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Privatisations and golden shares : bridging the gap between the State and the market in the area of free movement of capital in the EU

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PART I

Regulatory framework governing capital
liberalisation

1 | Free Movement of capital at the international level

1 INTRODUCTION

This chapter introduces the theoretical discussion about capital liberalisation at the international level with the purpose of shedding light on some controversial aspects of the economic and political debate about the risks and benefits of free capital flows. It also provides an overview of the historical development and institutional embedment of financial integration in the modern international monetary order, focusing in particular on the birth of the Bretton Woods system in the aftermath of the Second World War, its demise in the late 1970s and the emergence of the neoclassical economic theory as the predominant ideology until today. This theoretical and historical context will enable us to grasp better the process of capital liberalisation in the European Union and its far-reaching implications for the property ownership and corporate governance systems of the Member States.

It should be clarified at the outset that this introductory chapter does not purport to contain a detailed analysis of the various *economic* aspects of the debate about capital account liberalisation. Neither does it claim to provide an extensive analysis of all the axioms underpinning the two opposing schools of thought, namely Keynesianism and neoclassical economics, or an evaluation of how each specific historical development in the post-war international financial system was influenced by adherence to either Keynesian or neoclassical tenets. This task has been successfully carried out by others, primarily economists and economic historians, who are evidently in a better position to delve into these questions compared to an EU lawyer. Besides, it would fall outside the scope of this thesis and it would substantially deviate from its ultimate objective, which is to explore whether the current EU legal framework allows capital liberalisation to be reconciled with State participation in the Market.

However, any effort to provide a thorough legal analysis of the free movement of capital as one of the fundamental freedoms of the EU's Internal Market presupposes a sufficient understanding of the economic debate about capital integration and how this has historically affected the view endorsed by international financial institutions. Therefore, this chapter has a two-fold objective: firstly, to present and explain the heated economic debate over the risks and

benefits of capital liberalisation and the on-going theoretical discussions as to whether liberalising the capital markets leads to higher economic growth (Chapter 1, Section 2); and secondly, to provide a brief historical overview of the evolution of capital liberalisation at the international level, from the 'Keynesian' Bretton Woods system and its collapse after the 'Nixon shock' to the rise of 'neoclassical economic theory' and the recent questioning of its intellectual foundations and its societal consequences by the IMF itself (Chapter 1, Section 3). On a more normative level, this theoretical exercise will hopefully help us understand how and why international financial institutions, such as the IMF and the OECD, have recently gone through a phase of self-criticism in relation to the uncritical acceptance of a completely unrestrained capital liberalisation, as the economic doctrine that had prevailed over the last three decades. This will inevitably make us wonder why the EU has not gone through the same process of self-criticism and is still in denial regarding the far-reaching implications of unfettered financial integration.

2 THE THEORETICAL CONTROVERSY SURROUNDING CAPITAL LIBERALISATION

2.1 Defining capital liberalisation

The term *capital liberalisation* is used to describe the removal of measures designed to limit capital flows, in other words the abolition of all restrictions on capital inflows and outflows.¹ Capital flows include several categories of financial transactions, such as foreign direct investment, portfolio investment (i.e. bond and equity flows), financial derivatives (i.e. financial contracts used to trade risks in financial markets), bank related flows and trade credit.² The concept of capital liberalisation covers both the underlying capital transaction and the related payment and 'it implies unrestricted convertibility of local currency in international financial transactions'.³ It is also referred to as *capital flow liberalisation*, *capital account liberalisation*, *capital market liberalisation* or even *financial liberalisation*, *financial globalization*, *financial integration* or *financial openness*.⁴ Strictly speaking, capital liberalisation is regarded as a prerequisite

1 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (Staff Paper of the IMF Executive Board, 2012), p. 10.

2 Ibid; Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (London: Bretton Woods Project, 2011), p. 4.

3 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 10.

4 The IMF is using primarily the terms 'capital account liberalisation' and 'financial liberalisation'. See IMF, 'Capital Account Liberalization: Theoretical and Practical Aspects' (1998). Financial globalisation and financial integration are two similar, though not identical, concepts. Financial globalisation is an aggregate concept that refers to increasing global linkages created through cross-border financial flows, whereas financial integration refers to an individual country's linkages to international capital markets. However, the two concepts are inextricably linked, since increasing financial globalisation leads inevitably

for the achievement of financial globalization,⁵ as the latter ‘requires that governments liberalise the domestic financial sector and the capital account’.⁶ For the purposes of this thesis, the aforementioned terms are used interchangeably.

Capital movements are not a recent phenomenon.⁷ They have existed for a long time and they have traditionally followed the movement of the other factors of production, i.e. goods, services and labour.⁸ Zooming in on the most recent history, the process of liberalising capital flows that has occurred since the late 1970s – early 1980s,⁹ culminated in mid-2007 when international capital flows reached historical highs. It is estimated that before the outbreak of the financial crisis, the size of annual gross cross-border flows increased considerably from about 5% of world GDP in the mid-1990s to approximately 20% in 2007.¹⁰ The wave of financial globalization prior to the crisis was driven by financial innovation and development, the explosion of the banking sector, the abolition of capital controls, the globalization of trade with the ensuing creation of trade credits and export insurance, the increased attractiveness of emerging market economies, cyclical factors such as the prolonged period of low interest rates in advanced economies and the introduction of the euro in the Eurozone Member States.¹¹ Financial liberalisation was further accelerated by the revolutionary progress in information and communication technologies, which radically transformed the financial industry worldwide.¹² However, with the advent of the financial crisis, international capital mobility significantly decreased, albeit only for two years. Empirical evidence shows that since 2009 international capital flows have partially rebounded, though in a quite

to increasing financial integration and thus the two terms can be used interchangeably. See Eswar Prasad and others, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (IMF, Occasional Paper 220, 2003).

- 5 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 6.
- 6 Sergio Schmukler, ‘The Benefits and Risks of Financial Globalization’ in José Antonio Ocampo and Joseph Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), p. 49.
- 7 Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011). For a historical overview of general monetary law from the Middle Ages until the early 1970s, see David Fox and Wolfgang Ernst (eds), *Money in the Western Legal Tradition: Middle Ages to Bretton Woods* (Oxford University Press 2016).
- 8 Sergio Schmukler, ‘The Benefits and Risks of Financial Globalization’ in Ocampo and Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), p. 50.
- 9 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 1.
- 10 OECD, *Getting the most out of International Capital Flows* (OECD Economic Outlook, 2011), p. 290-291.
- 11 *Ibid*, p. 291-292.
- 12 Barry Eichengreen and others, *Liberalizing Capital Movements: Some Analytical Issues* (IMF Economic Issues No 17, 1999).

diversified manner, affecting heterogeneously various countries around the globe.¹³

In Europe, which was severely, though unevenly, hit by the recent global financial crisis, and whose periphery is still – despite the seemingly positive figures – suffering from an agonizing economic stagnation, the need for investment to promote growth is more imperative than ever.¹⁴ The ambitious project recently launched by the European Commission to create a Capital Markets Union reveals the commitment of the European institutions to further integrate capital markets and to complete the process of financial integration that started in the 1980s.¹⁵ Capital mobility is hoped to boost Europe's severely damaged economy, bring economic growth and combat the massive unemployment rates which are ravaging the Southern countries and are eroding the economic, political and social foundations of the European edifice.

However, the question whether international capital mobility is beneficial for the economy does not have a straightforward answer. Although neoclassical economic theory suggests that the free flow of capital across borders can increase economic efficiency, there is a protracted controversy among economists not only as to the actual benefits of capital liberalisation for economic growth but also as to its possible contributory effect to the worryingly rising levels of income inequality. The next section introduces the theoretical controversy surrounding capital liberalisation and attempts to explore the arguments in favour and against free capital flows. This theoretical analysis will allow us to contextualize the European debate about free movement of capital and to approach the research question of this thesis – i.e. whether capital liberalisation can be reconciled with State participation in the market in the EU – from a holistic angle that takes into account not only the particularities of the European integration project but also the conclusions that have been drawn from years of pre-existent capital liberalisation at the international level.

2.2 Neoclassical economic theory v Keynesianism

Capital account liberalisation is a highly controversial subject, which deeply divides the academic community and raises an animated controversy as to its actual contribution to global economic growth. The consensus in favour of capital liberalisation has always been less clear-cut than that in favour of

13 OECD, *Getting the most out of International Capital Flows* (2011), p. 290.

14 European Commission, *Green Paper: Building a Capital Markets Union* (COM(2015) 63 final, 2015).

15 European Commission, *Communication: Action Plan on Building a Capital Markets Union* (COM(2015) 468 final, 2015).

globalized trade. Indeed, although the majority of existing literature has found that trade globalization has a positive effect on economic growth,¹⁶ the same cannot be said unconditionally about financial liberalisation.¹⁷ The reasons for this scepticism towards international capital mobility relate primarily to the lack of scientific evidence proving a correlation between capital liberalisation and economic growth. Thus, over the years, two economic schools of thought have emerged representing two opposing views regarding capital account liberalisation: on the one hand, the *neoclassical economic theory* suggesting that capital liberalisation contributes to higher economic growth and, on the other hand, the *Keynesian school of thought* contesting the correlation between capital liberalisation and economic growth.

