montiel and Reinhart,1999).

Capital controls are not necessarily the answer for every country that experiences a financial crisis or that wants to avoid crisis. For instance, El Salvador endured crises in 1986 and 1990 despite controls. Another example is Kenya which has experienced 6 currency crises since 1975 with controls in place (Glick et al.,2006). However, it would be imprudent to rule out controls as a measure of prevention or last resort (Krugman,1999).

## Regulatory framework, capital flows and economic fundamentals

Some of those that advocated capital account liberalization in the past recognize now the influence of volatile capital flows on the instigation and spread of crises. However, they stress that it is the lack of a regulatory system and strong economic fundamentals, and not the opening of the capital account, that are the causes[15]. Consequently, the right response in developing countries should not be to restrict liberalization, but to strengthen the supervisory system first, which should be done in any case (Fischer,2002).

For some others sequencing is not that important, because some argue that just as financial opening *needs* a good regulatory system and fundamentals, financial liberalization also *leads* to a better regulatory system and fundamentals. This idea is present in a very influential paper by Kose (2006) aimed at vindicating the financial globalization process. The author stresses that financial globalization leads to economic growth and also to other "collateral benefits" that reinforce its effect on growth. These other collateral benefits include better institutions, better structure of capital flows, better market discipline, and a better regulatory framework.

What is indisputable is that regulation and fundamentals are important for a healthy financial system, either with an open capital account or without. In fact, one of the conclusions following the current financial crisis that started in the US in 2008 is that a good regulatory system as well as strong economic fundamentals are essential for the healthy functioning of financial markets and the prevention of crisis. There is no literature available suggesting anything otherwise. But what deserve further elaboration are the following questions: 1)

are good economic fundamentals and regulation enough to restrict the risks coming from dangerous flows?, and 2) can regulation and good economic fundamentals result from those flows as Kose (2006) argues?.

With respect to the first question, it is important to start by saying that putting in place an adequate set of prudential and regulatory controls to prevent moral hazard and excessive risk-taking is a lot easier said than done (Rodrik and Velasco,1999). Even the most advanced countries have failed in this attempt. Note that if developed countries such as Japan, the US, and Iceland have regulatory deficiencies, one can imagine the difficulty of creating an effective regulatory system in a developing country. A good regulatory system and strong economic fundamentals are not only difficult to achieve, but it is not even clear whether they will be able to stop destabilizing flows and their consequences. "It is easy to say: follow sound macroeconomic policies, adjust your exchange rates, improve your banks, eliminate cronies; etc. there has been no dearth of such advice, but can anyone seriously maintain that if these conditions can be fulfilled, panic fed out-flows of huge quantities of capital in the absence of controls will not materialize? Both empirical evidence and theoretical indicate that we have to be more prudent." (Bhagwati,2003)'

For the second question, the mere argument that financial liberalization leads to so called "collateral benefits" is contentious. It is difficult to find those benefits given the fact that liberalization, as has been generally supported in academic circles, can create massive inflows and later outflows of capital. It is difficult to have a better regulatory system, better and accountable macroeconomic management when a country is facing unstable and destabilizing flows.

Kono's paper is based on two ideas that commonly don't hold in reality. The first idea comes from the "impossible Trinity theorem" which holds that countries with flexible exchange rates and capital mobility have the opportunity to use their monetary policy for domestic interest. But in the presence of destabilizing flows, how is macroeconomic management going to improve and be independent when inflows and outflows are disestablishing the exchange rate and asset prices in the domestic country?.

The second is the idea that international investors penalize countries with unsustainable macroeconomic policies and regulation, and therefore liberalizing financial services will create better regulation and economic policies. But the truth is that international investors, usually short term investors, do not have a long term interest in the host country. They may be willing to invest in a sector, even if that sector is loosely supervised, at a time when long term fundamentals appear to be worsening (Stiglitz et al.,2006).

In summary, liberalization of capital flows may increase instability. Even considering that capital flows do not increase financial instability in the

presence of a good regulatory system, creating such a regulatory system is extremely difficult for developing countries. And, even if, as has been said by the IMF paper presented, liberalization would create pressure for a better regulatory system, this paper argues that it is not feasible.

**Are we inhibiting development when we restrict capital flows?**

Capital flows can be dangerous and can lead to financial instability, but at the same time capital coming into developing countries is intended to finance countries with a shortage of capital, and it is a legitimate concern to think that limiting capital flows in any way could be too painful for developing countries in the pursuit of their economic and social development.

The truth is that external private capital flows as a basis for development policy is a double edged-sword(Kregel,2004). If we talk about development from a narrow point of view, meaning mainly GDP growth, capital flows liberalization are supposed to generate growth in developing countries by the increase of capital in the domestic economy. However, as appalling as it sounds, in this moment, developing countries are not attracting that capital. Instead, it has been evident how capital is flowing from north to south recent years. Due to this phenomenon called the "Lucas paradox"[16] we can affirm that Latin America and Asian countries are making a contribution to the financing of development in the United States and other industrialized countries (Kregel,2004). It is evident as well that low income countries, especially in sub-Saharan Africa, have difficulty attracting flows, and this is based in structural factors, rather than cyclical ones (Griffith-Jones and Leape,2002). However, and this is even more important, empirical studies cannot find a positive relationship between *de facto* financial flows globalization in developing countries and economic growth (Kose et al.,2009) This means that even if poor countries could attract those capitals, this does not mean they would grow more.

If we take a broader understanding of development more towards what is called social development, foreign capital flows is not there to finance poor entities. In terms of portfolio investment, only big companies and entities in developing countries find finance issuing short term commercial papers and stocks. The only capital that could go to small business and development projects are bank loans, but capital flows in the form of bank loans do not reach the poorest people. International lending is unable to provide wide access to financial services to small enterprises (World Bank,2008) even less than local smaller banks (Detragiache et al.,2006). Foreign banks practice cream-skimming in poor countries (Detragiache et al.,2008) lending mainly to big multinationals or firms and raising concerns about the ability of foreign bank services providing to boost social development.

Capital flows coming to a developing country may also reduce the options its government has to spend in development. When international private capital flows come to developing countries, prudential policies on the part of government require that they maintain reserves equal or very close to the ones that they hold in short term foreign denominated liabilities. When a company in a developing country borrows $100 abroad in short term, it then has to set aside the corresponding amount in reserves, typically in American T-bills at very low (close to zero) interest rates. The country loses as a whole in this transaction not only because the money the business borrows has a higher interest rate than the T-bills, but also because the money the government puts into reserves could be used in development investment (Stiglitz,2003).

Moreover, the cost of allowing capital flows without any restriction and control is costly for countries in general (Allen and Gale,2004) and for developing countries in particular. Financial instability hurts the poor relatively more than the rich (Jeanneney and Kpodar,2006). The poor have no way of protecting themselves against the risks resulting from capital account liberalization (Stiglitz et al.,2006), they have no bank accounts in Switzerland to isolate themselves from exchange rate risk, and they are the first to feel the shortage of credit, which is very restricted anyways.

Then, appealing to the developmental role is another of the substantial gains from free capital mobility that has been more asserted than demonstrated (Bhagwati,1998), either in theory or in empirical analysis. This is not to say that developing countries cannot benefit from the inflow of capital. Many countries have managed to benefit enormously: cases from China, India, and Brazil are clear examples. However, just the mere liberalization of capital does not imply development or growth to developing countries, just as the mere restrictions of certain capital flows do not imply limits on development[17].

### 2.1.2. Foreign competition and financial instability

The process of financial liberalization is said to affect financial instability when increasing competition. Competition has been blamed for affecting financial micro-instability making each individual bank willing to take more risk and making each bank more vulnerable to failure. At the same time, competition is blamed for creating financial macro-instability by incentivizing firms to compete with new products that can pose silent threats to the overall financial system.

#### Competition and risk taking

Since the Great Depression, the dangers of competition for financial instability have been presented (Allen and Gale,2004). This view has been

influential in making policy officials less strict in implementing antimonopoly measures against banking than against other economic sectors. Just as examples, for a long time, banking in many EU countries was exempted from the reach of competition law (Canoy,2001) and mergers in the American financial sector are easily allowed, particularly after 1999 when the American process of financial reform that abolished The Glass-Stealgall act was concluded (Semmler and Young,2008).

Critics of financial liberalization have stressed that there are many theoretical reasons to believe that a non competitive system of few banks[18] with monopoly power is preferable to one of many competitive banks. A bank system with monopoly power may be preferred for one important reason: banking, when faced with competition, reduce their monopoly profits which are their cushion, incentivizing them to be less risk averse (Beck et al.,2003) which in turn affects financial micro-instability. This risk-taking behaviour is the product of information asymmetries present in financial systems.

There are large volumes of literature concluding that when financial institutions face lower profits, moral hazard intensifies and the incentive to choose riskier portfolios increases (Allen and Gale,2001, Beck et al.,2006, Smith,1984) to an extent far beyond what is socially desirable (Demirgüç-Kunt et al.,1998). In an influential article Keeley (1988) empirically tested this effect in the US, showing how banks with more market power hold more capital relative to assets and have lower default risk.

