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SM/97/173
Correction 1

July 9, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Capital Account Convertibility—Transitional Arrangements,
Approval Policies and Financing Under an Amendment**

The following correction has been made in SM/97/173 (7/1/97):

Page 7, footnote 7, last line: for "(EBS/88/13, 01/28/97)"
read "(EBS/88/13, 01/28/88)"

A corrected page is attached.

Att: (1)

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Department Heads

deference to approval and transitional arrangements relating to restrictions on capital movements would require an amendment of the GATS.⁶ The extent to which the MAI will defer to both existing and future jurisdiction is currently under consideration. These issues will be discussed in a subsequent paper.

Unenforceability of contracts

12. Article VIII, Section 2(b), of the Fund's Articles reads, in part, as follows:

“Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.”

13. The meaning of the above provision has not been interpreted uniformly by the courts of the Fund's various members. Under the interpretation that prevails in certain jurisdictions, contracts that are contrary to restrictions on current payments and transfers that have been approved by the Fund or are maintained under the transitional provisions of Article XIV will not be enforceable. Under this interpretation, therefore, the Fund's approval of exchange restrictions imposed, for example, on loan repayments that fall within its jurisdiction (interest payments and moderate amortization of principal) would result in an automatic stay in creditor litigation relating to the arrears arising from such restrictions. Under the much narrower interpretation that currently prevails in the United States and the United Kingdom, however, Fund approval of such restrictions would not give rise to such a stay.⁷

14. If the Fund's Articles are amended to bring international capital movements within the jurisdiction of the Fund, it is likely that the meaning of Article VIII, Section 2(b) will change for certain countries, even if the text is not revised. Specifically, for members that have adopted the broad interpretation described above, restrictions on capital movements would be consistent with the Articles only if they are maintained under the transitional provisions or

⁶ Under the relevant provision of the GATS, restrictions on capital movements that are otherwise inconsistent with the terms of the GATS will be permitted only if they are requested by the Fund under Article VI, Section 1, which empowers the Fund to request members to impose controls to prevent use of its resources for large or sustained capital outflows. As will be discussed in this paper, it is for consideration as to whether this or a similar provision should be retained in the Articles in the context of the proposed amendment.

⁷ A detailed review of Article VIII, Section 2(b), and the various interpretations that have been given to this provision is set forth in “Legal Effects of Approval and Nonapproval of Exchange Restrictions by the Fund” (EBS/88/13, 01/28/88).

have been approved by the Fund.⁸ In that case, therefore, restrictions imposed on the capital portion of loan repayments (i.e., bullet repayments of bonds and loans) would result in a temporary stay if they have received Fund approval. However, given the proposed scope of the Fund's coverage of capital movements, an additional question of interpretation would arise for these countries. Specifically, since this provision, unless modified, would be applicable only to restrictions on capital movements that are considered "exchange controls", the question would arise as to whether "exchange controls" would be limited to capital payments and transfers or would also embrace underlying capital transactions and, if so, which transactions.

15. Given the lack of uniformity of interpretation of this provision among the Fund's members and the additional uncertainty that an extension of Fund jurisdiction will create if this provision is not clarified, the amendment will have different and, in some cases, unpredictable consequences in various jurisdictions. Accordingly, it is for consideration whether this section should be modified to clarify its meaning or, alternatively, deleted altogether.

16. The application of Article VIII, Section 2(b) is of particular relevance in light of the increasing importance of international bonds in private sector borrowing from international capital markets, and the possibility that bondholders will initiate litigation following a default. Such litigation may make it difficult for the Fund to obtain adequate financing assurances to provide support for a member's adjustment efforts.⁹ Issues relating to Article VIII, Section 2(b) will be discussed at a later stage of the amendment and will also be addressed in the forthcoming review of the Fund's policy on external payments arrears to private creditors.

The signaling effect

17. Under the Fund's existing policy, members are encouraged to accept the obligations of Article VIII when they are satisfied that they are not likely to need recourse to such measures in the foreseeable future. Accordingly, when a member notifies the Fund that it accepts the obligations of Article VIII, this notification (which is publicized) represents a clear commitment by the authorities to avoid, to the extent possible, reliance on restrictions on current payments and transfers. As a result of the design of the Fund's policies, the imposition of any new restriction will be approved only if it is judged to be temporary, nondiscriminatory, and imposed for balance of payments reasons.

18. As will be discussed in greater detail below, the transitional arrangements and approval policies applicable to restrictions on international capital movements would, to the extent

⁸ In Germany, courts have refused to apply Article VIII, Section 2(b) to capital transactions on the grounds that they are outside the Fund's jurisdiction.

⁹ A related question concerns whether members should be protected from litigation following a default on sovereign obligations.