2.2.1 Arguments in favour of capital liberalisation

Neoclassical economic theory argues that in order to achieve higher levels of growth and economic efficiency, countries and international institutions should promote financial globalisation through the abolition of all measures designed to restrict capital movements.¹⁸ Advocates of this theory, such as Peter Blair

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- 16 Jeffrey Sachs and Andrew Warner, 'Economic reform and the process of global integration' (1995) 1 *Brooking Papers on Economic Activity* pp. 1; Athanasios Vamvakidis, 'Regional Trade Agreements or Broad Liberalization: Which Path Leads to Faster Growth?' (1999) 46 *International Monetary Fund Staff Papers* 42; Romain Wacziarg, 'Measuring the dynamic gains from trade' (2011) 15 *The World Bank Economic Review* 393; Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 167-168. It should be noted that despite the growing consensus regarding the economic benefits of trade liberalisation, there is still part of the literature which questions its social consequences, see in particular Joseph Stiglitz, *Globalization and its Discontents* (W.W. Norton & Company 2002); Joseph Stiglitz, *The Roaring Nineties: A New History of the World's Most Prosperous Decade* (W.W. Norton & Company 2003); Joseph Stiglitz, 'Whither Reform? Towards a New Agenda for Latin America' (2003) 80 *Revista de la CEPAL* 7; Francisco Rodri'guez and Dani Rodrik, 'Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence' in Ben Bernanke and Kenneth Rogoff (eds), *NBER Macroeconomics Annual 2000* (MIT Press 2001); José Antonio Ocampo, 'Latin America's Growth and Equity Frustrations During Structural Reforms' 18 *Journal of Economic Perspectives* 67.
- 17 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 3.
- 18 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012); Jonathan D. Ostry, Atish R. Ghosh and Anton Korinek, *Multilateral Aspects of Managing the Capital Account* (IMF Staff Discussion Note, 2012); OECD, 'International Capital Mobility: Structural Policies to Reduce Financial Fragility?' (2012) No. 13 *OECD Economics Department Policy Notes*; Joshua Aizenman and Vladyslav Sushko, *Capital Flows: Catalyst or Hindrance to Economic Takeoffs?* (National Bureau of Economic Research Working Paper No 17258, 2011); Janet L. Yellen, *Improving the International Monetary and Financial System* (Speech at the Banque de France International Symposium, Paris, 4 March 2011); Hongyi Chen, Lars Jonung and Olaf Unteroberdoerster, *Lessons for China from financial liberalization in Scandinavia* (European Commission, Economic and Financial Affairs, Economic Papers 383, 2009); M. Ayhan Kose and others, 'Financial Globalization: A Reappraisal' (2009) 56 *IMF Staff Papers*;

Henry,¹⁹ Maurice Obstfeld²⁰ and Kenneth Rogoff,²¹ espouse the view that international capital mobility provides significant economic benefits by contributing to economic efficiency, faster growth, better allocation of investment and rising living standards for many countries.²² Drawing from the theory of trade liberalisation, proponents of capital liberalisation argue that governments should eliminate not only trade barriers but also all capital restrictions, as this will lead to higher growth and economic efficiency.²³ This theory is based on the ideological premise that free markets are inherently better than restricted markets (inspired by Adam Smith's 'invisible hand'). The liberalisation of capital markets is believed to allow countries with limited savings to attract foreign financing for productive domestic investment projects, to

Frederic S. Mishkin, 'Why We Shouldn't Turn Our Backs on Financial Globalization' (2009) 56 *IMF Staff Papers* 139; Maurice Obstfeld, 'International Finance and Growth in Developing Countries: What Have We Learned?' (2009) 56 *IMF Staff Papers* 63; Joshua Aizenman and Reuven Glick, *Sterilization, monetary policy, and global financial integration* (National Bureau of Economic Research, Working Paper No 13902, 2008); Giovanni Dell'Ariccia and others, *Reaping the Benefits of Financial Globalization* (IMF Occasional Paper No 264, 2008); John Greenwood, 'The costs and implications of PBC sterilization' (2008) 28 *The Cato Journal* 205; M. Ayhan Kose, Eswar S. Prasad and Marco E. Terrones, *Does Openness to International Financial Flows Contribute to Productivity Growth?* (National Bureau of Economic Research, Working Paper No 14558, 2008); Eswar S. Prasad and Raghuram Rajan, *A Pragmatic Approach to Capital Account Liberalization* (National Bureau of Economic Research Working Paper No 14051, 2008); Kristin J. Forbes, 'The Microeconomic Evidence on Capital Controls: No Free Lunch' in Sebastian Edwards (ed), *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences* (University of Chicago Press 2007); Kristin J. Forbes, 'One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms' (2007) 71 *Journal of International Economics* 294; Sebastian Edwards, *Capital Controls, Sudden Stops and Current Account Reversals* (National Bureau of Economic Research, Working Paper No 11170, 2005); M. Ayhan Kose, Eswar S. Prasad and Marco E. Terrones, *How Do Trade and Financial Integration Affect the Relationship between Growth and Volatility?* (IMF Working Paper WP/05/19, 2005); Ross Levine, 'Finance and Growth: Theory and Evidence' in Philippe Aghion and Steven N. Durlauf (eds), *Handbook of Economic Growth* (Elsevier 2005); M. Ayhan Kose and Eswar Prasad, 'Liberalizing Capital Account Restrictions' (2004) 41 *IMF Finance and Development* 50; Stanley Fischer, 'Globalization and Its Challenges' (2003) 93 *American Economic Review* 1; Shogo Ishii and Karl Habermeier, *Capital Account Liberalization and Financial Sector Stability* (IMF Occasional Paper No 211, 2002).

- 19 Peter Blair Henry, 'Capital Account Liberalization: Theory, Evidence, and Speculation' (2007) *XLV Journal of Economic Literature* 887.
- 20 Maurice Obstfeld, 'The Global Capital Market: Benefactor or Menace?' (1998) 12 *Journal of Economic Perspectives* 9.
- 21 Kenneth Rogoff, 'International Institutions for Reducing Global Financial Instability' (1999) 13 *Journal of Economic Perspectives* 21;
- 22 Barry Eichengreen, Michael Mussa, Giovanni Dell'Ariccia, Enrica Detragiache, Gian Maria Milesi-Ferretti and Andrew Tweedie, *Liberalizing Capital Movements: Some Analytical Issues* (1999); Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (Peterson Institute for International Economics 1999); Christopher J. Neely, 'An Introduction to Capital Controls' (1999) 81 *Federal Reserve Bank of St Louis Review* 13, at p. 14.
- 23 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 10.

enable investors to diversify their portfolios and to spread investment risk more broadly.²⁴ The process of financial integration enables capital flows to be channelled from developed countries, where the abundance of capital usually implies lower profits for investors, to developing countries, where the scarcity of capital entails higher profits for investors.²⁵ In other words, the proponents of capital liberalisation believe that capital flows naturally towards where it is most needed, 'just like water naturally flows downhill'.²⁶

The corollary of this theoretical assumption is that when a country faces an economic downturn, the devaluation of the labour cost and the price levels will attract foreign funds, which will subsequently stimulate the economy and put it back on growth track.²⁷ In fact, neoclassical theoretical models have identified a number of direct and indirect channels through which financial integration can promote growth in developing countries.²⁸ These channels include, *inter alia*, increased domestic savings, lower cost of capital through better global allocation of risk, transfer of technological and managerial know-how and promotion of specialization.²⁹

Finally, it has been argued that capital market liberalisation can impose macroeconomic discipline, as countries failing to implement substantive reforms in their economy will not be able to attract foreign funds.³⁰

24 Barry Eichengreen, Michael Mussa, Giovanni Dell'Ariccia, Enrica Detragiache, Gian Maria Milesi-Ferretti and Andrew Tweedie, *Liberalizing Capital Movements: Some Analytical Issues* (1999); Maurice Obstfeld, 'The Global Capital Market: Benefactor or Menace?' (1998) 12 *Journal of Economic Perspectives* 9, who argues that financial openness allows developing countries to borrow money in order to finance investment, improve infrastructure and promote their economic growth, while at the same time he acknowledges that it poses some 'genuine hazards' and that the 'duality of benefits and risks is inescapable in the real world of asymmetric information and imperfect contract enforcement'. Nevertheless, he does not depart from conventional economic wisdom and he believes that 'the best way to maximise net benefits is to encourage economic integration'.

25 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), pp. 10-11; Sergio Schmukler, 'The Benefits and Risks of Financial Globalization' in Ocampo and Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), at p. 57.

26 Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 169.

27 *Ibid.*, p. 169.

28 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 13.

29 *Ibid.*

30 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 10.

2.2.2 Arguments critical of capital liberalisation

On the other hand, the second school of thought, which includes economists such as Joseph Stiglitz, José Antonio Ocampo and Dani Rodrik, contests the correlation between capital liberalisation and economic growth and even goes thus far as to suggest that in some circumstances free capital flows can be detrimental for national economies.³¹ In particular, for the critics of neo-classical economics, the argument that the case for capital liberalisation is the same as the case for trade liberalisation is a fallacy.³² Capital is fundamentally

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- 31 Olivier Jeanne, Arvind Subramanian and John Williamson, *Who Needs to Open the Capital Account?* (Peterson Institute for International Economics 2012); Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011); José Antonio Ocampo and Joseph E. Stiglitz, *Capital Market Liberalization and Development* (Oxford University Press 2008); Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006); Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57; Esvar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003); Ajit Singh, *Capital Account Liberalization, Free Long-term Capital Flows, Financial Crises and Economic Development* (University of Cambridge, ESRC Centre for Business Research-Working Papers, No 245, 2002); Joseph Stiglitz, 'Financial Market Stability and Monetary Policy' (2002) 7 *Pacific Economic Review* 13; Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075; Dani Rodrik, 'Who Needs Capital-Account Convertibility?' in Stanley Fischer, Richard N. Cooper, Rudiger Dornbusch, Peter M. Garber, Carlos Massad, Jacques J. Polak, Dani Rodrik and Savak S. Tarapore (eds), *Should the IMF Pursue Capital-Account Convertibility?* (*Essays in International Finance* No 207, May 1998) (International Finance Section, Department of Economics, Princeton University 1998); Alberto Alesina, Vittorio Grilli and Gian Maria Milesi-Ferretti, 'The Political Economy of Capital Controls' in Leonardo Leiderman and Assaf Razin (eds), *Capital Mobility: The Impact on Consumption, Investment, and Growth* (Cambridge University Press 1994); Vittorio Grilli and Gian Maria Milesi-Ferretti, 'Economic Effects and Structural Determinants of Capital Controls' (1995) 42 *IMF Staff Papers* 517; Aart Kraay, *In Search of the Macroeconomic Effect of Capital Account Liberalization* (World Bank 1998); Areendam Chanda, 'The Influence of Capital Controls on Long Run Growth: Where and How Much?' (2005) 77 *Journal of Development Economics* 441; Carlos Arteta, Barry Eichengreen and Charles Wyplosz, *On the Growth Effects of Capital Account Liberalization* (University of California 2001); Sebastian Edwards, *Capital Mobility and Economic Performance: Are Emerging Economies Different?* (National Bureau of Economic Research, Working Paper No 8076, 2001); Helmut Reisen and Marcelo Soto, 'Which Types of Capital Inflows Foster Developing-Country Growth?' (2001) 4 *International Finance* 1; Hali Edison and others, *Capital Account Liberalization and Economic Performance: A Review of the Literature* (IMF Working Paper 02/120, 2002); Hali Edison and others, 'International Financial Integration and Economic Growth' (2002) 21 *Journal of International Money and Finance* 749; Carlos F. Díaz-Alejandro, 'Goodbye Financial Repression, Hello Financial Crash' (1985) 19 *Journal of Development Economics* 1.
- 32 Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075, p. 1079.