Not only is moral hazard in banks attenuated by competition, but in competitive markets the free rider problem in areas of information and monitoring appears, creating a degree of information and monitoring far below that which may be necessary for a healthy financial sector. As an example, in a banking system with monopoly power, a particular bank would be interested in investing in information searching and monitoring projects in respect of a new firm with unknown records because monopolistic banks have more certainty about a long term relationship with its clients. However, when competition exists, no bank would be interested in monitoring or research a firm that could defer to a competitor institution. This lowers the average monitoring and information gathering (Caminal and Matutes,2002).

Furthermore, a monopolistic banking system may be more profitable because it can inter-temporally share surplus (Petersen et al.,1994) That is to say, a bank can subsidize the interest rate of a small new enterprise because it can be sure that that firm will continue its credit relationship with it at a higher interest rate in the future. Competition creates exactly the opposite scenario: when there is competition, small and risky firms will get expensive credit, if any, while very profitable firms will pay only small interest. This makes banks more profitable and stable under monopolist power.

Adverse selection can also arise as competition increases. When one risky project cannot find financial capital in one institution, it can knock many doors until one bank accepts. Risky projects will find finance more easily in competitive un-concentrated markets creating a pool of funded projects with lower average quality of loans (Koskela and Stenbacka,2004).

But before accelerating the discussion to conclude that everything that creates competition will engender financial instability, it is be important to expose this argument to the newest literature. New theories have emerged in recent years which change radically the way the competition-financial relationship instability is going to be theorized[19].

The link between competition and risk taking incentives was very clear when considering only one of the activities of banking: taking deposits. But there is a totally neglected view about the incentives derived from the other main activity of banking: making loans. The mainstream focuses only on the *yang* of finance; but there are incentives coming from its *yin* (Boyd et al.,2009).

Boyd and Nicolo (2003) describe how when monopoly profits exist there are incentives that operate in exactly the opposite direction to financial instability: banks with monopoly power charge higher loan rates, which will exacerbate the moral hazard of the firms requesting loans, raising the bankruptcy risk, and then creating financial-micro instability. Also, another asymmetric information problem arrives in the case of higher rates: adverse selection. Only firms with very risky activities are likely to assume this cost of capital. Competition lowers the relative bargaining power of banks, which lead to lower lending rates in less risky projects (Koskela and Stenbacka,2004).

The idea that competition in financial markets can lead to more financial stability receives more empirical support when using cross country data. In effect, most papers supporting the negative relationship between financial stability and competition were based on data from the US. Acknowledging that the US banking sector is not representative of the remaining banking systems of the countries of the world, a test with cross country data for 72 countries and over 1400 banks revealed that entry barriers increase banks' profitability (Demirguc-Kunt et al.,2004). Another study by Beck, Demirguc-Kunt and Levine (2003) concludes that effectively, competition is linked positively with financial stability for 79 countries for a period from 1980-1997 for 50 banking crisis episodes.

All told, it can be stated that there are two incentive forces working in totally different directions when a country decides to increase competition in its banking sector. There is a "mainstream effect" that gives incentives for banks to take higher risks, and there is what has been called "the BDN effect" (Boyd et al.,2009) which provides reasons for business to take more risk averse measures. The further question is to know which one would prevail in certain

countries. An empirical study found the BDN effect to be greater than the mainstream effect in 134 countries and 3000 banks over the period from 1993 to 2004 (Boyd et al.,2009). Although most empirical work focused on cross-country studies points to a positive relationship between competition and stability, implying that the BDN effect is greater, the same cannot be said about country-based studies that lead to ambiguous results (Beck,2008).

A better and more comprehensive way of understanding the BDN effect is present in Martinz-Miera and Repullo (2008). In their paper, they explain some limitations of theories of the BDN effect as explained by Boyd et al. In particular, they state that the BDN effect is based on the assumption that the probability of loan default is the same as probability of bank failure; implying a linear relationship between interest rate and financial instability (see **figure 1-a**). However, - and this is their contribution to the discussion- all banks deal with loan defaults and that doesn't necessarily imply bank failure and micro instability. Bank failure comes about when income coming from "good loans" cannot support losses coming from "bad loans". Interest rate fluctuations affect not only the value of the losses coming from "bad loans"(BDN effect) but also the income coming from good loans (the margin effect).

**Figure 1. Competition and financial instability**

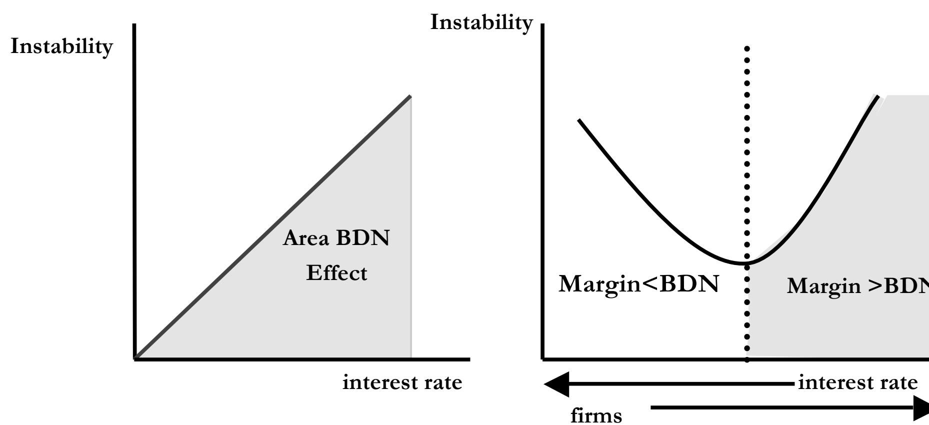


**Figure 1a.** Instability only taking into account the BDN effect

**Figure 1b.** Instability taking into account the BDN effect and the margin effect.

They stress that the probability of bank failure has to take into account not only the BDN effect (as the model designed by Boyd, Nicolo and Jalal) but also the margin effect. When they take into account all these effects, what they get is a u-shaped curve relationship between competition and bank instability as was proved and modeled by Repullo and Martinez (2008). Its relationship with interest rate was already proved in 1981 by Stiglitz and Weiss (1981)[20] (**see**

**figure 1-b**). The reasoning of figure 1-b is the following: an increase in competition lowers the interest rate for borrowers. This creates better loans, less adverse selection and moral hazard of firms, and consequently less loan defaults and less financial macro-instability for banks (BDN effect). However, the drop in interest rates also means less income for the bank and a flatter cushion to protect the bank against defaults (margin effect). In economies with low competition and high interest rates, the BDN effect is higher than the margin effect, while in economies with high competition and low interest rates the margin effect overrules the BDN effect.

As was shown, the vision of competition and instability is not as simple as was theorized in the 1990s. The question of whether competition will increase financial instability has no simple theoretical answer. The answer will definitely depend on specific country competition structures and real interest rates. Some countries may be located in the upward part of the curve of **figure 1-b**, implying more instability when competition is introduced while other countries may be in the downward region of the curve. All this means that the competition and risk-taking link cannot be considered *a priori* a "bad component" of the process of financial liberalization. If it is true that for some countries competition implied more micro-instability as was proven by Keeley (1988), for others the process was positive as seen in Beck et al (2003).

**Competition and new products.**

Financial liberalization and competition usually come together with waves of financial innovation. Firms facing competition, as recognized by Schumpeter in the beginning of the 20th century, try to compete for dominance through the introduction of new generation products (Allen and Gale,2004). Financial institutions are no exception.

The number of innovative financial products has grown rapidly. There has been a global explosion in the development of financial derivatives since 1990 (Ocampo et al.,2007a) and highly innovative derivatives in the form of credit default swaps and mortgage backed securities or loan backed securities have expanded exponentially in recent years (Semmler and Young,2008). Many of these derivative products are not entirely new[21], but the majority of modern transactions involves individually customized combinations of these derivatives which when packaged together, become incredibly complex (Kregel,2001)

Derivatives can be used to hedge risk associated with certain transactions, some contract can even cancel part of all risks associated with a transaction. For this reason, using derivatives should be associated with more stability in the financial sector of a country. However, the usage of derivatives can also potentially threaten financial stability because of their ability to encourage cross-border capital flows and to add more complexity to the

regulatory process - already difficult in financial markets. Firstly, derivatives incentivize actors to increase their level of debt as they minimize risks associated with international transactions. Lending and portfolio flows in equity and debt can be intermediated through structured derivative instruments, allowing investors to hedge against currency, liquidity and interest rate risk[22]. Once exchange rate or/and interest rate risk is gone from an international transaction, more risks can be taken in terms of quantity of financial flows. When investors have more certainty about future exchange and interest rates, they are more likely to invest abroad even in risky activities, but they also leave as soon as the situation in the foreign country changes, increasing volatility in exchange markets and exacerbating boom-bust cycles (Ocampo et al.,2007a).

This is particularly dangerous when these instruments are used in 'bad' capital flows, and in short term currency and money markets (Ocampo et al.,2007a). In practice, in emerging markets, that is what derivatives have been used for: principally to hedge an agent's exchange rate risk driven by an investors desire to invest in emerging market bonds and equity(Bank for International Settlements,2008) .Derivatives also play an important role in increasing short term lending in developing countries. Kregel (2001) shows why the usage of derivatives as the vehicle for lending to Asia as well as the short term nature of the flows explains the predominance of commercial banks as lenders, and how this played an important role in the Asian crisis.

