

Have a View

Chile FTA and Capital Flows: A Bad Precedent?

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In December 2002 the Chileans finally succeeded in their long quest (more than ten years) for a free trade agreement with the United States. Chile's record of fiscal good sense, unilateral trade liberalization, democratic politics, and respect for human rights made it an obvious candidate for the Bush Administration's emerging strategy of negotiating bilateral agreements with favored countries of the developing world. With WTO-sponsored multilateral trade talks floundering, more developing countries are likely to want to get in on the kind of deal Chile made, with its enormous benefit of unusual access to the U.S. market.

But on one issue the outcome of the bilateral negotiation with Chile looks like a case of special interests in the U.S. trumping good sense. The U.S. pushed for and got agreement that reduces Chile's freedom to manage its own capital account. Chile long ago disavowed any controls on the ability of foreign investors or creditors to withdraw capital. After all, controls on outflows would discourage the inflows it seeks to boost its productive investment and its access to new technology and best management practice. But it has in place legal arrangements that permit its government, when and if the need arises, to "tax" inflows of capital. The idea is to throw sand in the wheels of hot money inflows during global booms -- a sensible tool for managing the effects of surges in inflows on the exchange rate, and for encouraging capital inflows associated with productive investment

rather than financial speculation. With the decline in such inflows since the late 1990s, Chile has in fact kept that rate at 0 – but still retains the legislation to raise the rate should events make that sensible.

Nonetheless, the U.S. demanded and got an arrangement to "protect" U.S. firms from the unlikely danger that Chile would suddenly and surprisingly impose harmful capital controls. The U.S. "won" the right of firms to request damages should they suffer "substantial" losses due to restrictions on taking capital out, and restitution (only) should they suffer substantial losses associated with bringing capital in. Chile, standing to benefit greatly from the trade part of the trade agreement, and having no desire to send even a faint signal that it would ever restrict capital movements anyway, accepted this administrative solution. It managed to have the arrangement relegated from the investment section of the agreement to the dispute resolution section, where it is less visible and less flexible for potential complainants, and obtained a cooling off period (six months on outflows, one year on inflows).

The deal raises troubling issues for those in the U.S. anxious to support the Bush Administration's efforts to expand free trade arrangements globally. Most economists now agree that the global capital market is subject to booms and busts, and that emerging market economies are particularly vulnerable to the problems that hot money inflows and sudden

panicked outflows of capital pose for financial and economic management in developing economies. That was one hard lesson of East Asia's experience, where heavy inflows and the resulting asset boom in the early 1990s contributed to the 1997-98 crisis and ended up threatening global financial stability. The IMF has made it clear that its emphasis of the early 1990s on opening of capital markets has been tempered by the hard lessons of that crisis. Even where financial markets are reasonably well developed (and Chile is one of the best of the emerging markets on this score), gradualism and limited intervention can make sense – including in the enlightened self-interest of U.S. investors. There is no religion, either from theory or from practice, that dictates that in this imperfect market, developing countries should give up flexibility and autonomy – at the very least to manage inflows.

It would be ironic if Chile, a country with a demonstrated track record of keeping its

economy open, sets a precedent for U.S. bullying on this issue in other bilateral negotiations. The Administration's strategy of pursuing bilateral agreements to maintain momentum in the global struggle for free trade can make sense. But what if the Chile arrangement becomes the opening position of the U.S. in negotiations of the Free Trade Agreement of the Americas? And what effect will this deal have on the treatment of developing countries' capital account regimes in the multilateral trade round?

The pressure for bringing the capital control issue into a trade agreement purportedly came from the U.S. Treasury not from the U.S. Trade Representative. Whether due to Wall Street influence or free market fervor at Treasury, it's an unfortunate step. Let's hope the U.S. position in future bilateral free trade negotiations will be more business-like and pragmatic.

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