different from goods or services,³³ as contrary to the latter the primary function of capital is 'information-gathering' in the form of 'assessing which projects and firms are most likely to yield the highest returns'.³⁴ Despite the fact that there is evidence proving a correlation between *trade integration* and economic growth, there is no such evidence in relation to *financial integration*.³⁵ In the same vein, there is an interesting empirical literature examining the impact of trade and financial integration on a society's health status, which proves that despite the fact that trade integration is associated with faster increase in life expectancy and faster reduction in infant mortality in developing countries, such a relationship is not confirmed in relation to financial integration.³⁶

Furthermore, adherents of this theory question the presumption upon which the neoclassical model is based, i.e. that capital markets are perfect, with perfect information, perfect competition, perfect employment and perfect rationality, and argue instead that, under the existing *imperfect* capitalism with *asymmetric* information, financial liberalisation may lead to economic instability.³⁷ Contrary to the claims made by neoclassical economists, empirical data accumulated over the past decades has not provided any consistent and persuasive evidence that capital liberalisation brings higher levels of growth.³⁸ It should be noted, however, that this finding holds true especially insofar as *short-term* capital flows are concerned, which are regarded by some economists as particularly destabilising.³⁹ By contrast, even opponents of capital liberalisation do acknowledge, though with certain caveats, that capital flows

33 Carlos F. Di'az-Alejandro, 'Goodbye Financial Repression, Hello Financial Crash' (1985) 19 *Journal of Development Economics* 1; Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 170.

34 Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075, p. 1079.

35 *Ibid* p. 1078.

36 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 19, citing S.J. Wei and Y. Wu, *The Life-and-Death Implications of Globalization* (National Bureau of Economic Research, Inter-American Seminar in Economics, 2002).

37 Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, pp. 57-71.

38 Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011); M. Ayhan Kose and others, *Financial Globalization: A Reappraisal* (IMF Staff Papers, Vol 56, No 1 2009); Alexander Cobham, *Capital Account Liberalisation and Poverty in Go with the flow? Capital account liberalisation and poverty* (Bretton Woods Project and Oxfam, 2001); Dani Rodrik, 'Who Needs Capital-Account Convertibility?' in Fischer and others (eds), *Should the IMF Pursue Capital-Account Convertibility? (Essays in International Finance No 207, May 1998)* (International Finance Section, Department of Economics, Princeton University 1998).

39 Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, p. 60.

in the form of *foreign direct investment* appear to have a positive impact on economic growth.⁴⁰

By the same token, critics of financial integration argue that due to the high macroeconomic volatility of capital flows, capital account liberalisation is associated with economic instability, increased likelihood of financial crises and a substantial hindrance of national governments' ability to respond to negative macroeconomic shocks.⁴¹ Joseph Stiglitz goes thus far as to suggest that not only is there no case for capital liberalisation, but there is actually a compelling case against unfettered capital liberalisation, especially in developing countries.⁴² He claims that the argument of neoclassical economists that capital liberalisation leads perforce to economic growth as it allows countries to attract more capital inflows is 'like assuming that an open birdcage will inevitably attract a bird'.⁴³ In addition, he refutes the claim made by advocates of the neoclassical theory that capital flows *into* a country when the economy is weak and *out* of the country when the economy is strong.⁴⁴ Quite the contrary, he says, capital flows are *pro-cyclical*, not counter-cyclical,⁴⁵ and as such

40 Ibid, pp. 60, 64. Stiglitz argues that although there is a broader sentiment in favour of FDI (as opposed to short-term capital flows), the actual benefits they bring to national economy depend on the type of FDI. For instance, privatisations do not always lead to economic efficiency and can significantly reduce a country's wealth. See William L. Megginson and Jeffrey M. Netter, 'From State to Market: A Survey of Empirical Studies on Privatisation' (2001) 39 *Journal of Economic Literature* pp. 321; Simeon Djankov and Peter Murrell, 'Enterprise Restructuring: A Qualitative Survey' (2002) 40 *Journal of Economic Literature* 739. Furthermore, there is evidence that FDI in the field of natural resources development are often not associated with faster economic growth. See Jeffrey D. Sachs and Andrew M. Warner, 'The Curse of Natural Resources' (2001) 45 *European Economic Review* 827.

41 Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, p. 59; Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075, p. 1079; William Easterly, Roumeen Islam and Joseph Stiglitz, 'Volatility and Macroeconomic Paradigms for Rich and Poor' in Jacques Drèze (ed), *Advances in Macroeconomic Theory* (Palgrave Macmillan UK 2001), pp. 352-372.

42 Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075, p. 1076.

43 Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 170.

44 Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, p. 61.

45 Ibid, p. 61, citing an important study that was conducted by the World Bank, *Global Economic Prospects and the Developing Countries* (The World Bank 1998/1999), Chapter 3, pp. 121-157, at p. 146. When an economic quantity is procyclical it means that it is positively correlated to the state of the economy, i.e. it tends to increase in times of economic growth (boom) and tends to decrease in times of economic recession (bust). To the contrary, an economic quantity is countercyclical it means that it is negatively correlated to the state of the economy, i.e. it tends to increase in times of economic recession.

'they exacerbate both economic booms and recessions'.⁴⁶ Thus, capital liberalisation 'exposes a country to the irrationality of market sentiment based on the changing whims of short-term investors'.⁴⁷

Furthermore, there is increasing evidence that capital liberalisation has a negative effect on poverty and income inequality, as (a) it weakens the bargaining position of labour; (b) it affects disproportionately the poor, who are particularly vulnerable to economic volatility and financial crises; and (c) it limits drastically the regulatory autonomy of national governments to implement redistributive and social policies, since any plan of tax increase is likely to lead to a capital flight, which depending on its scale, might lead to a considerable wealth loss and possibly to a severe financial instability.⁴⁸

Finally, from a political economy perspective, the argument that financial integration acts as a disciplinarian, which rewards or punishes countries depending on the economic reforms they implement, is fiercely criticised by opponents of the neoclassical orthodoxy, who argue that market discipline is usually guided by myopic short-term investors and, most importantly, lacks democratic legitimacy and undermines the very foundations of a democratic society.⁴⁹

2.2.3 Capital controls

Economists who support the view that financial markets are inherently unstable and can cause severe financial crises believe that the use of 'capital account regulations' should be regarded as an essential part of the macroeconomic policy toolkit and not as mere measures of last resort.⁵⁰ The term 'capital account regulations' is in effect a synonym of the much-stigmatised term

46 Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 170.

47 *Ibid.*, p. 171.

48 Andrew Charlton, 'Capital Market Liberalization and Poverty' in Ocampo and Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), pp. 121-138; Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 185.

49 Joseph Stiglitz, José Antonio Ocampo, Shari Spiegel, Ricardo Ffrench-Davis and Deepak Nayyar, *Stability with Growth: Macroeconomics, Liberalization and Development* (Oxford University Press 2006), p. 188; Joseph Stiglitz, 'Capital-market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, p. 62.

50 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (The Frederick S Pardee Center for the Study of the Longer-Range Future, No 22, 2011)

‘capital controls’.⁵¹ It is used by certain economists in order to highlight the fact that ‘capital account regulations’ belong to the broader family of ‘financial regulations’.⁵² Other economists use the term ‘capital management techniques’,⁵³ whereas the IMF prefers the term ‘capital flow management measures’.⁵⁴ All these variations, as synonyms of ‘capital controls’, refer in reality to measures designed to limit capital movements. These measures can be imposed either on capital inflows or on capital outflows. Examples of regulations imposed on capital inflows may include unremunerated reserve requirements (i.e. the requirement that investors make a deposit in the central bank equivalent to a certain percentage of their investment, aiming essentially at discouraging short-term investors), taxes on foreign short-term debt instruments, mandatory approval for some capital transactions, minimum stay requirements, limitations on foreign borrowing, control on foreign ownership of companies and government approval for foreign investment in certain sectors (for instance, when there is a threat to national security).⁵⁵ Examples of regulations imposed on capital outflows may include taxes on capital outflows, mandatory approval for domestic agents to invest abroad or to hold bank accounts abroad, restrictions on the withdrawal of cash or on the transfer of capital to foreign bank accounts intended to prevent capital flight and limits on how much non-residents can borrow in the domestic market.⁵⁶ Another categorization of capital account regulations distinguishes between price-based measures, which alter the price of foreign capital (e.g. taxes on inflows or outflows) or quantity-based measures, which include prohibitions or caps on certain types of transactions (e.g. on foreign borrowing for purposes other than investment or international trade).⁵⁷ A third categorisation of measures restricting capital flows, followed by the IMF, distinguished between ‘residence-based capital flow management measures’ (i.e. measures that discriminate on the

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- 51 Indeed, the use of the term ‘capital controls’ can bring stigma to some countries and can have a negative impact on the investment climate, as it can lead to downgrading by credit rating agencies. See Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Harvard University Press 2009).
- 52 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (2011).
- 53 Gerald Epstein, Ilene Grabel and K.S. Jomo, *Capital Management Techniques in Developing Countries: An Assessment of Experiences from the 1990s and Lessons for the Future* (UN G-24 Discussion Paper Series, 2004); José Antonio Ocampo and Joseph E. Stiglitz, *Capital Market Liberalization and Development* (Oxford University Press 2008).
- 54 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012).
- 55 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (2011), p. 3; Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011), p. 2.
- 56 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (2011), p. 3; Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011), p. 2.
- 57 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (2011), p. 3.

basis of residence, usually referred to as 'capital controls' in the IMF papers) and 'other capital flow management measures' (i.e. prudential policies that do not discriminate on the basis of residence).⁵⁸

The scientific research that has been conducted so far is inconclusive about the effectiveness of capital controls.⁵⁹ This inconclusive research has given rise to three different schools of thought regarding the policy options that national governments can pursue in order to minimize the risks associated with capital liberalisation. The first school of thought opposes any type of government intervention. Economists belonging to this group argue that capital controls impose constraints on project financing by restricting the availability of foreign capital and by limiting investment possibilities.⁶⁰ Furthermore, they can reduce macroeconomic discipline, promote risk-seeking behaviour, moral hazard and corruption, repress the financial sector and distort the allocation of capital.⁶¹ On the other end of the spectrum, the second school of thought supports the view that national governments should be able to deploy capital controls in order to prevent or mitigate the effects of financial crises caused by international capital flows.⁶² Finally, the third school of thought acknowledges that capital movements can be risky, but it does not go so far as to suggest that governments should be able to impose capital controls. To the contrary, economists endorsing this theoretical framework emphasise the significance of risk management and argue that financial integration can be pursued insofar as it is combined with transparency and prudential supervision

58 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012).