Furthermore, in the case of FDI, the safest of all flows, "financial engineering" makes it possible for multinationals to use techniques to sell very illiquid assets in times of crisis, which renders the hypothesis of a hierarchy of volatility less clear-cut (Ocampo et al.,2007a). Under this era of derivative products, even FDI in critical moments is as volatile as traditional financial flows (Ocampo and Griffith-Jones,2007).

Secondly, there is a concern that foreign entrants with sophisticated instruments will crush weak supervisory systems designed only to deal with simple domestic financial services. This is a completely legitimate concern. The use of derivatives has made the formulation of appropriate regulations much more complex (Stiglitz et al.,2006) for both the developing world and developed countries.

The process of regulation of financial services has always been difficult, but in line with the proliferation of derivatives, the problems are exacerbated. This is because derivatives reduce transparency (Dodd,2002, Stiglitz et al.,2006) A firm's derivatives positions become almost opaque as these commitments are part of the off-balance-sheet transactions. In other words, derivatives drive a wedge between a firm's actual risk exposure and that reflected in its balance sheets. Derivatives can also lead to misleading representations of the market risk exposure of entire countries. This risk was traditionally represented by the maturity and currency denomination of its

foreign assets and liabilities in the balance of payment. Now, derivatives can add subtract significantly from the values indicated in the balance of payment, because the currency denomination of assets and liabilities can change with foreign exchange derivatives, and a long term loan can become short-term with interest rate options, and so on (Dodd,2002).

Additionally, large parts of those derivative markets are not regulated as they operate in the OTC market and off-shore (Ocampo and Griffith-Jones,2007). Regulating derivative markets is difficult even for developing countries (Ocampo and Griffith-Jones,2007). It is worth pointing out here that there is an entire school of thought[23] which argues that it is precisely an overuse of imperfectly understood financial innovation (securitization of credit risk through CDO's) combined with a the lack of regulation which lead to the rise of the supreme crisis of 2008 ((Semmler and Young,2008).

To sum up, financial liberalization enables competition from new firms. These new firms bring new products which increase the volatility and magnitude of capital flows, and limit the scope of regulation.

## *2.2. Step 2: financial liberalization and FTAs*

In the previous section, two of the common criticisms of the broad process of financial liberalization were explained and contrasted with up-to-date literature. It is evident that the main problems with financial liberalization for developing countries from a theoretical point of view are the liberalization of the capital account and the proliferation of new and sophisticated financial products, which usually follow as a result of increased competition in domestic markets.

Now that the dangers of capital account liberalization and financial innovation have been shown, the purpose of this section is to identify in which ways new free trade agreements may influence and engender these dangers.

### 2.2.1. Capital account opening

Free trade agreements can influence the process of opening the capital account in two ways. Firstly, do to their commitments to trade in financial services; the liberalization of some services may be impossible without opening of the capital account. Secondly, due to the importance of an open capital account to international investors, investment chapters within new generation FTAs could explicitly or implicitly state how capital controls should be restricted and liberalization allowed.

#### 2.2.1.1. Capital account and trade in financial services

Trade in financial services is difficult to conceptualize since, in contrast to trade in goods, services are invisible, intangible and non-storable (Tamirisa,2003). The WTO has used the notion of modes of supply to help the management and conceptualization of this kind of trade. Insurance, banking, derivative services and other financial services can be supplied in four modes: the domestic consumer can purchase the service in the domestic territory from a foreign supplier located abroad (mode 1); a domestic consumer can go abroad to purchase a service from a foreign institution (mode 2); a foreign supplier can open a subsidiary, acquire a domestic institution, etc, and sell a service to domestic consumers (mode 3);); and a foreign person can come to the domestic territory and supply a financial service (mode 4).

Commitments in trade in financial services in any mode of supply are not the same as capital account liberalization. In fact, only an untutored economist would argue that free trade in widgets and life insurance policies is the same as capital mobility (Bhagwati,1998). One main difference between the two concepts is statistical: trade in financial services is registered in the current account and corresponds to charges and fees for a transaction, being the mentioned transaction, a possible capital cross-border flow which must be registered in the capital account (Kireyev,2002).

However, the two concepts are closely related. The concept of trade in financial services in statistical terms is not the same as the concept which is used in the international trading system. The 4 types of trade in financial services just described comprise many more transactions than just those registered under "trade in financial services" in the current account of the balance of payments. Some of those (specifically under mode 1 and mode 3) have implications for the capital account, and some of them have *only* implications for the capital account[24].

I the case of cross-border trade (mode 1), each type of service has a different demand on the capital account regulation. For instance, a financial consulting institution providing a cross-border consulting service to a domestic firm does not imply capital flows and therefore will not require capital account liberalization. But there are other transactions that require a capital flows as essential to the supply of that service. To enhance the analysis of the links between cross-border trade in financial and the requirements of capital account liberalization as an inherent part of the service provision, **Table 1** presents a list of financial services used in GATS and also in FTAs, along with the types of flows that have to be liberalized in the case of liberalization commitments following the methodology found in (Tamirisa,2000).

**Table 1** shows three types of financial services. There are some financial services which are inseparable from capital flows, and liberalizing those services is analogous to liberalizing the underlying capital movements. That kind of service is shown in the black cells in **table 1**. There are other services where the capital movement is separable from the financial service (shown in the gray cells in **table 1**), and in such cases liberalizing trade in services *usually* implies both lifting restrictions on trade in services and also lifting restrictions on some capital movements. As an example, to allow residents to purchase asset management services abroad not only trade in financial services in asset management services has to be allowed, but also it has to be allowed for residents to purchase capital market securities abroad, this latest being a capital account restriction liberalization. There is a final type of financial service shown in the white cells in **Table 1,** which has no impact on the capital account.

As a conclusion for trade under mode 1, most commitments in trade in services related to bank and other financial sectors very often require some degree of capital account liberalization. In particular, commitments such as the acceptance of deposits, lending, financial leasing, asset management, payments and money transmission, money broking, guarantees, trading in exchange and over the counter market, derivatives, and money market instruments cannot proceed without capital account liberalization.

When a financial institution delivers financial services through mode 3, a difference has to be drawn between when it implies independent capital or not. When subsidiaries come to a country with independent capital, they are considered residents (Lehmann et al.,2003) and they would only be allowed to provide those services allowed by the capital account regulation of the host country and the services that do not imply capital movement. But, when it implies branches (branches have usually no independent capital, and are considered non-residents) service transactions would be analogous to cross border trade under mode 1.

When we talk about establishing a commercial presence with independent capital, either through entry or mergers and acquisitions or through a green-field investment, the only capital flow necessary is foreign direct investment. **Table 2** shows how most services in the GATS list do not imply other capital flow when supplied under mode 3. It is clear that some may include capital flows, services such as trading in derivatives may imply capital movements when the instrument involves foreign capital but, as is evident in **Table 3**, when that service implies no foreign capital it does not have any effect on the capital account of the balance of payments.

**Does trade in the financial sector mean capital account liberalization of "bad flows"?**

Until now, there is no literature linking trade in financial services and capital flows. However, as shown in the previous section, the implication of trade in financial services depends greatly on the mode of supply concerned. If we are talking about mode 3 with subsidiaries legalized as independent entities, commitments would imply liberalization of FDI, which is considered a "good" financial flow. But the problem arises when trade in financial services is supplied through mode 1 or through mode 3 involving branches without independent capital, because in these cases, trade commitments would imply liberalization of "bad flows".

A similar conclusion has been drawn in literature relating to GATS' commitments to trade in financial services. Kono and Schuknet for the WTO (1998) analyze GATS commitments and their effect on financial flows. They conclude that commitments in mode 3 result in less dangerous capital flows and a reduced bias towards short-term lending, since they facilitate the assessment of credit-worthiness and, hence, financial institutions are more willing to accept long-term commitments. In the case of cross border trade it tends to imply more capital flows, increase volatility and incentivize short term lending over long term lending. The problems with commitments in trade under mode 1 have been proven empirically by Valckx (2002a) who analyzed the link between financial crises and commitments in trade in financial services under GATS, and found that countries which faced a financial crisis committed by 5-10 basis points more than non-crisis countries in trade in services in general. And also those financial crises occurred predominantly in countries that were more lenient to mode 1 commitments.

### 2.2.1.2. Capital account opening and investment chapters

For foreign investors capital controls are costs that reduce the expected profit derived from an investment and it is in an investor's interest that countries do not impose them. Capital controls on unexpected outflows, as those imposed by Malaysia in 1998, are very painful for investors, and investment chapters would try to limit their usage.

An investment chapter may restrict capital controls implementation in two important ways. The first one, regularly used by EU FTAs, consists of an article explicitly prohibiting such measures. The second one is to use transfer protection and the definition of investment to include a wide range of products under investment protection. The first mode of prohibition is straightforward, but the second deserves further attention

**Capital controls under transfer's articles.**

The idea that investment transfers should be protected is completely understandable. When a company opens a subsidiary abroad, allowing the repatriation of profits is reasonable, as I the repatriation of principal in case of liquidation. In these circumstances it is clear that state intervention may undermine investors' rights.

But at the same time, in case of crisis, a state may not be willing to let those companies' capital leave the country, thereby worsening the domestic situation. In contrast, it is in a country's interests to have the opportunity to adopt measures to retain that capital for a certain period - until the situation improves. This is, in fact, part of the "monetary sovereignty" that customary international law recognizes as an entitlement of sovereign states (Dolzer and Stevens,1995).

In this tradeoff between interests, restricting the imposition of any capital controls results in the victory of the interests of the investor over those of the public host interest. This is, in fact, what many academics and legal practitioners have seen in the legal regime that governs foreign investment nowadays[25]

It is important to note that the definition of transfer changes among FTAs. The basic transfers allowed under investor protections is the requirement to permit free repatriation of the gains generated to the covered investment and also the repatriation of principal in case of liquidation. The basic transfers referred to under FTAs are related to outward transfers and not transfers coming into the host country. However, FTAs may also provide fot inward transfer in the form of the new investment capital or capitalization of a foreign affiliate (UNCTAD,2000).

The impact of permitting without restriction and delay basic transfers as these depends greatly on the definition of investment. For instance, if investment is greenfield FDI, allowing repatriation of gains means that profits coming from the FDI can be repatriated, affecting the current account of the balance of payments. But agreements also guarantee the right of investors to repatriate the capital in case of liquidation. This means that in moments of panic, a multinational can liquidate a subsidiary and send the capital abroad. However, it's well known that in moments of distress a subsidiary cannot be liquidated that easily. To liquidate a subsidiary involves a long and tedious legal process that cannot be done in a matter of days and it is possible that the panic will ends before the subsidiary is able to leave.

But very often definitions of investment imply more than FDI. The ultimate solution of this trade-off between investors and stability has to do with the definition of "investment" in trade agreements. Traditionally speaking, investment was mainly related to foreign direct investment, and investment treaties included protection for this kind of investment. But in a radical

departure from the past, free trade agreement definitions include portfolio investment and credit, which means a vast number of other financial products that could potentially become the target of state regulation (UNCTAD,2009). Investment in the form of "hot money" transactions could seek protection from these chapters in new generation free trade agreements (Siegel,2004).

To exemplify, if a foreigner acquires equity in a developing country, that foreigner obtains the title of "investor", and that equity is interpreted as the "investment". If a financial crisis fires up, a foreigner would be willing to take the capital of its investment back to its country promptly, before it loses value. Then this "investor" is allowed to take its capital out of the country without restriction and delay. It is clear then, that investment protection enables the flight of capital out of a country and, as almost every financial asset is investment, then the law allows the flight of almost every flow without government restriction. The scope of the definition of investment determines the potentially exclusion of purely speculative forms of short-term portfolio transactions from the definition of investment. And therefore, transfer would not necessarily imply serious limitation of a government's ability to apply capital and exchange controls.

Now, post-crisis capital controls are not the only kind that exists. There are preventive capital controls, such as the famous Chilean *encaje* or the controls imposed by China. Those would be forbidden to the extent that transfers of inwards (capitals as contribution to capital and the principal of a new investment) are allowed and a wide definition of investment is used. Foreign actors investing in any assets defined as "investment" are granted pre-establishment rights, thus drastically reducing the scope for a host country to decide whether or not to approve a foreign investment or impose conditions for such an approval (UNCTAD,2007). (see **box 4** for a review of investment definition in treaties).

In sum, this combination of a broad definition of investment with the provisions on pre-establishment rights and free transfer of funds means capital account opening for financial inflows as well as financial outflows. Restringing seriously the policy options left to the economic authorities.

**Safeguard measures.**

Historically, the US agreements with Chile and Singapore and the EU trade agreement with Chile formed the origins of this new generation of free trade agreements with chapters on investment. The US agreement with Chile and Singapore received the harshest critiques from the academic world as well as from the political audience (See **Box 2** to see a summary of criticism). In contrast with this reaction, there was notable lack of criticism for the EU-Chile agreement.

This lack of disapproval was not by any means on account of a lack of scrutiny. Instead, it was due to the fact that the EU was able to design an agreement with Chile with safeguard measures to ensure that if under exceptional circumstances, payments and capital movements between parties were to cause or threaten to cause serious difficulties for the operation of monetary policy or exchange rate policy for either party, that party may apply the strictly necessary safeguard (Saez,2006).

These "balance-of-payments derogation" provisions reflect the recognition that under certain circumstances, restrictions on transfers may be necessary in order to redress balance of payment (BoP) problems. They also show the growing recognition for the fact that investor protection and BoP safeguards are not mutually exclusive concepts (UNCTAD,2000). Consequently this kind of safeguard measure is present in most multilateral negotiations and codes in investment. See **Box 3** for a summary of multilateral negotiations and their relevant balance of payment safeguard.

The absence of such provisions has been recognized as problematic because of its difficult implications for global governance – the issue of overlapping competencies with the IMF (Siegel,2004) which states in its Articles of Agreements that "members may exercise such controls [capital controls] as are necessary to regulate international capital movements" (Article VI section 3). While the IMF is equally entitled, under certain circumstances, to requests that a member exercise capital controls (Article VI section 1).[26]

The absence of such a provision is also extremely dangerous for developing countries. On the one hand, developing countries when facing disruptive capital migration of the kind encountered by Argentina in 2001, may have no means of coping with such a massive flow of capital. Another common article of essential security interest provision present in many agreements has been used as a tool to protect economically disrupted countries from liability in international investment treaties, but tribunals disagreed, however, on the degree of severity of an economic crisis that would justify invocation of the national security exception (UNCTAD,2009). In fact, as shown in a long series of litigation, the severity of the 2000-2001 crisis in Argentina was not considered enough to protect against accusation and compensation for non accomplishment of responsibilities acquired under investment treaties[27].

The importance of this umbrella article for developing countries was recognized by the European community in a communication to the World Bank on the strategy of Investment for Development (IFD)[28]:

> *The EC Considers that future IDF should include the possibility for members to take safeguard measures in case of BOP crises. This kind of safeguard is particularly important for developing countries, whose financial system may be more fragile*

> *and exposed to instability […] a future IDF in our view should provide […] as an exception, a safeguard clause to preserve members in case of serious BOP difficulties. This provision should allow temporary restrictions on the outflows of current and capital transfers related to those investments covered.*
>
> *(European Community,2002)*

On the other hand, the non-existence of such protection tools does not exist in a vacuum. On the contrary, it occurs in treaties with substantive liberalization of capital flows. The implication is that the same agreement that increases flows limits an important control a state might have over a possible massive escape of capital.

The balance of payment safeguard is not, however, a green light for imposing capital controls. It doesn't cover, for instance, measures such as the Chilean *encaje*, or Colombian restrictions on inflows aimed at preventing financial crisis. These only can be invoked when an exceptional emergency has already occurred and the measures are strictly necessary. However, neither "exceptional circumstances" nor the "necessity test' are clearly defined.

### 2.2.2. New products and FTAs

FTAs include mandates to liberalize new financial services often through a single article called "new financial services". Many of them follow a model of liberalization set out in GATS -the" understanding of commitments in financial services"- which states that "a Member shall permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service".

Chapters on new financial services have two important implications. Firstly, any new financial product resulting from financial innovation cannot be restrained, regardless of its nature. This includes poorly comprehended financial products and derivatives. A developing country signing an agreement of this type could not, for example, do what the UK and the US did in September 2008 which was to of prohibit short-selling without legal implications.

Secondly, they permit any new technology that gives rise to a new manner of delivering financial. Today it's unimaginable for there to be another way of supplying financial services other than that which is currently employed. However, technology brings new methods of supplying services which are unimaginable at present. For example, no one could imagine the existence of internet banking 25 years ago.

A key element in the literature of FTAs is the approach to liberalization or, in other words, the type of list the text uses. Traditionally a distinction has been drawn on the basis of whether they follow a GATS list or a NAFTA list (Roy et al.,2007).

A GATS list is a positive one, all financial services liberalized are listed, and the liberalization excludes all services that are not explicitly listed. A NAFTA list, on the other hand, is a negative list, which means everything is liberalized as long as it is not present in the list.

The approach to liberalization is important for shaping the scope of new financial services because the financial service has to be liberalized before a country commits to allowing any new service. Liberalization under NAFTA implies greater liberalization, since any new service has to be liberalized.

## *2.3. Conclusion*

In this chapter it was shown that the process of financial liberalization has been linked in theory and practice with financial instability. The problematic reforms of the broad process of financial liberalization are the authorization of foreign competition in the domestic market and the liberalization of the capital account.

The authorization of foreign competition is blamed for threatening financial stability reducing profitability in financial markets and creating riskier behaviour. Furthermore, when foreign competition is accompanied by financial innovation it is held responsible for adding risk to the system. At the same time, the liberalization of the capital account is answerable for increasing instability and encouraging volatile and procyclical capital flows which are recognized as triggers of financial crisis.

After a profound literature review, the assumption that competition leads to more instability creating incentives in financial institutions to become riskier doesn't hold in light of new theories of banking and firm's behaviour. However, the instability coming from the propagation of derivatives and liberalization of capital account are well founded in the literature of financial liberalization.

Although trade in financial services and investment chapters are not the same as financial liberalization, they may incorporate the same dangerous components -competence and capital account liberalization- and it is through these components that new generation of free trade agreements can lead to financial instability.