59 Sergio Schmukler, 'The Benefits and Risks of Financial Globalization' in Ocampo and Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), p. 65.

60 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 10; Joshua Aizenman and Reuven Glick, 'Sterilization, monetary policy, and global financial integration' (2008) 17 *Review of International Economics* 777; Kristin J. Forbes, 'Capital controls: mud in the wheels of market efficiency' (2005) 25 *Cato Journal* 153; Kristin J. Forbes, 'The Microeconomic Evidence on Capital Controls: No Free Lunch' in Edwards (ed), *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences* (University of Chicago Press 2007); Kristin J. Forbes, 'One Cost of the Chilean Capital Controls: Increased Financial Constraints for Smaller Traded Firms' (2007) 71 *Journal of International Economics* 294; John Greenwood, 'The costs and implications of PBC sterilization' (2008) 28 *The Cato Journal* 205.

61 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 10; Joshua Aizenman and Reuven Glick, *Sterilization, monetary policy, and global financial integration* (2008).

62 Kevin P. Gallagher, Stephany Griffith-Jones and José Antonio Ocampo, *Capital Account Regulations for Stability and Development: A New Approach* (2011); Paul Krugman, 'Saving Asia: It's Time to Get Radical' (1998) 138 *Fortune* 74; James Tobin, 'Financial Globalization' (2000) 28 *World Development* 1101; Joseph Stiglitz, 'Capital Market Liberalization, Economic Growth and Instability' (2000) 28 *World Development* 1075; José Antonio Ocampo, 'Capital-Account and Counter-Cyclical Prudential Regulations in Developing Countries' in Ricardo Ffrench-Davis and Stephany Griffith-Jones (eds), *From Capital Surges to Drought: Seeking Stability for Emerging Economies* (Palgrave/MacMillan 2003).

to ensure the safety and soundness of the financial markets, without however distinguishing between foreign and domestic capital.⁶³

3 THE HISTORICAL EVOLUTION OF CAPITAL LIBERALISATION

3.1 The Gold Standard

The 'first age of globalisation' (1870-1923) has been largely portrayed as the 'high noon' of capitalism.⁶⁴ The great expansion of trade and the accelerated growth of transnational investment that marked this period have been attributed to a harmonious combination of liberal and interventionist measures: a strong adherence to free market doctrines regarding fiscal policy (the balanced budget doctrine) and monetary policy (the Gold Standard) but also a significant participation of the State in the market with labour regulations, social welfare schemes, public investment in infrastructure and education.⁶⁵

In relation to monetary policy, after the expansion of Europe's trade in the 1860s and despite the fact that there was no formal international agreement on a common standard for exchange-rate stability,⁶⁶ national governments (with Germany pioneering in 1871) started unilaterally pegging their currency to gold and thus, from 1880 until 1914, the Gold Standard prevailed as the normal state of affairs.⁶⁷ The monetary system of the Gold Standard was intended to foster monetary and price stability, as it linked the money supply to the quantity of gold reserves in a country.⁶⁸ In this way, the rates of exchange among the franc, the mark, the pound and the dollar were essentially fixed. Those fixed exchange rates were effectively expanded to other States as well, as they were linking their currencies to one of the key currencies and keeping their reserves either in gold or in one of those currencies.⁶⁹ However, sooner or later, the countries using the Gold Standard realised that they could not increase the money supply if they did not have enough reserves in gold

63 Sergio Schmukler, 'The Benefits and Risks of Financial Globalization' in Ocampo and Stiglitz (eds), *Capital Market Liberalization and Development* (Oxford University Press 2008), p. 66.

64 Ha-Joon Chang, *Economics: The User's Guide* (Penguin 2014), p. 65.

65 *Ibid.*, p. 72.

66 In the international conference that was held in Paris in 1867 for the purpose of establishing a common standard, the bimetallic lobby remained powerful and was able to thwart all attempts to formally establish the gold standard as the international standard for stabilizing exchange rates. See Barry J. Eichengreen and Marc Flandreau (eds), *The Gold Standard in Theory and History* (Routledge 1997), p. 4.

67 *Ibid.*, pp. 3-5. This unique volume brings together literature selections of economists, historians and political scientists and provides an important insight into the international gold standard.

68 Jonathan Law, *A Dictionary of Finance and Banking* (Oxford University Press 2014).

69 Andeas F. Lowenfeld, *International Economic Law* (Oxford University Press 2008), p. 598.

and therefore they could not devalue their currency in order to increase the competitiveness of their exporting products.⁷⁰ Thus, as there was no international legal obligation for adherence to the Gold Standard,⁷¹ with the advent of WWI all the major powers suspended their participation in the Gold Standard. Nevertheless, they tried to maintain fixed-exchange rates and imposed capital controls as a method of generating revenues for the governments and financing wartime expenditures.⁷²

During the 1929 Great Depression it became clear that the Gold Standard deprived central banks of the possibility to increase the supply of money due to the fear of compromising the value of the currency.⁷³ This in turn meant that there was significantly restricted money supply, which led to credit scarcity and restricted private-sector activities.⁷⁴ The reduced demand was further exacerbated by the rigid doctrine of balanced budget, which imposed fiscal discipline and drastic cuts in spending.⁷⁵ The Great Depression forced many countries to depreciate their exchange rates in an attempt to foster trade and, by the mid-1930s, all countries had abandoned the Gold Standard. During the interwar period, the British pound and the French franc floated against the dollar. The United States abandoned the gold standard as one of the first acts of the Roosevelt presidency and rejected a proposed dollar-franc-pound stabilization proposal at the London International and Monetary Conference of 1933.⁷⁶ The monetary chaos caused a widespread political and economic turmoil. 'It was as if someone had picked up the world and shaken it into utter confusion' wrote the novelist Polish American Sholem Asch.⁷⁷ An example of the economic despair experienced worldwide was the 'pioneering' approach (as characterised by Mark Mazower) adopted by the Greek Government of bisecting all circulating banknotes, holding the one half as a loan certificate and returning the other half to their original owners!⁷⁸

As trade contracted sharply and unemployment increased worldwide, governments were employing manipulative devices, such as devaluations of domestic

70 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 45.

71 Stephen Zamora, 'Sir Joseph Gold and the Development of International Monetary Law' (1989) 23 *The International Lawyer* 1009, at p. 1011.

72 Christopher J. Neely, 'An Introduction to Capital Controls' (1999) 81 *Federal Reserve Bank of St Louis Review* 13, p. 17.

73 Ha-Joon Chang, *Economics: The User's Guide* (Penguin 2014), p. 77.

74 *Ibid.*

75 *Ibid.*

76 Andeas F. Lowenfeld, *International Economic Law* (Oxford University Press 2008), p. 598.

77 Quoted in Mark Mazower, *Dark Continent, Europe's twentieth century* (USA: Vintage 2000), p. 104.

78 *Ibid.*

currencies, multiple exchange rates and protectionist trade restrictions in order to increase the competitiveness of the national exports and to divert economic distress abroad. In the 1930s, Nazi Germany was particularly adept at those manipulative devices, such as exchange controls, competitive currency depreciation and blocked balances, aiming at exploiting their creditors, their customers and their competitors in their international trade and financial relations.⁷⁹ In essence, using the words of US Secretary of the Treasury, Henry Morgenthau, 'these monetary devices were measures of international economic aggression and they were the logical concomitant of a policy directed toward war and conquest'.⁸⁰

Instead of fostering growth, states were introducing exchange controls coupled with the erection of protectionist barriers to international trade, such as high tariffs and quotas aiming at reducing costly imports. This ultimately led to the phenomenon known as 'beggar thy neighbour', a dangerous economic strategy by virtue of which a country can remedy its economic hardship by harming its trading partners, which can ultimately lead to trade wars.⁸¹ Countries were led to a race to the bottom with consecutive currency depreciations along the lines of a policy of 'each-country-for-itself-and-the-devil-take-the-weakest'.⁸² The economic crisis and the contradictions of the capitalistic economic model of the inter-war period forged a new economic nationalism in Europe, which would ultimately shake the foundations of liberal democracies and would cause the outbreak of World War II (WWII).

79 Andeas F. Lowenfeld, *International Economic Law* (Oxford University Press 2008), p. 599.

80 Henry Morgenthau, 'Bretton Woods and International Cooperation' (1945) 23 *Foreign Affairs* 182, at p. 185.

81 Peter Moles and Nicholas Terry, *The Handbook of International Financial Terms*, (Oxford University Press 2005); Craig Calhoun (ed), *Dictionary of the Social Sciences* (Oxford University Press 2002). This strategy has been closely linked to two examples in game theory: the 'tragedy of the commons' and the 'prisoner's dilemma'. The 'tragedy of the commons' theory by Garrett Hardin explores problems of resource distribution and essentially argues that if each individual rationally pursues his or her own short-term interest while disregarding others similarly pursuing theirs, then the long-run consequence is that everyone loses their share in the collective resource. Similarly, the 'prisoner's dilemma' theory illustrates the divergence between individual and collective rationality, and the difficulty of maintaining cooperation in strategic situations. See Garrett Hardin, 'The Tragedy of the Commons' (1968) 162 *Science* 1243 and John Scott and Gordon Marshall, *Dictionary of Sociology*, (Oxford University Press 2009).

82 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), pp. 45-46, citing J. Keith Horsefield (ed), *The International Monetary Fund, 1945-1965: Twenty Years of International Monetary Cooperation, Volume III: Documents* (IMF 1969), p. 40.

3.2 The Bretton Woods system

The period between the end of WWII (1945) and the first Oil Shock (1973) is usually referred to as the 'Golden Age of Capitalism', as it had the highest growth rate ever, unemployment was eliminated in the advanced capitalist countries and there was a high degree of financial stability (no banking crisis).⁸³ Among the factors that contributed to the Golden Age were first, the implementation of a well-designed policy of mixed economy (combining positive features of capitalism and socialism, i.e. free market with state-owned enterprises in key industries and welfare state facilitating social mobility and thus legitimizing the capitalist system) and secondly, the establishment of an ambitious and sophisticated global economic governance system consisting of three main institutions: the International Monetary Fund, the World Bank and the General Agreement on Trade and Tariffs, which later led to the creation of the World Trade Organisation.⁸⁴ It is the IMF to which we will now turn our attention.