# 3. Case studies

The space between theory and practice in the case of FTAS may be large. To start with, there are conceptual discrepancies. The analysis of FTAs in theory has been limited to economic notions and methods, while those agreements, in practice, use mainly pure international law connotations. Furthermore, while in theory we can talk about consequences of FTAs as a generic term, in practice, we know all FTAs are different in content and form. FTAs are the result of exhausting negotiations about mostly sensitive topics; this battle of interest and power result in different commitments for each sector and chapter. Therefore, to evaluate whether new generation of FTAs between developed and developing countries potentially increase financial instability in developing countries it is important to go beyond theory. Theory gives us a guideline for highlighting the points to look at when analyzing FTAs, but it is the real FTAs that gives us the definitive answer.

The important aspects to inspect in a treaty are its implication for the capital account and the liberalization of new financial products. In relation to the capital account, this liberalization can be found either in its commitments in trade in financial services or in investment chapters. In respect to the new financial products, the article on new financial products and the type of list gives the implication.

The objective of this chapter is to look at FTAs and their implications for financial instability. The FTAs that were evaluated were selected out of treaties signed by developing countries in Latin America with developed countries since 2008. The treaties selected are: EU-CARIFORUM, EFTA-Colombia FTA, US-Colombia FTA and the Panama-Colombia FTA.

## *3.1. Analysis of Agreements*

### *EU-Cariforum agreement*

The Economic Partnership agreement signed in 2008 between the CARIFORUM countries and the European Union was the result of a process of negotiation that started in 2002 aimed to construct a WTO-compatible trade scheme between the European Union and the ACP countries. The agreement of several hundred pages is divided in six parts and three protocols. For the objective of this paper, the focus will be in part II called trade and trade related matters, and more specifically in titles II and III. Title II the agreement rules all

related to investment and trade in services, its chapter 2 rules commercial presence, its chapter 3 cross border trade in services and chapter 5 section 5 deals with some particularities of financial services, not implying liberalization commitments but specific issues applicable to financial services, such as language on the prudential carve-out and on new financial service. Commitments of commercial presence and cross border trade include financial services and those are included in a positive-type of list in Annex IV. Title III contains 3 articles about current payments and capital movements.

On the subject of liberalization of capital account, this agreement impacts the capital account in two ways. First, in its commitments in trade in financial services many services commitments on cross border trade cannot exist without an underlying capital flow, but the absence of an article liberalizing those underlying capital flows makes that only those services inseparable of capital flows are being liberalized[29], this implies that only those commitments in services under black cells in **Table 1** are being liberalized under EPAS. See **table 4** for the liberalization commitments on services inseparable of capital flows in this EPA.

Second, there is in title III a literal prohibition of limits of free movement of capital (article 123), but this has to be related to an investment, this latest understood narrowly as setting up a commercial presence in form or FDI or long term loans of a participating nature for a period more than 5 years. EPAS leave the protection guarantees of investors to investment treaties between individual EC countries[30]. For this reason, the investment transfers protection is quite limited; it only protects transfers related to profits liquidation and repatriation of a commercial presence activity (article 123) meaning that, according to title III, outflows of FDI and long term loans cannot be restrained, this is not a major problem since in case of crisis, the target of capital controls are not FDI or long term loans. Moreover, in case of a crisis, EPAS contain a balance of payment safeguard (article 124) which says that if, under exceptional circumstances, payments and capital movements between the parties cause or threatened to cause serious difficulties for the operation of monetary policy or exchange rate policy in one or more states, safeguard measures with regard to capital movement that are strictly necessary may be taken by the party for a period not exceeding six months

In terms of new financial services, EPAS follows the WTO "understanding of commitments" approach. It states that a financial service supply is permitted to provide any new financial service similar to those that the other states permit their own financial services suppliers to provide (Art 106). But it adds that a party may require authorization for the provision of the service, and the authorization may only be refused for prudential reasons (i.e. ensuring the integrity and stability of their financial system).

Overall, the EPA-Cariforum do not seriously imply opening of the capital account for dangerous capital flows, most of the liberalization has to do

with FDI, considered harmless from the theory here discussed. In addition, EPAS contains a safeguard measure (article 124) to use in times of balance of payments difficulties.

## *EFTA-Colombia agreement*

The European Free Trade Association (EFTA) composed by Iceland, Liechtenstein, Norway and Switzerland, started in 2007 trade negotiations with Colombia as part of its policy of strengthening and expanding their trade network with countries other than the EU. The agreement was signed in June 2008. The agreement is organized in 13 chapters and 10 annexes, but for this paper the interest will be focused in chapter 4 of trade in services including financial services, chapter 5 on investment excluding financial services and annex XVI on financial services that complements the chapter on trade in financial services.

In terms of liberalization of capital account, this agreement has commitments of liberalization in the chapter of financial services and also in the chapter of investment. In its chapter on trade in financial services, the agreement explicitly communicates under Article 4.4.1. That to ensure market access, where the cross-border movement of capital is an essential part of a service supplied through any of the 4 modes of supply, that party is committed to allow such movement of capital. This liberalization obligation, copied from GATS' footnote 8, means that the liberalization of each service listed in **Table 1** signify the liberalization of the financial flows in both gray and black cells. **Table 5** presents those commitments and the effects on the capital account, showing that this FTA implies, in fact, liberalization of capital flows different than FDI.

The chapter of investment (chapter 5) refers to investment in the non-financial sector. This chapter prohibits restrictions on all transfers and payments related to an investment (art. 5.10) without expressing what the concept "transfer" means. however, this restriction doesn't mean much for the capital account since the definition of investment is narrowed to only commercial presence (art. 5.1), meaning with commercial presence any type of business establishment including the constitution acquisition or maintenance of a juridical person, or the creation or maintenance of a branch or a representative office (art. 4.2)

The limits on the prohibition of capital restrictions is reinforced by a balance of payment safeguard in chapter of trade in financial services (Art 4.14) and investment (chapter 5.11). Both of them incorporate article XII of GATS[31] *mutatis mutandis* as a balance of payments safeguard. Moreover, both chapters incorporate into its text annex XIV, which gives Colombia the rights to "include measures to ensure currency stability and the normal operation of

domestic and foreign payments. Such measures includes a wide variety of tools that "may include the establishment of restrictions or limitations on current payments and transfers (capital movement) to or from Colombia, as well as transactions related thereto, such as requirements that deposits, investments or credits from or to a foreign country be subject to a reserve requirement (deposit) ".

In terms of new financial products annex XVI article 2. ensures that a party shall permit financial service suppliers of another party established in its territory to offer in its territory any new financial service, and a new financial service means not only services related to existing products, but also a new way of delivery. And, since Annex XV liberalizes without restrictions derivatives securities including (but not limited to) futures and options, this article 2. implies the liberalization of all new forms of derivatives.

In sum, this free trade agreement contains the two dangerous components recognized in the theoretical part of this paper: capital account opening and new financial services. First, in terms of liberalization of the capital account, some non-FDI flows are liberalized when allowing cross-border trade in banking sectors, and initial FDI flows related to the commercial presence are also liberalized when allowing commercial presence mode of supply. The investment chapter also liberalizes FDI capital flows while it forbids the usage of capital controls on transfers related to an investment. However, this agreement not only allows Colombia to impose capital controls in case of balance of payments difficulties as ruled by GATS, but also, Colombia is allowed to impose capital controls in inflows and impose "deposits" on flows coming in or out of the country for the objective of ensuring currency stability and the normal operation payments. This latest part limits enormously the scope of the liberalization coming from investment and trade in services chapters.

Second, in terms of new services, this agreement means a complete liberalization of new forms of financial services such as derivatives of all kind.

### *US-Colombia and US-Panama agreements*

The U.S. trade agreements with Panama and Colombia, called trade promotion agreements by the US, were signed on June 2006 and November 2006 respectively. Both still pending approval from the US congress which gives no general support to the aforementioned treaties.

The architecture of both agreements differs in structure, but for the interest of this paper (which is focused in investment and trade in financial services commitments) both agreements are structured in an identical way. In relation to financial services, all liberalization is regulated in the chapter of

financial services (chapter 12), leaving the chapters on cross border trade (chapter 11) and investment (chapter 10) for other kinds of services. Nevertheless, some articles from chapter 10 on investment have been incorporated in the chapter on financial services (chapter 12).

The effect of the agreement on the capital account of the balance of payments is found in the trade in financial services commitments and also in its investment regulation. In regards of financial services commitments article 11.10 of both agreements states that all transfers related to the cross-border supply shall be permitted, this meaning that the liberalization of financial services imply the liberalization of the flows illustrated in **Table 1** with gray (services separable from capital flows) and black cells (services inseparable from capital flows). **Table 6** shows the sectors liberalized for both countries and the financial flows liberalized, showing a substantial liberalization of "dangerous" capital flows for both countries.

The agreements in their transfer articles (art. 10.8) permit transfers as contributions to capital and proceeds from the sale or liquidation of the covered investment to be made freely and without delay into and out of its territory. The treaty understands investment in a wide asset-based way (article 10.29) as every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including an enterprise; shares, stock, and other forms of equity participation in an enterprise; bonds, debentures, other debt instruments, and loans, futures, options, and other derivatives. These broad definitions of investment in conjunction with an article liberalizing transfers imply a large degree of liberalization. furthermore, in case of balance of payments difficulties the treaty do not provide a safeguard article, just an exception article (article 12.10) which enables countries to take measures for prudential reasons in aims of ensuring the integrity and stability of the financial system which does not apply to capital controls.