In the aftermath of WWII, the speed and the zeal with which politicians and economists engaged in the effort to rebuild the global economy were truly remarkable.⁸⁵ The Bretton Woods Conference (named after the meeting of forty-four countries in Bretton Woods, New Hampshire which took place in July 1944) created two permanent financial organisations, which are still regarded as the two bastions of global capitalism: the International Monetary Fund and the International Bank for Reconstruction and Development (the original World Bank institution).

The principal protagonists of the creation of the Bretton Woods system were the United Kingdom, led by the eminent economist John Maynard Keynes,⁸⁶ and the United States, led by Harry Dexter White, assistant to the Secretary of the Treasury Henry Morgenthau and also fond of Keynesian economic theory. The main objective of this political effort was to create an international monetary system that would not repeat the mistakes of the past. In order to prevent an economic disaster from reoccurring, the architects of the Bretton

83 Ha-Joon Chang, *Economics: The User's Guide* (Penguin 2014), p.79.

84 *Ibid*, pp. 80-82.

85 Lord Keynes wrote in 1942 that only a 'single act of creation, made possible by the unity of purpose and energy of hope for better things to come' brought about by the war could lead to a creation of an international monetary institution. See Roy F. Harrod, *The Life of John Maynard Keynes* (New York: Harcourt, Brace and Company 1951, repr. 1963, 1969), p. 551.

86 With his inspirational and revolutionary book John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Palgrave Macmillan 1936), John Maynard Keynes laid down the theoretical foundations of the post-World War II economic boom, a period that is still regarded as the 'Golden Age of Capitalism'.

Woods system built the ‘embedded liberalism’ compromise⁸⁷ that allowed the coexistence of free markets and with a tissue of exceptions within the framework of multilateral free trade.⁸⁸ The outcome was the longest period of economic expansion in history.⁸⁹

In particular, within the framework of the new monetary system, exchange rates would be reasonably stable and exchange controls on current transactions would be prohibited with the aim being ‘equilibrium’ in the balance of payments of the Member States.⁹⁰ The purpose was to create ‘an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations [were] prevented’.⁹¹

In the field of monetary policy, the founders of the Bretton Woods system abandoned the Gold Standard, as they recognised that it made macroeconomic management too rigid.⁹² In practice, however, they retained gold as the ultimate source of value, but the only currency directly tied to gold was the dollar. All the other currencies had fixed exchange rates with the dollar.⁹³

87 The term ‘embedded liberalism’ was coined by John Ruggie in order to describe the post-war economic system in which multilateralism and domestic stability were linked to and conditioned by one another. According to Ruggie, the ‘embedded liberalism’ compromise operated on a double level: on the one hand, movement toward greater openness in the international economy was coupled with measures designed to cushion domestic economy from external disruptions and on the other hand, the latter were supposed to be proportionate to the degree of external disturbances and in line with the long-term expansion of international transactions. See John Ruggie, ‘International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order’ (1982) 36 *International Organizations* 379, at p. 405. The theoretical background upon which Ruggie based his analysis was Karl Polanyi’s instrumental work *The Great Transformation*, in which he introduced the seminal distinction between ‘embedded’ and ‘disembedded’ economy. See Karl Polanyi, *The Great Transformation* (Beacon Press 1944, 1957, 2001), p. 60 et seq. ‘According to Polanyi, embeddedness means the degree to which social relations are protected from and are sustainable independently of the markets. In contrast, disembedding the economy means commodifying the “very substance” of society, that is, land, money, and human beings’. See Martin Höpner and Armin Schäfer, ‘Embeddedness and Regional Integration. Waiting for Polanyi in a Hayekian Setting’ (2012) 66 *International Organization* 429, p. 433.

88 James A. Caporaso and Sidney Tarrow, ‘Polanyi in Brussels: Supranational Institutions and the Transnational Embedding of Markets’ (2009) 63 *International Organization* 593, p. 596.

89 *Ibid.*

90 Andreas Lowenfeld, *Bretton Woods Conference (1944)* (Oxford University Press 2013).

91 John Maynard Keynes, ‘Proposals for an International Clearing Union’ in J. Keith Horsefield (ed), *The International Monetary Fund, 1945-1965: Twenty Years of International Monetary Cooperation, Volume III: Documents* (IMF 1969), at p. 20.

92 Ha-Joon Chang, *Economics: The User’s Guide* (Penguin 2014), p. 87.

93 Richard Baldwin and Charles Wyplosz, *The Economics of European Integration* (MacGraw-Hill Education 2006), p. 303.

This mechanism was created on the basis of the assumption that the dollar was 'as good as gold', given that at the time the American production counted for about half of the global output and the American dollar was admittedly the strongest and most wanted currency in the world.⁹⁴

The Bretton Woods Agreement (IMF Agreement)⁹⁵ was formally adopted in July 1944 and entered into force in December 1945; it laid down the foundations of an international monetary and financial system based on two hallmarks: (1) a fixed exchange rate system; and (2) the possibility of imposing capital controls.

3.2.1 Fixed exchange rate

In relation to the fixed exchange rate system, a pegged currency system was established, under which all countries were supposed to peg their currencies to the US dollar, which in turn was tied to gold. This effectively meant that all currencies were tied to gold, though indirectly.⁹⁶ Legally speaking, the obligation under Article IV of the IMF Agreement was to actively ensure that the value of their currency would not fluctuate.⁹⁷ But it was not the purpose of the Bretton Woods Agreement to replicate the rigid gold standard regime of the pre-WWI period. Therefore, under the motto 'stability without rigidity', Article IV (5) IMF Agreement allowed States to adapt the value of their currency in case of imbalance of payments after consulting the IMF and obtaining its approval if the change of the value was more than 10%.⁹⁸

The Bretton Woods system secured exchange rate stability based on an indirect recognition of the gold standard for 25 years. However, the 'Nixon shock' of the early 1970s marked its demise. In particular, in 1971, in the midst of economic uncertainty and political unrest, President Richard Nixon decided to suspend the convertibility of the dollar into gold in order to redress the balance of payments deficit that the US economy was running since the late 1960s and the erosion of confidence in the dollar, largely caused by the financing of the expensive and highly unpopular military operations in Vietnam.⁹⁹

94 Ha-Joon Chang, *Economics: The User's Guide* (Penguin 2014), p.88.

95 Articles of Agreement of the International Monetary Fund (signed and entered into force 27 December 1945) 2 UNTS 39

96 Joseph Gold, 'The Legal Structure of the Par Value System' (1973) 5 *Law and Policy of International Business* 155, at p. 157.

97 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 47.

98 *Ibid.*, p. 48.

99 Sabine Schlemmer-Schulte, *International Monetary Fund (IMF)*, (Max Planck Encyclopedia of Public International Law, Oxford University Press 2013); Richard Baldwin and Charles Wyplosz, *The Economics of European Integration* (MacGraw-Hill Education 2006), p. 303.

The suspension of the convertibility of the dollar into gold caused unprecedented waves of shock to the international monetary system and marked the *de facto* collapse of the Bretton Woods system.¹⁰⁰ Legally speaking, the Bretton Woods system did not cease to exist after the 'Nixon shock'. However, two important features of the Bretton Woods system, the dollar convertibility and the par value system, had ceased to exist. The violation by the US government of the obligation under the IMF Agreement to take all necessary measures to keep the dollar within the Bretton Woods margins in order to maintain the exchange rate stability¹⁰¹ gave the right to (in effect legitimised) the non-observance of this obligation by the other members as well.¹⁰² Therefore, after the subsequent reluctance of other members like Japan, Germany, France, Belgium, the Netherlands, the UK and Sweden to prevent their currencies from floating, the Bretton Woods system was *de facto* abandoned as the national economies moved from a fixed to a flexible/floating exchange rate system.¹⁰³ The *de jure* abolition of the fixed exchange rate regime came a few years later, in 1978, when the Second Amendment of the IMF Agreement came into force,

100 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), pp. 56-57; Sabine Schlemmer-Schulte, *International Monetary Fund (IMF)*, (Max Planck Encyclopedia of Public international Law, Oxford University Press 2013).

101 It should be clarified that the violation of the IMF Agreement was not the suspension of the dollar convertibility into gold, but the announcement of the Secretary of the Treasury that the US government had no intention to keep the dollar within the Bretton Woods margins. See Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 57. Moreover, it is important to note that the US was not the first country breaching the obligation under Article IV of the IMF Agreement. Mexico (1948), Canada (1950) and Germany (1971) had previously let their currencies float and, in fact, the decision of the German government to let the mark float aggravated the distress of the US economy. See Robert Leeson, *Ideology and the International Economy: The Decline and Fall of Bretton Woods* (Palgrave Macmillan UK 2003), pp. 66-71.

102 Joseph Gold, 'Unauthorized Changes of Par Value and Fluctuating Exchange Rates in the Bretton Woods System' (1971) 65 *American Journal of International Law* 113, at p. 124.

103 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 58. It is interesting to note that following those developments, the US proposed a fundamental reform of the international monetary law, which would pursue as a primary objective 'equilibrium' in the balance of payments. According to the US proposal (referred to as 'Outline of Reform'), neither surplus nor deficit could be accepted. Just as states in deficit were imposed strict conditionality by their creditors in order to reduce government spending, comparable remedies should be imposed to states in persistent surplus (like Germany or Japan) such as increased imports, a charge on excessive reserve accumulation or revaluation of their currency. However, this Outline of Reform was never legally adopted and it is still considered to be 'one of the great might-have-beens of history'. See Andeas F. Lowenfeld, *International Economic Law* (Oxford University Press 2008), p. 631.

which established the right of the members to adopt exchange rate arrangements of their choice.¹⁰⁴

3.2.2 Restrictions on capital flows

In relation to capital controls, the solution that was adopted reflected the generalised reluctance to promote capital mobility that prevailed during the course of the 20th century, as international capital flows were widely held responsible for repeated balance-of-payment deficits and banking crises.¹⁰⁵ John Maynard Keynes was aware of the risks of free capital flows and sceptical about their benefits. He believed that capital mobility restrained a national government's ability to implement countercyclical macroeconomic policies in order to combat recessions and compromised national efforts to establish a strong welfare state and to pursue social policies of employment and growth, as anytime the government would plan to impose taxes on wealth, capital would flow out of the country.¹⁰⁶

Thus, under his influence, the rules of the IMF provided Member States with the right to use capital controls and the IMF could even request governments

104 The amended version of Article IV of the IMF Agreement represents a complete departure from the Bretton Woods system, as it legalises a member's freedom to choose whatever exchange arrangement it wishes, including floating exchange rate regime. The introduction of flexible exchange rate system provided for under the amended Article IV brought significant changes to the discretion of the members to impose capital controls. In particular, the Fund adopted policies recognising that the right to regulate capital flows under Article VI was now qualified by members' newly established obligations under Article IV, Section 1 relating to the stability of the system of exchange rates. Thus, the 1977 Surveillance Decision recognised that members' use of capital controls could give rise to a breach of their obligations under Article IV, Section 1 (iii) to avoid manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair comparative advantage. Other provisions of the Articles that further qualify members' right to regulate capital movements include Article VI, Section 1 and Article VIII, Section 2(a). See IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), p. 30; IMF, *Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework* (Prepared by the Legal Department, 2006).