On the subject of new financial products, both countries liberalize new financial products with article 12.6 following WTO understanding of commitments, but parties have the right to determine the institutional form of this new services and suppliers need authorization which shall have a reasonable time and only rejected for prudential reason. The difference of Colombia and Panama is that in Colombia the company supplying has to be established the territory of the party, this requisite is not present in the Panama-USA FTA.

To conclude, this set of agreements represents all the dangers theory suggest, it liberalizes capital flows in two ways: liberalizing trade in financial services with all its related capital flows, and also with the combination of transfer protection and a wide definition of investment that includes dangerous types of capital. All this liberalization is not accompanied by balance of payments safeguards. Furthermore, it liberalizes new financial although this latest is not unrestrained.

### *3.2. Comparative analysis*

All the agreements analyzed in this paper liberalize new financial products in an ample way, but what changes between the agreements is their approach to liberalization of financial flows and possibilities of capital controls. In general terms the agreements represent 3 approaches to liberalization. The US-Cariforum means mainly liberalization of "good" capital flows with balance of payments guarantees. The EFTA FTA with Colombia liberalizes all capital flows (including dangerous ones) but gives Colombia the freedom to use capital controls in case of BoP problems and also for preventive reasons. And finally, the US FTA here analyzed represents all dangers the theory suggest: it liberalizes dangerous capital flows, while at the same time it limits the possibilities of using capital controls for any reasons. See **table 8** for a summary of the 3 approaches.

It is clear by now that the first two ways of liberalization do not represent major effects on financial stability in developing countries. These two first approaches are also coherent with the particularities of the signatory countries. In the case of the EPA, it makes sense to have a low degree of liberalization of dangerous financial flows and balance of payments safeguards since, as this agreement encompass a wide range of countries with different financial systems, one agreement would create disproportional effects on such different countries country. For instance, it is well know that many Cariforum countries, very notable countries as Guyana and Suriname, have no financial services capacity (Brewster,2008), while some others completely depend on offshore finance. In reference to the EFTA FTA, a country such as Colombia, which has used capital controls for many years as a preventive mechanism, should keep its sovereign authority to continue using them.

The third way of liberalization, the one used in the FTA of US with Panama and Colombia, implies a difficult step towards liberalization of financial flows and the prohibition of capital controls, and the way it affects countries as different as Panama and Colombia is very problematic too. For the case of Panama, the liberalization of Panamanian capital financial market is a redundant process; Panamanian authorities have been famous for its levels of liberalization that has gone to the edge of illegality[32]. The Panamanian financial system, which was designed in 1970 for the Chicago University economist Nicholas Ardito Barletta with the intension to create a strong economy less based in the canal and more based in its financial sector was one with no central bank, no exchange controls, no capital controls, no taxes for depositors. Although this free-for-all bank system has been somehow regulated due to all the scandals of drug traffic (The Economist,2009), capital never had restrictions in Panama and has been highly encouraged. Moreover, in relation

to investment, the protection of investment given by the Panamanian authorities to foreign firms is extensive. Panama's lax corporate laws allow foreign companies to be created in minutes in an anonymous ownership with very open ways for capital participation, and this, together with the strict bank-secrecy rules and a dollarized economy, has made this country a magnet of capitals, many of doubtful origins, but also in form of FDI coming from prestigious financial institutions. Panama is now the country with the highest number of subsidiaries of foreign origin in the world (350.000). (Public Citizen,2009). Given the liberalized scenery of Panama, a trade agreement that liberalizes capital flows may not have much effect on panama´s economy.

In regards to Colombia, its financial sector, by contrast, is largely regulated. As other Latin American countries, Colombia started the process of liberalizing its economy in the 1990s. The idea of this set of reforms, called "the opening" by the Colombian authorities, was the liberalization of trade and capital in the country. However, neither its trade nor its capital were fully liberalized. In terms of trade, the country did not substantially increase its penetration into the global economy (Villar,2001) and in terms of capital, the process was always accompanied with the famous chilenean style *encaje,* which is a non-remunerated reserve requirement on short term capital inflows .

The value of the Colombian *encaje* has varied from 140% of the value of the liability to 0%, value that is used now (Uribe,2003). The value of the *encaje* depends of the economic situation (see **Table 7** for a sequence of Colombian usage of capital controls). In 2007, for example, before the global financial crisis, in a context of a Colombian boom in financial inflows, inflation and revaluation, the Colombian monetary authority imposed the *encaje* of 40%. This measure, together with a contractive monetary policy, cooled off the economy and prepared the domestic economy to face and been only slightly affected by the financial crisis of 2008 (Uribe,2009).

Unlike in Panama, a liberalization of capital inflows has been completely contrary to Colombian economic policies; Colombian authorities have been reluctant to allow speculative capitals into the country and have developed a history of capital control usage that has been repeated in other countries. This FTA will potentially increase the inflow of capital of speculative nature[33] and at the same time will prohibit the usage of the controls that Colombia has successfully used during its modern economic history.

## 4. Conclusion

New generation of free trade agreements between the north and the south can potentially increase financial instability in developing countries. While free trade agreements are not the same as the wide process of financial liberalization as many critics stress, free trade agreements have components that have been recognized as harmful to financial stability in the developing world, namely the process of capital account liberalization and the proliferation of new and sophisticated financial products.

When FTAs contains substantial liberalization of financial services, underlying capital flows are liberalized as well, and those capital inflows are usually associated with more vulnerability of the financial sector. Moreover, when trade agreements contain financial chapters with the wicked combination of a wide definition of investment, ambitious transfer protections and no balance of payments safeguard, the policy options of developing countries to attack and prevent financial crisis are severely restricted. The liberalization of sophisticated financial products in the articles of these agreements adds more vulnerability to this equation, making the process of regulation of financial markets more complicated while at the same time incentivizing the entrance of dangerous financial flows and making the reversibility of those flows more severe.

However, as was shown with the Latin American case studies, not all FTAs expose developing countries to the dangers of financial instability. Regarding capital account issues, some agreements do imply wide liberalization of dangerous capital flows and limit or forbid countries to use capital controls to prevent or manage financial instability, as in the case of USA-Panama and USA-Colombia agreements. This is worrisome for countries such as Colombia, which opposing to Panama, has used capital controls in all its modern economic history. Contrarily, some agreements, although liberalizing capital flows, give developing countries the rights to use capital controls for prevention and crisis management such as the Colombia-EFTA agreements, or define the agreement in a way in which mainly liberalizes FDI and not dangerous capital flows, which are included with BoP safeguards, as was evidenced in the latest case of EU-CAREFORUM.

The most persistent problem of FTAs is in the liberalization of financial products. All of the case studies imply a wide liberalization of these products. Although a wide liberalization of financial flows does not represent an imminent danger to developing countries, it makes other problems such as regulatory control, inflow of dangerous capital flows and volatility more severe.

**Table 1: cross border trade in financial services and capital account.**

| | Can trade in Financial services occur without cross border capital flow? | Portfolio Equity | Portfolio Debt | trade credits | Loans | Currency and Deposits | Other |
|---|---|---|---|---|---|---|---|
| **Insurance and insurance-related services** | | | | | | | |
| Direct insurance life and non life | | | | | | | |
| reinsurance and retrocession | | | | | | | |
| services auxiliary to insurance: consultancy, actuarial, risk assessment | | | | | | | |
| **Banking and other financial services** | | | | | | | |
| Acceptance of deposits and other repayable funds from the public | no | | | | | | |
| Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions | no | | | | | | |
| Financial leasing | no | | | | | | |
| All payment and money transmission services, credit, charge and debit cards, travelers checks and bankers drafts | no | | | | | | |
| Garanties and committent | no | | | | | | |
| Trading, whether on exchange , in an over-the-counter market or otherwise, money market instruments ( including checks, bills, certificates of deposit); foreign exchange; derivative products; exchange rate and interest rate instruments ; transferable securities, and other negotiable instruments and financial assets including bullion | no | | | | | | |
| Participation in issues of all kinds of securities, including underwriting and placement as agent and provision of the related services | no | | | | | | |
| Money broking | no | | | | | | |
| Asset management such as cash or portfolio management, collective investment management, pension fund management, custodial depository and trust services. | no | | | | | | |
| Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments | no | | | | | | |
| Provision and transfer of financial information | | | | | | | |
| Advisory intermediation and other auxiliary financial service | | | | | | | |

*Source:* based in (Tamirisa,2000) with some modifications from the author.

**Table 2: Commercial presence trade in financial services and capital account**

| | **Can trade in Financial services occur without cross border capital flow?** |
|---|---|
| **Insurance and insurance-related services** | **yes** |
| Direct insurance life and non life | yes |
| reinsurance and retrocession | yes |
| services auxiliary to insurance: consultancy, actuarial, risk assessment | yes |
| **Banking and other financial services** | |
| Acceptance of deposits and other repayable funds from the public | Yes |
| Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions | yes |
| Financial leasing | yes |
| All payment and money transmission services, credit, charge and debit cards, travelers checks and bankers drafts | y/n |
| Garanties and committent | yes |
| Trading, whether on exchange , in an over-the-counter market or otherwise, money market instruments including checks, bills, certificates of deposit); foreign exchange; derivative products; exchange rate and interest rate instruments ; transferable securities, and other negotiable instruments and financial assets including bullion | Yes and for derivatives y/n |
| Participation in issues of all kinds of securities, including underwriting and placement as agent and provision of the related services | y/n |
| Money broking | yes |
| Asset management such as cash or portfolio management, collective investment management, pension fund management, custodial depository and trust services. | y/n |
| Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments | yes |
| Provision and transfer of financial information | yes |
| Advisory intermediation and other auxiliary financial service | yes |

*Source:* based in (Liu,2005) and (Tamirisa,2000)).