105 Willem Molle, *The Economics of European Integration: Theory, Practice, Policy* (Ashgate 2006), pp. 122-123.

106 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), pp. 50-51, citing John Maynard Keynes, *The Collected Writings of John Maynard Keynes, XXV: Activities 1940-1944 Shaping the Post-War World – The Clearing Union* (CUP 1980), p. 149. It is also worth mentioning that in this historical context, the UK feared that without some form of capital controls at the close of World War II, excessive sums would be transferred out of the country, see Andeas F. Lowenfeld, *International Economic Law* (Oxford University Press 2008), p. 608.

to use them as a condition for IMF financing.¹⁰⁷ It should be clarified at the outset that the fact that the Bretton Woods system allowed the introduction of capital controls in order to prevent balance of payment crises did not mean that it promoted 'isolationism as a recipe for the avoidance of contagious crises'.¹⁰⁸ Quite the contrary, the Bretton Woods system was very much in favour of trade liberalisation and, as such, the *current account convertibility* (i.e. the convertibility of currencies for the purpose of a transaction recorded on the *current* account)¹⁰⁹ was enshrined as a legal obligation in Article VIII (2) of the IMF Agreement. Under that provision, the parties to the Agreement undertook the obligation not to impose, without the approval of the Fund, restrictions on the making of payments and transfers for current international transactions. The distinction between *current transactions* and *capital transfers* is crucial for the understanding of the IMF regime, which is also reflected in the WTO rules. Under Article XXX (d) IMF Agreement, the term 'current transactions' means 'payments which are not for the purpose of transferring capital'. These include inter alia (1) payments due in connection with foreign trade or any current business including services, and normal short-term banking and credit facilities, (2) payments due as interest on loans and as net income from other investments, (3) moderate payments for amortization or depreciation of loans or of direct investments, and (4) moderate remittances for family living expenses. Article XXX (d) IMF Agreement further states that the IMF may, after consultation with the members concerned, determine whether certain specific transactions are to be considered *current transactions* or *capital transactions*.

107 Sacha Dierckx, 'After the Crisis and Beyond the New Constitutionalism? The Case of the Free Movement of Capital' (2013) 10 *Globalizations* 803, p. 807; John Ikenberry, 'The Political Origins of Bretton Woods' in Michael D. Bordo and Barry Eichengreen (eds), *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform* (University of Chicago Press 1993), p. 155-198.

108 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 51.

109 A country's balance of payments sheet, which records all transactions between the country and the rest of the world, consists of two separate parts: the 'current account' and the 'capital account'. On the one hand, the 'current account' records all receipts and payments due to imports and exports of goods and services. On the other hand, the 'capital account' records all transactions associated to international financial assets and liabilities, such as inward and outward foreign direct investment acquisitions of foreign securities by residents and of domestic securities by non-residents, lending to foreigners, borrowing from foreigners etc. 'A deficit in the current account is always accompanied by an equal surplus in the capital account and vice versa. This is because a country that imports more goods and services than it exports (i.e. current account deficit) must pay for those extra imports by selling assets or borrowing money (i.e. capital account surplus)', see *ibid*, p. 52. For an economic definition of the terms see also Jonathan Law, *A Dictionary of Finance and Banking* (Oxford University Press 2014); Peter Moles and Nicholas Terry, *The Handbook of International Financial Terms*, (Oxford University Press 2005).

Contrary to the obligation to liberalise *current transactions*, no such obligation was undertaken in relation to *capital transfers*, which remained within the sphere of State sovereignty. In particular, Article VI (3) IMF Agreement allowed IMF Members to exercise such controls as were necessary to regulate international capital movements. Furthermore, by virtue of Article VI (1) IMF Agreement, the IMF could even request governments to impose capital controls as a condition for IMF financing. In essence, the recognition of national discretion in relation to the imposition of capital controls was intended to provide States with the necessary macroeconomic leeway to prevent balance of payments crises and recessions.¹¹⁰ In other words, State sovereignty in these matters was preserved for the sake of the protection of the balance of payments.¹¹¹ The IMF Executive Board in fact adopted a decision stating that the prohibition of discriminatory currency arrangements or multiple currency practices, which is enshrined in Article VIII (3) IMF Agreement, is inapplicable to capital controls.¹¹²

The economic explanation restricting capital flows by allowing States to introduce capital controls is found in the so-called 'irreconcilable trilemma/trinity' of the Mundell-Flemming model,¹¹³ according to which it is impossible to have (1) free capital flows, (2) fixed exchange rates and (3) independent monetary policy at the same time. The trilemma is synopsised as follows: if a country wants to maintain an independent monetary policy and capital mobility, it can only do so under a floating/flexible exchange rate system; if a country wants to preserve exchange rate stability and capital mobility, this will inevitably curtail its monetary independence; if, finally, a country wishes to preserve both monetary independence and exchange rate stability, it will perforce have to impose restrictions on capital movements.¹¹⁴ Necessarily one of the three has to be sacrificed. In the Bretton Woods system, it was the free movement of capital that was sacrificed.

110 A country with a balance of payments deficit must finance it by borrowing from other countries or the IMF, or by using foreign currency reserves. Such deficits can cause a reduction in the reserves, which subsequently leads to economic pressure for devaluation in order to correct the imbalance. A country with a surplus is in a favourable position, but may come under international pressure to revalue its currency.

111 Matthias Ruffert, *Free Flow of Capital* (Max Planck Encyclopedia of Public International Law, 2013).

112 Legal Department of the IMF, Decision No 8648-[87/104], Multiple Currency Practices Applicable Solely to Capital Transactions (1987).

113 Robert Mundell, 'Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates' (1963) 29 *The Canadian Journal of Economics and Political Science* 475; Marcus Fleming, 'Domestic Financial Policies under Fixed and Floating Exchange Rate' (1962) 9 *IMF Staff Papers* 369. In 1999, Robert Mundell won the Nobel Prize in economics.

114 Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), p. 49.

3.3 The ambivalent standpoint of international institutions and the re-discovery of capital restrictions as a legitimate policy tool

In the 1990s, there was an important shift in the IMF policy towards capital account liberalisation.¹¹⁵ The proponents of this shift tried to institutionalise capital liberalisation by proposing amendments to the IMF Agreement. In September 1997, the IMF formally proposed amending its charter to promote free capital flows, calling it ‘an essential element of an efficient monetary system in this age of globalization’.¹¹⁶ These amendments would include the promotion of the orderly liberalisation of capital accounts as one of the main objectives of the Fund and would give the Fund jurisdiction over the capital accounts of its members.¹¹⁷ However, due to the Asian financial crisis and the subsequent resistance primarily from developing countries, the opinion among IMF Members shifted against free capital markets and the amendment proposal was never legally adopted.¹¹⁸

The absence of reliable scientific data led the IMF to openly question the neo-classical orthodoxy, which associates capital account liberalisation with higher levels of economic growth. In a paper published in 2003, the IMF’s former chief economist and Professor of Public Policy and Economics at Harvard University, Kenneth Rogoff admits that the pertinent literature overwhelmingly finds no strong correlation between capital account liberalisation and growth, especially in emerging and developing countries.¹¹⁹ After a critical analysis and collation of theoretical developments and empirical evidence on the effects of financial

115 Sacha Dierckx, ‘After the Crisis and Beyond the New Constitutionalism? The Case of the Free Movement of Capital’ (2013) 10 *Globalizations* 803, p. 807.

116 IMF, *Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund* (Press Release Number 97/44, 1997).

117 Sacha Dierckx, ‘After the Crisis and Beyond the New Constitutionalism? The Case of the Free Movement of Capital’ (2013) 10 *Globalizations* 803, p. 807. See also the cited Jeffrey Chwieroth, *Capital Ideas: The IMF and the Rise of Financial Liberalisation* (Princeton University Press 2010).

118 Peter Chowla, *Time for a New Consensus: Regulating Financial Flows for Stability and Development* (2011).

119 Kevin P. Gallagher and José Antonio Ocampo, ‘IMF’s New View on Capital Controls’ (2013) XLVIII *Economy & Political Weekly* 10; Dani Rodrik, ‘Who Needs Capital-Account Convertibility?’ in Fischer and others (eds), *Should the IMF Pursue Capital-Account Convertibility? (Essays in International Finance No 207, May 1998)* (International Finance Section, Department of Economics, Princeton University 1998); José Antonio Ocampo, ‘A Broad view of Macroeconomic Stability’ in Narcis Serra and Joseph E. Stiglitz (eds), *The Washington Consensus Reconsidered* (Oxford University Press 2008), pp. 63-94; Anton Korinek, ‘The New Economics of Prudential Capital Controls: A Research Agenda’ (2011) 59 *IMF Economic Review* 523; Olivier Jeanne, Arvind Subramanian and John Williamson, *Who Needs to Open the Capital Account?* (Peterson Institute for International Economics 2012); Kevin P. Gallagher, Stephany Griffith Jones and José Antonio Ocampo, *Regulating Global Capital Flows for Long-Run Development* (Boston, Pardee Center for the Study of the Longer Range Future, 2012).

globalisation for developing economies, the paper concludes that notwithstanding the *prima facie* strong theoretical presumption, it is in fact difficult to detect a strong and robust correlation between financial integration and growth, especially in relation to developing countries.¹²⁰ Furthermore, the paper reports that there is some evidence suggesting that some countries may have experienced greater consumption volatility as a result of financial integration.¹²¹ Due to the lack of sufficient and persuasive evidence of a correlation between financial globalisation and economic growth, developing countries should not be forced to fully open up their capital markets too quickly.¹²² The paper underlines that countries can benefit from financial globalisation only if they have a robust legal and supervisory framework, low levels of corruption, a high degree of transparency and good corporate governance.¹²³

This position was emphasised again in 2012 when the IMF adopted its institutional view regarding capital liberalisation. In particular, the IMF recognised – although in very careful wording – that full capital liberalisation might not be an appropriate goal for all countries and that under certain circumstances ‘capital flow management measures’ might be useful (or even necessary) in order to redress certain macroeconomic shortcomings. This carefully drafted institutional view is largely considered to have improved the public image of the IMF as a doctrinaire proponent of unfettered capital liberalisation.¹²⁴ The IMF supported the view that free capital mobility is advantageous to the global economy, while at the same time recognising that liberalised capital markets carry risks for economies which have not reached a certain level of financial and institutional development.¹²⁵

Therefore, although this institutional view was largely regarded as embracing free capital flows, it also emphasised that there is no presumption that full liberalisation is an appropriate goal for all countries at all times.¹²⁶ With respect to the legal value of this institutional view, it should be noted that it did not change the rights and obligations that the Members have undertaken under the IMF Agreement, as legally this would require an official amendment of the Agreement.¹²⁷ Nevertheless, the Fund underlined that this view could

120 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003), p. 13.