**Table 3: Resident vs non-resident capital and commercial presence**

| | **Provided by foreign supplier established in the country with independent capital** | **Provided by foreign supplier established in the country i.e. without independent capital** |
|---|---|---|
| **involves domestic capital only** | Neither financial services trade nor international capital flow | Financial services trade |
| **involves international capital only** | Only international capital flow | Financial services plus international capital flow |

*Source*: based in Kono and Schuknecht (1998) with some modifications from the author.

**Table 4: CARIFORUM-EU list of commitments of cross-border trade and capital flows**

| | Liberalized? | trade credits | Loans | Currency and Deposits | Other |
|---|---|---|---|---|---|
| **Banking and other financial services** | | | | | |
| Acceptance of deposits and other repayable funds from the public | Yes, but In Estonia this service requires authorization. Malta and Romania do not liberalize it | | | | |
| Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions | Yes, but Malta does not liberalize it. | | | | |
| Financial leasing | Yes | | | | |

*Source*: Author's

**Table 5. FTA Colombia-EFTA list of commitments of cross-border trade and capital flows**

| | Commitments in market access. | Portfolio Equity | Portfolio Debt | trade credits | Loans | Currency and Deposits | Other |
|---|---|---|---|---|---|---|---|
| **Banking and other financial services** | | | | | | | |
| Acceptance of deposits and other repayable funds from the public | unbound | | | | | | |
| Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions | unbound | | | | | | |
| Financial leasing | unbound | | | | | | |
| All payment and money transmission services, credit, charge and debit cards, travelers checks and bankers drafts | unbound | | | | | | |
| Garanties and committent | unbound | | | | | | |
| Trading, whether on exchange , in an over-the-counter market or otherwise, money market instruments ( including checks, bills, certificates of deposit); foreign exchange; derivative products; exchange rate and interest rate instruments ; transferable securities, and other negotiable instruments and financial assets including bullion | unbound | | | | | | |
| Participation in issues of all kinds of securities, including underwriting and placement as agent and provision of the related services | unbound | | | | | | |
| Money broking | unbound | | | | | | |
| Asset management such as cash or portfolio management, collective investment management, pension fund management, custodial depository and trust services. | Restrictions in custodial trustee and execution services. | | | | | | |
| Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments | unbound | | | | | | |

*Source*: Author's

**Table 6. Panama-US and Colombia-US list of commitments of cross-border trade and capital flows**

| | Commitments in market access. | | Portfolio Equity | Portfolio Debt | trade credits | Loans | Currency and Deposits | Other |
|---|---|---|---|---|---|---|---|---|
| | COL | PAN | | | | | | |
| **Banking and other financial services** | | | | | | | | |
| Acceptance of deposits and other repayable funds from the public | yes | yes | | | | | | |
| Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions | yes | yes | | | | | | |
| Financial leasing | yes | yes | | | | | | |
| All payment and money transmission services, credit, charge and debit cards, travelers checks and bankers drafts | yes | yes | | | | | | |
| Garanties and committent | yes | yes | | | | | | |
| Trading, whether on exchange , in an over-the-counter market or otherwise, money market instruments ( including checks, bills, certificates of deposit); foreign exchange; derivative products; exchange rate and interest rate instruments ; transferable securities, and other negotiable instruments and financial assets including bullion | yes | yes | | | | | | |
| Participation in issues of all kinds of securities, including underwriting and placement as agent and provision of the related services | yes | yes | | | | | | |
| Money broking | yes | yes | | | | | | |
| Asset management such as cash or portfolio management, collective investment management, pension fund management, custodial depository and trust services. | yes | yes | | | | | | |
| Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments | yes | yes | | | | | | |

*Source*: Author's

**Table 7. Colombian capital controls on inflows.**

| Year | Month | percentage |
|---|---|---|
| 1991 | January | |
| 1993 | September | 47% |
| 1994 | March | 93%-50%-64% |
| 1994 | August | 42%-140% |
| 1996 | February | 50% |
| 1996 | March | 50% |
| 1997 | January | Depending of the difference of interest rates. |
| 1997 | March | 50% |
| 1997 | May | 30% |
| 1998 | January | 25% |
| 1998 | September | 10% |
| 2000 | May | 0% |
| 2007 | May | 40% |
| 2008 | May | 50% |
| 2008 | Oct | 0% |

*Source*: based on (Ocampo,2003a)

**Table 8. Comparative table of FTAs selected**

| | Liberalizes new financial products? | Liberalizes dangerous capital flows? | Allows capital controls? |
|---|---|---|---|
| EPAS | yes | Limited | Yes, both inflows and outflows |
| EFTA | yes | Yes | Yes, both inflows and outflows |
| US | yes | Yes | no |

*Source*: Author

**Box 1. The concept of financial instability.**

In theory; there is no generally accepted definition of financial instability (Batra,2002). But, it can be said that a system is stable when its key financial markets are stable and its prices do not vary substantially so that the system is being "able to mobilize savings and allocate funds efficiently and absorb shocks without major damage to the real economy or other parts of the financial system" (Bakker,2003).

There are two distinguished and interrelated types of instability. There is micro-stability which is related to the health of each individual financial institution, and there is a concept of macro-stability, which focuses on the health of the whole financial system as a whole, including all financial institutions, balance of payments, and all financial markets. This latest could exist even when all financial institutions may look fine in individual basis.

Also, it is important to distinguish between financial instability and a financial crisis. Financial crisis occurs when the "...*financial instability is severe enough that [it] leads to almost a complete breakdown in the functioning of financial markets*" (F.S. Mishkin,1999). Financial crisis are usually divided into bank crisis (domestic crisis), external crisis (balance of payment crisis) or both (twin crisis).

For the purpose of this paper, the malignant symptoms of financial instability are exchange rate volatility, interest rate volatility and credit access volatility. It is important to say that in theory market volatility *per se* does not necessarily imply financial instability. (International Monetary,2003). Market volatility implies financial instability only when this instability is not based on economic fundamentals.

**Box 2. Opinion about the inclusion of investment issues in FTAs**

The inclusion of investment issues in FTAs have been severely criticized since the first of this FTA-plus were negotiated for the first time in 2003 with the treaties of the US with Singapore and Chile.

In April 2003, the US House of Representatives of the US issued a hearing on the Chile and Singapore agreements where important academic and politic figures were invited. In general terms, there was a unanimous critique to the fact that those treaties seriously limited the possibilities of those developing countries to use capital controls.

An economic critique was developed by Columbia university professor Bhaguati, who concluded that pure economics cannot explain the limitation of capital controls for signatory countries, instead, it seems that those measures are based in ideological and/or a result of narrow lobbying interests hiding behind the assertion of social purpose (Bhagwati,2003).

Nobel Price J. Stiglitz, after explaining how capital controls may be, and have been, useful for restoring stability, was concern about political issues of sovereignty. Arguing that "problems are encountered when trade agreements go beyond trade issues […] forcing countries to undertake measures which should be a matter of national sovereignty. Such provisions have earned trade agreements a reputation for undermining democracy. And he believes that sometimes these accusations are deserved" (Stiglitz,2003).

Daniel Tarullo, member Board of Governors of the Federal Reserve and current Obama advisor concluded saying that American government's insistence on such kind of agreements is bad financial policy, bad trade policy and bad foreign policy (Tarullo,2003).

In another hearing in may 2009, after President Obama has called a possible reformulation of the way investment has been treated, panelists such as Professor Robert K. Stumberg Director of Harrison Institute for Public Law, Georgetown University Law Center and Boston University professor Kevin P. Gallagher proposed that capital account convertibility must be removed from American investment treaties (Lee et al.,2009).

**Box 3. BoP safeguards in multilateral and regional negotiations.**

Most multilateral negotiations include the possibility of imposing restrictions to capital flows in case of balance of payments difficulties. The General Agreement on Trade in Services **GATS** allows under Article XII to members to adopt or maintain restrictions of capital transfer "in the event of serious balance-of-payments and external financial difficulties or threat thereof".

The OECD negotiated between 1995 and 1998 of the multilateral agreement on investment (**MAI**). Produced a first draft made public in 1997. MAI would have prohibited capital restrictions on the investment transactions covered by the treaty, but under Chapter VI a safeguard measure was available for cases of Balance of Payments imbalances. Although the MAI did not get the support needed to be an effective treaty, following OECD mandates acknowledged the need of safeguard measures.

The **Code of Liberalisation of Capital Movements** of OECD countries, for example, has under article 7 that members may temporarily suspend their measures of liberalisation "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..."

In terms of regional integration the same type or safeguard is found in the North American Free Trade Area. Under Art.2104 of the **NAFTA** treaty a country was allowed to restrict international capital transactions if consistent with IMF art VI. **IMF** does not have a safeguard article because it allows the usage of capital controls (Art. VI, section 3) and has also the entitlement to "request" a country to impose capital controls.