121 *Ibid.*, pp. 1-3.

122 *Ibid.*, p. 1.

123 *Ibid.*

124 IMF, *The IMF's Approach to Capital Account Liberalization* (Independent Evaluation Office of the International Monetary Fund, 2015).

125 IMF, *The Liberalization and Management of Capital Flows – An Institutional View* (2012), pp. 10-12.

126 *Ibid.*, p. 13.

127 *Ibid.*, pp. 29-30.

be used as the basis for making recommendations, which the Members are encouraged to follow in the context of policy advice and bilateral or multi-lateral surveillance.¹²⁸ From a legal point of view, the decision of the IMF to slowly but steadily seize authority over capital movements – despite the lack of competence – was in line with the legal theory on the evolution of an international organisation’s mandate. In particular, it was argued that, under the ‘implied powers’ doctrine, the evolution of the IMF’s mandate to encompass capital movements into its monetary supervision powers in order to safeguard monetary stability (which can be impacted by unpredictable capital flows) was legally rational and justifiable.¹²⁹

In 2016, eminent economists of the IMF published yet another paper which openly criticises ‘neoliberalism’, a term which – as the paper notes – is used more by its critics than by its architects.¹³⁰ Under the catchy title ‘*Neoliberalism: Oversold?*’ the paper, in a rather self-critical spirit, tackles particularly two aspects of the neoliberal agenda, i.e. the *capital account liberalisation* and the *fiscal consolidation* (the so-called ‘austerity’). It argues that the benefits of those two policies, such as foreign direct investment and reduction of public debt, have been somewhat overplayed, whereas the costs in terms of lower output, retrenched welfare, higher unemployment and increasing income inequality have been underplayed.¹³¹ As it is aptly observed, ‘the increase in inequality engendered by financial openness and austerity might itself undercut growth, the very thing that the neoliberal agenda is intent on boosting’.¹³² The authors of the paper bring back on stage the distinction between two types of capital flows: on the one hand, long-term capital flows, such as foreign direct investment, which usually entails technological transfer and labour mobility, seem to boost long-term growth; on the other hand, short-term capital flows, such as portfolio investments, banking and especially speculative debt inflows, not only do not seem to bring growth but they actually increase economic volatility and constitute one of the main risk factors liable to cause financial crises.¹³³

128 Ibid, pp. 31-32.

129 Antoine Martin and Bryan Mercurio, ‘The IMF and Its Shifting Mandate Towards Capital Movements and Capital Controls: A Legal Perspective’ (2017) 44 *Legal Issues of Economic Integration* 211, p. 228.

130 Jonathan Ostry, Prakash Loungani and Davide Furceri, ‘Neoliberalism: Oversold?’ (2016) 53 *Finance & Development* 38.

131 Ibid, p. 40.

132 Ibid, p. 40.

133 Ibid, p. 39. This distinction has also informed the analysis of other research papers, such as Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M. Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003) and Joseph Stiglitz, ‘Capital-market Liberalization, Globalization, and the IMF’ (2004) 20 *Oxford Review of Economic Policy* 57; Giovanni Dell’Ariccia, Julian di Giovanni, André Faria, Ayhan Kose, Martin Schindler and Marco Terrones, *Reaping the Benefits of Financial Globalization* (2008);

In fact, there is convincing evidence that surges in capital flows in emerging economies often end up in financial crises associated with large output decline.¹³⁴ Drawing from the past experience, the paper concludes that policy-makers and international financial institutions like the IMF 'must be guided not by faith but by evidence of what has worked'.¹³⁵ The search for scientifically sound evidence has therefore led economists of the IMF to reconsider their view on capital liberalisation and to acknowledge that in some cases capital controls are necessary in order to deal with the volatility of capital flows.¹³⁶

In the same vein, the OECD shares the view of the IMF that there is no presumption that full liberalisation is an appropriate goal for all countries at all times.¹³⁷ The 'rich-country club', as it is commonly referred to, acknowledges that capital liberalisation bears significant risks and is often associated with costly financial and banking crises.¹³⁸ The risk of 'pervasively asymmetric information' that is inherent in liberalised financial markets can give rise to problems of 'adverse selection',¹³⁹ 'moral hazard'¹⁴⁰ and 'herding',¹⁴¹ which

Jonathan Ostry, Alessandro Prati and Antonio Spilimbergo, *Structural Reforms and Economic Performance in Advanced and Developing Countries* (IMF Occasional Paper 268, 2009).

134 Jonathan Ostry, Prakash Loungani and Davide Furceri, 'Neoliberalism: Oversold?' (2016) 53 *Finance & Development* 38, p. 39 citing Atish Ghosh, Jonathan Ostry and Mahvash Qureshi, 'When Do Capital Inflow Surges End in Tears?' (2016) 106 *American Economic Review* 581 and Dani Rodrik, 'Who Needs Capital-Account Convertibility?' in Fischer and others (eds), *Should the IMF Pursue Capital-Account Convertibility? (Essays in International Finance No 207, May 1998)* (International Finance Section, Department of Economics, Princeton University 1998).

135 Jonathan Ostry, Prakash Loungani and Davide Furceri, 'Neoliberalism: Oversold?' (2016) 53 *Finance & Development* 38, p. 41.

136 *Ibid.*, p. 41.

137 OECD, *The OECD's Approach to Capital Flow Management Measures Used with a Macro-Prudential Intent* (Report to G20 Finance Ministers, 2015).

138 OECD, *Getting the most out of International Capital Flows* (2011).

139 The concept of 'adverse selection' refers to the tendency in the insurance sector for the most risky customers to be the most likely to demand products that exempt them from disclosing information on their risky status. For example, a person purchasing health insurance declines to reveal information on his/her serious health condition. To reduce their risk exposure, insurance companies often raise premiums generally or exclude high-risk customers. See Jonathan Law, *A Dictionary of Finance and Banking* (Oxford University Press 2014).

140 In economics, moral hazard results from asymmetric information and is a cause of market failure. Essentially it refers to a situation in which a person or an organisation has no incentive to act honestly or with due prudence, especially in the insurance sector where a typical example of a person exposed to moral hazard would be the owner of an insured car, who has little or no incentive to guard against theft. With the advent of the global financial crisis of 2007-2008 the term 'moral hazard' has also been used to describe the lack of transparency associated with complex structured finance products, which encouraged irresponsible risk taking. In relation to capital liberalisation, 'moral hazard' may also imply the risk that investors will expect governments to bail them out, an expectation created possibly by government guarantees in the absence of sufficient supervision and market discipline to police excessive risk taking. See Sergio Schmukler, 'The Benefits and Risks of Financial Globalization' in Ocampo and Stiglitz (eds), *Capital Market Liberalization and*

can subsequently lead to economic inefficiencies and financial crises harmful to the general welfare.¹⁴² In light of these risks, the OECD supports the view that capital liberalisation improves economic efficiency on the condition that it is accompanied by measures of prudential supervision and regulation, sound macroeconomic policies and transparency.¹⁴³

3.4 The current legal framework

After the collapse of the Bretton Woods system, the majority of national economies moved to a flexible exchange rate system, which meant that they no longer had to maintain capital controls. One after the other, most of the major economies (most notably the US, UK, Germany and France) started implementing 'policies of capital decontrol' and the global economy experienced an unprecedented wave of capital liberalisation and financial integration.¹⁴⁴ The election of Margaret Thatcher in the UK and Ronald Reagan in the US marked the beginning of the 'neoliberal' period which was characterised by reduced government spending (especially in education, housing and public transport), weakening of trade union power, widespread privatisation schemes in major State-owned enterprises (e.g. gas, electricity, water, airlines, automobile etc.), lower high-rate income taxes and abolition of capital controls.¹⁴⁵

Regarding the abolition of capital controls, it is indeed true that the past three decades have been associated with greater openness in global financial markets and there has been a steady decline in the number of restrictions that countries impose on international capital flows.¹⁴⁶ Nevertheless, it should be noted that despite its unprecedented magnitude, the process of financial integration is not the result of a coordinated international effort, but rather the result of separate actions pursued by individual countries. Contrary to trade liberal-

Development (Oxford University Press 2008), p. 60; Joseph Stiglitz, 'Financial Market Stability and Monetary Policy' (2002) 7 *Pacific Economic Review* 13, pp. 25-26.

141 'Herding behaviour' (which literally illustrates a form of social organisation in mammals) has become a pejorative term in the financial jargon portraying investors and fund managers as herds that change into risky ventures without adequate information and appreciation of the risk-averse trade-offs. See Bikhchandani Sushil and Sharma Sunil, *Herd Behavior in Financial Markets* (IMF Staff Papers Vol 47, No 3, 2001).

142 Barry Eichengreen, Michael Mussa, Giovanni Dell'Ariccia, Enrica Detragiache, Gian Maria Milesi-Ferretti and Andrew Tweedie, *Liberalizing Capital Movements: Some Analytical Issues* (1999).

143 OECD, *Getting the most out of International Capital Flows* (2011).

144 Pavlos Masouras, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (Eleven International Publishing 2013), pp. 62-72.

145 Ha-Joon Chang, *Economics: The User's Guide* (Penguin 2014), p. 90.

146 David Furceri and Prakash Loungani, *Capital Account Liberalization and Inequality* (IMF Working Paper WP/15/243, 2015).

isation, capital liberalisation is not subject to an international legal regime. The free movement of capital is embedded in a regime of multilevel regulation, based on the principle of State sovereignty in capital transfer matters.¹⁴⁷ Tendencies to promote the capital liberalisation have not yet found any reflection in general international law.¹⁴⁸ In legal terms, this constitutes a major difference between trade and capital: while there is a strong multilateral legal framework for international trade in goods and services established by the World Trade Organisation, there is no such legal framework for international capital flows.¹⁴⁹ In other words, the free flow of capital is not regulated at the international level and remains largely a national competence.

As explained above, the IMF has limited competence in relation to the capital account policies of its Members. Despite the political upheaval and the internal debate that dominated IMF discussions in the 1990s, the proposal for a formal amendment of the Articles of the Agreement did not go through. As a consequence, Article VI of the IMF Agreement on capital controls (Chapter 1, Section 3.2.2) still remains untouched. In other words, Article VI of the IMF Agreement is still in force today and thus capital controls are still allowed within the IMF framework.

Other attempts to promote and facilitate capital liberalisation have not yet found concrete reflection in general international law.¹⁵⁰ Within the WTO framework, contrary to what one would assume considering its overall global trade policy, there is no strong tendency to liberalise capital movements.¹⁵¹ The General Agreement on Trade in Services (GATS)¹⁵² includes some elements of capital liberalisation, but only insofar as capital movements are needed for the effective delivery of a service.¹⁵³ Indeed Article XI (1) GATS provides that 'A Member State shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments'. Therefore, under the WTO regime, payments are liberalised only to the extent that

147 Matthias Ruffert, *Free Flow of Capital* (2013) referring to *Case Concerning the Payment of Various Serbian Loans Issued in France*, Ser A, No 20, 1929 (Permanent Court of International Justice).

148 Matthias Ruffert, *Free Flow of Capital* (2013).

149 Olivier Jeanne, Arvind Subramanian and John Williamson, *Who Needs to Open the Capital Account?* (Peterson Institute for International Economics 2012), p. 3.

150 Matthias Ruffert, *Free Flow of Capital* (2013).

151 *Ibid.*

152 General Agreement on Trade in Services (adopted 15 April 1994, entered into force 1 January 1995) 1869 UNTS 183.

153 OECD, *International capital flows: Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements* (Report from the OECD to the G20 Sub-Group on Capital Flow Management, 2011).

they are necessary for 'current transactions', i.e. payments which are not for the purpose of transferring capital.¹⁵⁴

International investment law, consisting of Regional Free Trade Agreements and Bilateral Investment Treaties, provides certainly a more coherent and concrete protection regime of capital movements, as it promotes capital liberalisation through the expansion of foreign direct investment (one of the main transactions falling within the scope of 'capital movements') and it guarantees the right of foreign investors to transfer the investment gains into the country where the investor resides ('repatriation').¹⁵⁵ For instance Article 7 of the US Model Bilateral Investment Treaty¹⁵⁶ provides that each Party shall permit all transfers relating to a covered investment to be made freely, without delay, into and out of its territory, in a freely usable currency at the market rate of exchange prevailing at the time of transfer. It further explains that such transfers include (a) contributions to capital, (b) profits, dividends, capital gains and proceeds from the investment, (c) interest, royalty payments, management fees and technical assistance, (d) payments made under a contract, (e) any payments that may arise as a result of a violation of the fair and equitable treatment principle or due to an illegal expropriation as well as (f) payments arising out of a dispute. Other examples of similar provisions can be found in Article 1109 of the North American Free Trade Agreement,¹⁵⁷ Article 14 Energy Charter Treaty¹⁵⁸ as well as Article 8.13 of the recently entered into force (provisionally) and heatedly debated Comprehensive and Economic Trade Agreement between Canada and the EU (CETA).

The OECD Code of Liberalisation of Capital Movements is the only international legally binding instrument regulating comprehensively and exclusively international capital movements (both inflows and outflows).¹⁵⁹ The Code stipulates progressive, non-discriminatory liberalisation of capital flows and the right of establishment.¹⁶⁰ By adhering to the Code, the OECD Members have undertaken the obligation to remove restrictions on specified lists of capital movements between residents of different Member countries. The OECD Code covers all capital movements, ranging from direct investment, operations in

154 Matthias Ruffert, *Free Flow of Capital* (2013). It should be noted, however, that international investment law promotes capital liberalisation by protecting inward international investment (without however covering capital outflows by residents), see OECD, *International capital flows: Structural reforms and experience with the OECD Code of Liberalisation of Capital Movements* (2011), p. 4.

155 Matthias Ruffert, *Free Flow of Capital* (2013).

156 2012 U.S. Model Bilateral Investment Treaty.

157 1994 North American Free Trade Agreement, 32 ILM 289, 605 (1993).

158 1998 Energy Charter Treaty, 34 ILM 360 (1995).

159 OECD, Code of Liberalisation of Capital Movements (12 December 1961) OECD/C(61)96.

160 OECD, 'Investment Policy' <<http://www.oecd.org/daf/inv/investment-policy/codes.htm>> accessed 31-01-2019.

real estate, operations in securities on capital markets, financial credits and loans, operations in foreign exchange, life assurance to personal capital movements (such as loans, gifts and endowments, inheritances and legacies) and physical movement of capital assets.¹⁶¹ The OECD Code does not prohibit capital controls but neither does it encourage them. The Code allows for derogations from the obligation to liberalise capital movements, but only in so far as the economic and financial situation justifies such derogation and only for as long as it is deemed necessary. In this regard, a 'peer-review' system is established whereby countries introducing capital controls are examined by their peers in order to make sure that measures are implemented in a transparent and fair manner and are not maintained longer than necessary.

4 CONCLUSION OF CHAPTER 1

This Chapter has introduced the theoretical debate about 'capital liberalisation' and has provided an analysis of the legal framework governing capital movements at the international level. Capital liberalisation is a highly controversial subject, which deeply divides the academic community and raises an animated controversy as to its actual contribution to global economic growth. On the one hand, *neoclassical economic theory* suggests that the free flow of capital across borders can contribute to economic efficiency, higher economic growth, better allocation of investment and rising living standards for many countries. On the other hand, the *Keynesian school of thought* contests the correlation between capital liberalisation and economic growth and expresses fears over its possible contributory effect to financial instability, increased likelihood of financial crises and rising levels of income inequality.

Proponents of the neoclassical economic theory oppose any type of capital controls and contend that restrictions on the free movement of capital impose constraints on investment projects, reduce macroeconomic discipline, promote risk-seeking behaviour, moral hazard and corruption, repress the financial sector and distort the allocation of capital. By contrast, advocates of Keynesianism argue that governments should in principle be able to impose capital controls as an essential part of their macroeconomic policy toolkit in order to prevent financial crises and to mitigate their negative effects on the economy and the society as a whole. Due to the inconclusive evidence regarding the effectiveness of capital controls, there is a third school of thought emphasising the significance of risk management and arguing that financial integration can be pursued only insofar as it is combined with transparency and prudential supervision in order to ensure the safety and soundness of financial markets.

161 OECD, Code of Liberalisation of Capital Movements (12 December 1961) OECD/C(61)96.

This conclusion is supported by the IMF and the OECD, which acknowledge the risks inherent in the unfettered free movement of capital and express the institutional view that capital liberalisation improves economic efficiency only if it is complemented by measures of prudential supervision and regulation, sound macroeconomic policies and transparency.

The above-mentioned ideological controversies surrounding the costs and benefits of capital liberalisation are reflected in its historical evolution, which has followed a non-linear course. The 'first age of globalisation' (1870-1923) was characterised by a great expansion of trade and transnational investment, attributed to a combination of free market doctrines (especially the balanced budget principle and the Gold Standard) and State interventionism. However, the Great Depression forced many States to abandon the Gold Standard in order to become more competitive. The global economy experienced a period of severe economic recession, trade contracted sharply and unemployment increased worldwide. In the aftermath of World War II, the global economy experienced a radical transformation. Growth reached its highest rate ever, unemployment was eliminated in the advanced capitalist countries and there was a high degree of financial stability. It is argued that this economic miracle was primarily due to the implementation of a well-designed policy of mixed economy and the establishment of an international institutional framework for monetary issues, the Bretton Woods system.

The Bretton Woods Agreement (IMF Agreement), which was deeply influenced by the eminent British economist John Maynard Keynes, laid down the foundations of an international monetary and financial system based on two cornerstones: (1) a *fixed exchange rate system*; and (2) the *possibility of imposing capital controls*. Regarding the *fixed exchange rate system*, the IMF Agreement introduced a pegged currency system under which all countries were supposed to peg their currencies to the US dollar, which in turn was tied to gold. The adherence to an indirect Gold Standard guaranteed exchange rate stability until the early 1970s, when the 'Nixon shock' led to the suspension of the convertibility of the dollar into gold and thus marked the *de facto* collapse of the Bretton Woods system. Regarding the *possibility of imposing capital controls*, Article VI of the IMF Agreement allowed IMF Members to exercise such controls as were necessary to regulate international capital movements. Despite the internal debate that dominated IMF discussions in the 1990s and the ideological shift towards capital liberalisation, the proposal for a formal amendment of this provision did not go through.

The current legal framework regarding capital liberalisation at the international level is embedded in a regime of multilevel regulation, based on the principle of State sovereignty in capital transfer matters. In legal terms, this constitutes a major difference between *trade* and *capital*: while there is a strong multilateral

legal framework for international trade in goods and services established by the World Trade Organisation, there is no such legal framework for international capital flows. In particular, apart from Article VI of the IMF Agreement, which allows national government to adopt capital controls thus implicitly recognising that the free movement of capital remains a national competence, other attempts to promote and facilitate capital liberalisation have not yet found concrete reflection in general international law. Within the WTO framework there is no strong tendency to liberalise capital movements. A more coherent protection regime of capital movements is provided by International Investment law, consisting of Regional Free Trade Agreements and Bilateral Investment Treaties, which promote capital liberalisation through the expansion of foreign direct investment. At the same time, the OECD Code of Liberalisation of Capital Movements constitutes a comprehensive international legal instrument regulating capital movements at the international level.