The **EC treaty** in its article 57 gives the Council the entitlement to adopt, under certain circumstances, measures on the movement of capital to or from third countries. Also, if the **Lisbon treaty** is ratified, it will also include a safeguard clause. The article 66 of the Treaty of the Functioning of the European Union says that "Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, on a proposal from the Commission and after consulting the European Central Bank, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary".

**Box 4. Definition of Investment in FTAs.**

A *grosso modo* there are four ways of defining investment in investment chapters. First, there is an asset-based definition. This means that investment means typically every kind of asset" (UNCTAD,2004) this includes portfolio investment, FDI and debt. Note that this kind of definition is not related to control of companies and some qualifications of investment could be given to the definition of investment, for example, US FTAs sometimes includes that for an asset to be considered investment it shall have the characteristic of "the placement of capital at risk for purposes of gain".

Second, there is an enterprise-based definition, which is related to controlling the enterprise, or to have a "lasting interest" in the enterprise, this meaning for statistical purposes a 10% of vote power or shares (UNCTAD,2004).

Third, there is a definition which limits the term "investment" to cover only assets that contribute to economic development in the host country (UNCTAD,2009), this excludes "hot" capitals and focuses on sustainable FDI.

And finally, there is a new way of defining the meaning of investment through a closed-list. This is, the article defining what investment means and what it doesn't mean, creating an ample, but finite list of tangible and intangible assets (Echandi,2009).

It is clear how the first way of defining "investment" implies much more liberalization of "hot" capitals while the last three modes can limit to certain extend the liberalization of dangerous financial flows.

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# Notes

[1] Other relevant criticism of financial liberalization are: increasing inequality: see (Ang,2009) for a study with India as case study. And (Behrman et al.,2001) for the case of Latin America. Also, for destroying the developmental tool that historically allowed the late industrializes to growth and support important industries (Ghosh,2005).

[2] (Stiglitz,2008) comments about a Rogoff paper which states that "those countries that made the effort to become financially integrated…faced more instability". And recommends: "the report should be read seriously by past and present policy maker who have in the past pushed, and continue to push developing countries headlong into capital-market liberalization, who attempted to impose demands for capital market liberalization as part of the investment agreement in recent trade negotiations".

(Bhagwati,2003) has seriously criticized the inclusion of investment treaties for the case of Singapore and Chile FTAs in his speech in the hearing.

[3] The general assembly of the United Nations in its document "Recommendations of the Commission of Experts of the President of the general assembly on reforms of the international monetary and financial system" states that "*many bilateral and multilateral trade agreements contain commitments that limit the ability of countries to respond to the current crisis (…) and may have exposed them unnecessarily to the contagion"*. In the unedited draft of the document, they go even further saying that: *"Developing countries have had imposed on them not only deregulation policies akin to those that are now recognized as having played a role in the onset of the crisis, but also have faced restrictions on their ability to manage their capital account and financial systems ( eg, as a result of financial and capital market liberalization policies; these policies are now exacting a heavy toll on many developing countries"*

Document available at http://www.un.org/ga/search/view_doc.asp?symbol=A/63/838&Lang=E

Draft available at http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf

[4] The first FTAs encompassing services were the Canadian -American FTA in 1989. (Roy et al.,2007) and the first bilateral treaty treating investment and trade is found in the Friendship, commerce, and navigation treaty between US and France that concluded in 1778 (Sornarajah,2004)

[5] this may be due to lack of relevant data and methodologies, and also the short time spam (Stephanou,2009).

[6] The concept of financial liberalization is commonly attributed to Ronald McKinnon (1973) and Edward Shaw (1973) although it is older and can go back to Adam Smith (Saidane,2002)

[7] See for example (Van der Stichele,2008,2009).

[8] For an extensive definition of Financial liberalization see (Reinert et al.,2009)

[9] The term capital account liberalization refers to the liberalization of the financial account of the balance of payments as defined by the IMF balance of payments manual 2008 BPM6. In economic documents the use of capital account is usually used meaning actually the financial account of the balance of payments, this document uses the same understanding.

[10] Although in practice the use of capital controls is not generalized.

[11] Columbia University economist Jagdish Bhagwati, a strong advocate of trade liberalization states that the inclusion of capital control restrictions in trade agreements has no economic justification, instead is ideological and/or a result of narrow lobbying interests hiding behind the assertion of social purpose ". (Bhagwati,2003), he also criticises free movement of capital for its implications for the Asian crisis (Bhagwati,1998).

[12] Dani Rodrik has stressed this in his blog referring to Guillermo Calvo who used to be a notorious pro-liberalization economist and now is recommending capital controls.

http://rodrik.typepad.com/dani_rodriks_weblog/2008/11/an-unlikely-convert-to-capital-controls.html. The document where Calvo recommends capital controls is: The new Bretton Woods agreement, Calvo, Vox Publication. Abailable at http://www.voxeu.org/index.php?q=node/2543 .

[13] equity investment remains a small source of finance in the developing world, this may be attributed to the fact that the regulatory framework in the developing world doesn't accomplish minimum shareholder protection and disclosure requirements, making stock investment less attractive to foreign investors (Blair,2003). Also, the volatility of returns is higher than in bonds, making equity less attractive than bonds.

[14] For case studies on the effectiveness of price-based capital flows see: (David,2007) which shows how capital controls have been effective in two notorious cases: Colombia and Chile in the 90's. (De Gregorio et al.,2000) for an analysis of the case of Chile, deriving the same conclusions. (Ariyoshi,2000) for the case studies of developing countries as Brazil, Malaysia, Chile, Thailand and Colombia. And (Ocampo and Palma,2008)about the effectiveness of preventive capital controls in the case of Malaysia, Chile and Colombia.

[15] See for example (Claessens and Jansen,2000, Mishkin,2000, F.S. Mishkin,1999) in the latest paper from (Kose et al.,2009) they conclude that risk coming from financial globalization exist only when capital account liberalization interacts with bad economic policies.

[16] In accordance to the document written by Lucas (Lucas,1990)

[17] Very interesting in this respect is the description of the anti -FDI policy that Finland had for many years, which was coherent with high economic growth (Chang,2008, Kremer and Lieshout,2009).

[18] Note that banks in the financial literature mean more than what is communally known as banks. For the economic literature banks are those institutions that borrow on short-term and lend long-term. This includes new kinds of banks as hedge funds, or what after the crisis has been called shadow banking.

[19] See (Caminal and Matutes,2002). And (Beck,2008) for a literature review on this new literature.

[20] This paper explains how bank's profits are determined by two things: the risk of the creditor and the interest rate they will receive. However, the interest rate they charge will also affect the risk of the creditor. What they predict an inverse-U-Curve between the expected return to a bank and the interest rate.

[21] Ancient books of Aristotle commented about the existence of derivatives. The use and trade with forwards and futures existed in 1600 AC in Osaka Japan, and in Holland during the tulip mania in 1637 (Chisholm,2004)

[22] (Dodd,2002) gives an extensive description of how each kind of capital flows (Banks loans, Bonds, Equity and FDI) can be hedged against risk exposure using derivatives.

[23] Called by White the "what-is-different school" attempting to explain the financial crisis 2008 (White,2008).

[24] See for example in **table 3** how when a commercial presence is in form of subsidiary, the supply of a service as a loan is conceptualize as trade in financial services, although the account trade in financial services is not affected, it is capital flow.

[25] In February 2009 the faculty of Sustainable Investment of Columbia University send a memo to the US President Obama criticizing the system for seemingly favoring the interests of investors over those of host countries.

[26] See (Siegel,2004) for a discussion on the legal implications of the absence of a balance-of-payment safeguard in FTAs with Investment chapters from an IMF perspective.

[27] In the case of the CMS and Enron tribunals against Argentina, Argentina justified "essential security interest" for measures undertaken after the financial crisis of 2001. The tribunal rejected the claims stating that security interest means that a country is in times of war or similar circumstances. The argument of Argentina was that when a State's economic foundations is under siege, the severity of the problem can equal that of any military invasion, the tribunal said the crisis was not severe enough (OECD,2007).

[28] Investment for development is an initiative from OECD countries to help developing countries to improve their investment climate, so that they attract private investment and that way generate development. More information on http:www.oecd.org

[29] The difference between services inseparable of capital flows and services where the capital movement is separable from the financial service is widely discussed in page 30.

[30] The Lisbon treaty, with the objective of achieving a common community investment regime, may increase the competences in the EU level and decrease those of individual countries, meaning that future EPAS or agreement between the EU and third countries may have more investment protection clauses. .

[31] See **box 3** for GATS' BoP safeguard explanation.

**32** Panama is at the centre of concern of the US State Departament´s Bureau of International Narcotics and Law Enforcement Affairs for drug related money laundering that is possible due to the liberalized financial system with lack of information gathering and sharing (Public Citizen,2009)

33 Qualitative studies of the impact of the US-Colombia FTA with Colombia recognize the importance of this agreement in increasing FDI and other financial flows based in the experiences of other countries (Castro and Cortés,2005). One quantitative study from the Colombian Central Bank estimates that FDI would increase 3,1% in the first three years, and an accumulated increase of 193M US dollars in the first three years in financial flows other than FDI (Toro et al.,2006)